Grattan Institute's report *Game-changers: economic reform priorities for Australia*

If Australian governments are serious about raising rates of economic growth, they must reform the tax mix and increase the workforce participation rates of women and older people. There's nothing else big enough to change the game over the next decade. Each of these reforms can increase economic growth substantially, and they should be the core economic reform priorities for Australian governments.

Leading political commentator, George Megalogenis, joined the report's author, Grattan's CEO, John Daley, in a discussion about the report and the importance of prioritising reform.

Speakers: **John Daley, CEO, Grattan Institute**
George Megalogenis, Senior Writer, *The Australian*

AUDIO: This is a podcast from Grattan Institute.

JOHN DALEY: Good evening ladies and gentlemen. My name is John Daley, I'm the Chief Executive of Grattan Institute and it's my very great pleasure to welcome you all here this evening. If I can start with a few thank-yous, to the State Library of Victoria for the chance to use this venue, and also to Grattan's founding members and affiliates who ultimately make this kind of thing possible. And then of course to introduce our guest, George Megalogenis.

George will be well known to many of you. He is a distinguished journalist and author. As a journalist he won the 2003 Melbourne Press Club Quill for the best columnist. He continues to write regularly for *The Australian* as one of its feature columnists. George is one of the few journalists in this country who still really does read the Australian Bureau of Statistics website to get the numbers and there's a great deal to be said for that.

As well, George is a very distinguished author who has written about Australian politics, Australian policy, the development of Australia as a country. He is the author of a number of books, *Faultlines: Race, Work and the Politics of Changing Australia*, a book which, as the name suggests, talks about how various demographic shifts in Australia have ultimately changed our politics. Other books include *The Longest Decade* about the shifts first under Keating and then under Howard, a Quarterly Essay "Trivial Pursuit" talking about the changes in our political life, not necessarily for the better, over the last year or two. And finally, a book called *The Australian Moment* which might be described as a short political primer of what has happened in Australian politics and Australian policy over the last 30 or 40 years, how those things have fitted together, how the changes in the external world affected Australia, Australian politics and Australian policy, and what does that say about where we are today. So George, thank you for joining us.

GEORGE MEGALOGENIS: Thank you.

JOHN DALEY: It's great to have you here. We're here to do two things: one is it's an excuse to talk about your book; and also to talk about a report that Grattan Institute published last week called *Game-changers: economic reform priorities for Australia* which is available on our website. So George, what struck you when you read it?

GEORGE MEGALOGENIS: I know for a number of years there's been concern at a public policy level about Australia losing its capacity to problem solve. When you think back to the last big reform that landed safely and survived a change of government, it was the GST, and that is a long time ago. Most of what the Gillard Government is doing now is contested. A lot of what the Howard government did in its final term was not just wound back, it was overturned. We're now in a position where a good 10 or so years have passed whilst Australia has been doing magnificent things on the international stage. It gets noticed each time the rest of the world takes a dip in its wealth and welfare, we're still reporting positive numbers. The national accounts last week show that Australia is defying the global trend.

We do know that we have lost our problem solving capacity, and this is one thing that John's report has addressed. There are a number of reasons we could go into, but what you've tried to do with this report is give people a fresh eye on reform challenges and incentivise people on the policy space. You've drawn up a matrix – almost like Kevin Rudd's evidence based policymaking. It's quite an interesting approach and I know a few people in bureaucracy who are aware of the early phase of this work. They were encouraged by what it is you were trying to do. There's a risk in return frame that you've used and I'm going to start at the bottom with a thing called industrial relations. Can we start at the bottom and tell me why industrial relations didn't make your priority list for reform?

JOHN DALEY: I was really surprised about this given, as you say, how much it's talked about. If you look at what's been said about industrial relations in Australia over the last year or two, we have what Saul Eslake described as an accumulation of anecdote. There's lots of individual instances you can point to where you can say this particular feature of the industrial relations regime appears to be reducing productivity in this particular business in this particular way. That cannot possibly be helping. So you can definitely see that.

But what you can't see in all of those anecdotes is how big is this, how much do we care? One thing that I took away from the report that the Business Council of Australia put out last week as they looked at the costs of infrastructure in Australia relative to places overseas was the admission that there were projects in Australia which were essentially best in class around the world in terms of productivity.

There isn't a lot of evidence that the Australian industrial relations regime makes it impossible to be productive, nor is there much evidence about how big the problem is. Is it possible that the problem is very large? Absolutely, yes. But do we know that? No. When you actually go and look at the evidence, what does it look like? And the answer is, around the world when you try and correlate particular changes in industrial relations regimes with economic outcomes, you struggle to draw much of a direct relationship, at least over the last decade or two.

There is a doctoral thesis written by a person who is now an academic at La Trobe, which one of the most elegant attempts I've seen to really try and prove that there's a link. What she did was look at firms, some of them in the services sector, some of them in the manufacturing, mining, construction and transport sector. She said let's take all the firms in those sectors, both firms that are unionised and not unionised, and we'll look at their productivity before and after the Workplace Relations Act which, at least in theory, was essentially aimed at reducing union power.

In summarising, I think it would be fair to say she didn't find much of a relationship. It was all over the place. The services firms went in the wrong direction, the medium sized manufacturing firms went in the right direction, but the small manufacturing firms went in the wrong direction, it was all over the shop. And so in terms of trying to find a smoking gun that industrial relations really makes a big difference to productivity, it's just not there. Maybe it's true, but you certainly can't find it in the evidence.

GEORGE MEGALOGENIS: That was the first thing that jumped off the page for me because it's the silver bullet, to continue this particular metaphor of the smoking gun, the silver bullet that business talk about and the BCA did refer to it last week again because we're a high cost economy. There are a lot of people trying to push Tony Abbot down that path even though intuitively he was one of the Cabinet Ministers that was most concerned by Work Choices in the final term of the Howard government. On the Labor side you've got this sort of existential dread that sooner or later a coalition government with a healthy mandate is going to wipe out the union movement. Why are people still talking about it if there isn't as much evidence on the ground? I mean what is the problem we're trying to solve here?

JOHN DALEY: I suspect actually that's a question for you because I wonder if it's really a historical issue. Look at our history as you documented in *The Australian Moment* and I wonder if it's about the way that this was a big deal 20 years ago, but maybe a lot's been done.

GEORGE MEGALOGENIS: My take out on this having gone back to the end of the '60s and to start to really drill down from the '70s onwards, for those of you who haven't had a chance to see it, but those of you who have had a chance to read it, essentially what the book does is look at our worst decade, which was the stagflation decade of the '70s, whatever the going rate of mediocrity was around the developed world, we took it and then added 10% to our particular problem. So we were doing things that I definitely wouldn't recommend to a society.

By the end, by the late '70s, early '80s we were heading into that double-digit inflation double-digit unemployment territory. One of the things, and this is interesting when you do look at the data again when adult size, during what was essentially my childhood, Australia was completely off the charts in terms of wage push inflation. And going into that last big recession of '82/3 we were the only developed world where each of those three years into that bust there were double-digit average wage increases.

This might be the reason why this thing is still hanging in over our heads, because of what the trade union movement did to the economy behind the tariff war in the '70s, pretty much destroyed the old economic model. A number of factors led us to that particular position, but the first problem in a sense for the Hawke and Keating Government to solve was wage push inflation. The Hawke and Keating Government did the currency, financial markets and then deregulated product markets, but never really got around to the labour market, at least not in a rhetorical sense. The accord sort of sat over the '80s and '90s reform approach to an Australian version of pragmatic egalitarian market-based solutions.

In the back of people's minds, that was always a bit of unfinished business. What we do know since is that Keating did enterprise bargaining and there was the first wave of industrial reforms, the Reith/Curnow reform that was signed in the Howard Government's name in '96 before they were relying on Mal Colston's vote for privatisation and budget cuts. What we can say now with the benefit of hindsight, there was a big productivity surge in the '90s. So that may well be, and we know it's competition policy and Keating and Howard wave one industrial relations reforms, and that was the decade where we did better than the going rate. And it was certainly the decade we were ahead of the US.

JOHN DALEY: But I think one of the issues is that historically it's very hard to pull apart which of those reforms was doing the heavy lifting.

If you look at where we are now and maybe this is the interesting contrast, '70s and '80s, you've got wages growth today which is essentially tracking GDP more or less, which is exactly what you would expect wages growth to do. Particularly when you look at the dates of the key industrial relations reforms over the last 15 years and you look at the changes in wage rates …

GEORGE MEGALOGENIS: Hasn't budged, yeah.

JOHN DALEY: Basically the wage rate just does a nice even move upwards and it doesn't seem to be particularly sensitive to what we've done in industrial relations.

GEORGE MEGALOGENIS: You admit yourself it's quite a surprising conclusion. Bear in mind what this report is trying to do; to get people thinking about reform again but also trying to give governments a checklist of priorities that are worth investing all the political capital that needs to be invested to land some of these reforms. And IR, you say, I wouldn't bother.

JOHN DALEY: You're exactly right, this is fundamentally a game about prioritisation. I suspect people who've worked in businesses tend to be more alive to this, the fact that for any given organisation there are only so many substantial reforms you can pull off in a given period of time. Indeed the best way or certainly the most reliable way of getting really big and important reforms through is to essentially decide that you're not going to do anything else. You can look at the history of the Rudd government as something which, as you point out, was trying to land a huge number of really big reforms simultaneously.

GEORGE MEGALOGENIS: In an election year.

JOHN DALEY: Not surprisingly they encountered a little grief. The most surprising thing for me in your entire book was Kevin Rudd saying that he didn't think in retrospect that he was trying to do too much.

GEORGE MEGALOGENIS: A federal government would look at its three year terms as the first two years of governing and the third year of campaigning. We've moved into continuous campaigning but the interesting thing about the Rudd government was they were running a continuous campaigning regime, they hadn't lost the oppositionist mindset so they had to try and win every day in the media, whilst also starting some of these huge conversations, mining tax, health care reform, emissions trading and the like. So I wonder, and this is just a more general question before we start to get into the nitty-gritty, whether the experience of that Rudd period is still informing a lot of the thought today about how you would progress reform. All the best intentions from Kevin Rudd, and there are lot of people that are prepared to work really hard for the first few months of that government, but now there's a more pragmatic mindset. Is it partly informed by the grand failure, if you could call it that, of Rudd?

JOHN DALEY: In a funny way, it's probably helping. I think there is a lot more awareness that prioritisation matters, and that if you try and do too much at once, chances are you won't pull any of it off. So I think it'll be fair to say there are more people aware that whether you use this technique or another technique, deciding to do a smaller number of big things is better than trying to do a large number of big things at once. We are still in a world in which a huge number of things were set running at that time, and one of the hardest things in any organisation is to turn something off. Recognising this is basically a good idea, but given our priorities we actually need to focus and declare this to be phase two.

GEORGE MEGALOGENIS: They had the opportunity of course with the global financial crisis but didn't take it.

JOHN DALEY: They kept all of them running. I think any government in that situation will find it hard to turn them off and just focus the agenda down to a small number of things. Inevitably some of these things are, really tough, relatively speaking insoluble problems. You can, for example, spend a lot of time saying we've got this patchwork economy and some parts are growing much faster than others and what do we do? And you wind up doing all of this analysis demonstrating that we're in a patchwork economy and all of this analysis showing that Asia's growing quickly, particularly when the answer may well be there's not a huge amount that government can do that will make a real difference to the way that all of that plays out. Nevertheless you wind up spending an enormous amount of time spinning wheels trying to find things which you can do.

GEORGE MEGALOGENIS: Let's visualise the matrix. So from top to bottom it's dollar return – boost to GDP that you're taking out to an annual gain in 2022.

Now across the bottom, of course, you're going from low confidence in solution to high confidence in solution. In the bottom rung there's these things that may contribute about an extra billion a year by 2022, which equates to don't waste your time. There are a couple of things there which are in the papers every day and in the news every day: transport infrastructure, urban water, foreign investment regulation, early childhood school performance, health costs. Have the public got it wrong? Or do the public not understand cost benefit?

JOHN DALEY: A mixture of the two, and some of it's also about the timeframe. Particularly if you take school performance, early childhood, disease prevention, health costs of ageing, these are all things that will make an enormous difference in 2032 or definitely 2042. Inherently they don't make that much of a difference in 2022, particularly if you take school education. There's no doubt if you really want to increase Australian GDP in 2052 the one thing you would do above everything else is improve the quality of school education. Lots of economic evidence around the world internationally shows that's the biggest lever. But inherently anybody who is in school today is only just going to be making it into the workforce in 2022. So it's just not a big lever in the short term, over the next 10 years.

Of the others that you've nominated, urban water is an interesting one. As you say, lots of people talk about it. Perhaps if we were doing this chart 10 years ago it would have been a bit different, but the reality is Australian governments have blown their dough, they've built a whole bunch of desal plants, it's very unlikely that we are going to come within cooee of using all the capacity that has been built in any of the major Australian capital cities over the next decade. And so it's too late. We've spent the money.

Foreign investment is an interesting one. The conventional wisdom is that we have a very tight regime. Interestingly the OECD marks Australia right down on this. The OECD's priority is about what Australia should do from an economic perspective. They only name about four things and this is one of them. I think that's a fundamental methodology problem. What they've done is that they've looked at what the formal restrictions are in various countries on foreign investment. The answer is the formal restriction in Australia is that a very large number of things have to be submitted to the Foreign Investment Review Board.

Essentially, it is a notification regime. The vast majority of things get waved through. And then when you look at actual foreign investment in Australia, it's extremely high. One of the things we pulled out as we were doing the analysis, is that there is more Chinese foreign investment in Australia than any other country in the world.

That's not per capita, that's as a matter of absolute dollars. So to the extent that this is a problem, all it's doing is restraining things from an extremely high level, it's not stopping anything from happening.

GEORGE MEGALOGENIS: Maybe what we would be doing if you did want to intervene in this area is probably point out to people that you might flip your matrix and start getting negative returns.

JOHN DALEY: Indeed.

GEORGE MEGALOGENIS: Some of these apparently front-of-mind popular issues don't have big payoffs. The things that do have really big payoffs will take you to the top of the matrix. Now we're in the $20b plus annual gain per reform proposal. Female workforce participation, older people's workforce participation and the one that dare not mention its name which is tax mix. Why are these three things so big relative to everything else?

JOHN DALEY: Inherently each of these three things affects what the economists would call factors of production and what ordinary sensible people would call things that make a difference across an economy. If you make changes to female workforce participation that affects every single industry. If you make changes to your taxation regime, that affects decisions that people make across the economy. Inherently these things tend to be big levers and that's the reason why they can be big. I think the reason why these three things have swum to the surface of an Australian world is actually the history.

If you look at the history that you've articulated in *The Australian Moment*, we spent a lot of time in the '80s looking at reforms that essentially opened up the Australian economy. We floated the dollar, we reduced tariffs very substantially, we let in a whole series of foreign banks with the explicit aim of freeing up finance in the country and integrating Australia into the global economy, and by and large that was a pretty good trick that substantially increased our prosperity as a nation. Then I think you can read the '90s, roughly speaking, as essentially increasing the level of competition inside the Australian economy.

So we privatised a whole series of Australian industries that were historically in government ownership, particularly things like utilities. The electricity industry put this in context. Something like 100,000 people who had been employed in the electricity industry essentially wound up having to find a job somewhere else. And we wound up producing exactly the same amount of electricity. So it was a huge boost to the productivity of the Australian economy, we produced the same amount of electricity with far fewer people doing it and those people were all then available essentially to do other work. There was that privatisation wave and at the same time there was a competition and deregulation wave. There were a whole series of industries that had been very heavily regulated where we very deliberately tried to break down many of those regulations, everything from the legal profession to a whole series of different industries. Again, that was a great trick and it resulted in an enormous boost in Australian productivity. But I think one of the problems that we faced in Australia over the last five years of thinking about reform is that we keep saying well we did that in the '80s and '90s, wasn't that good, can't we do it again.

GEORGE MEGALOGENIS: What's the next big trick.

JOHN DALEY: The answer is we've done most of what lies underneath those rocks. You can only open the Australian economy once to the world, you can't do it twice. And when top of your list for deregulatory reform is pharmacies, inherently it's just not that much of the economy. Don't get me wrong, it's probably worth doing, but it's just not that big. The lovely illustration of this is if you think about all of the policy and political angst we went through about parallel import of books, because it's about deregulating an industry and opening it up to the Australian economy, opening the Australian economy up to the world, increasing levels of competition. No disrespect to Australian publishers but I think we should do it. On the other hand, back of the envelope, it's worth about $400m a year to the Australian economy. In the scheme of an economy of $1.4 trillion, it's trivial, it's just not that big a deal. Whether you do it doesn't make any difference in the overall scheme of things.

GEORGE MEGALOGENIS: Especially if technology comea in over the top, as it did with the recorded music.

JOHN DALEY: Absolutely. But even without that technology, it's worth four or five hundred million dollars a year. It isn't that big a deal. Whereas these things, as you say, inherently, given where we are, given where we think we can realistically get to, they're worth $25b a year, that's heading up towards two per cent of GDP, that is big enough to get excited about.

GEORGE MEGALOGENIS: Bear in mind that up until last Friday when Glen Stevens joined my campaign, I'm claiming his speech, "The Glass Half Full" as the first recruit for the war on whinging, which I unleashed about two or three weeks ago. The point essentially of our opportunity is you wouldn't want to be anyone or anywhere else at the moment, as Australian. One of the things that jumped off the page at me when I looked at the wargaming you did for the risk and the return on these three areas, you benchmarked very cleverly against Canada or New Zealand in some of these areas. That to me is actually not a bad way to unlock a reform debate. We are the best at pretty much the macro stuff, but if you want to do female participation like the Canadians do, you're going to need to chase this benchmark. If you want to do participation of older workers like the New Zealanders do, you want to chase this particular benchmark. Were you conscious that that was one of the big take out messages of your report, that there is a way to activate without insulting the Australian population to start chasing the other gold medals that they don't have in the economic space?

JOHN DALEY: I probably hadn't articulated it quite that clearly, but that was definitely one of the ways we thought about it. That has always been the Australian way. We've always had a tendency in our public policy debate to look at world best practice and how far off are we. That's a perfectly sensible way of attacking lots of things, particularly when you are a little economy, essentially off on the edge of the world geographically in terms of trade routes. If all you do is ensure that you copy the best in the world at most things, you will wind up being the best in the world overall. It's a point that we make elsewhere about innovation. Inherently if Australia simply ensures that all of its industries copy the best ideas from the rest of the world in whatever we're doing, we will do very nicely even if we don't wind up inventing a single new idea.

Another part of the strategy here was to very deliberately pick Canada and New Zealand because you can see in Australia a tendency when you countries like South Korea or Finland, everyone goes that's all very different. The Scandinavians drink something different in their water and have completely different social expectations and structures. They do, they've got very different patterns of immigration and a whole series of things that make them quite different societies. That's why we were very keen to pick out places like Canada and New Zealand where those arguments don't really run. These are places that are very like Australia in any number of ways.

Particularly on the female workforce participation story for Canada, the story that we saw there was one that Canada's female workforce participation was not that different from Australia in the '90s. They went through a very tough fiscal period in the '90s, they were a little later than

Australia onto the reform agenda but they really cleaned up their government spending in the ‘90s. They then started to look at things like female workforce participation in about ’96, ’97 when they had the fiscal space to do so. They came to the conclusion that this was a real opportunity and went after it. They very consciously said the key driver here is essentially how much do you get to take home out of your pay packet after you’ve gone to work, been paid, but of course having paid tax on that, you’ve lost welfare benefits because earning money you wind up getting less welfare benefits, and you’ve paid for childcare net of whatever support the government pays for childcare.

Number one, it’s not wildly surprising that those things are the key drivers of decisions. Women going back to work face a really substantial opportunity cost and if the bottom line is you’re only keeping 10 cents of what you earn and that’s before you pay for transport, then chances are many people will decide not to go back to work. Secondly, when you look at the international evidence, there’s some nice regression analysis that says basically the extent to which a country creates incentives for women to go back to work in terms of how much they get to keep out of their pay packet, is what really drives female workforce participation.

Thirdly you’ll be able to say look at Canada, this is exactly what they did, female workforce participation then basically went through the roof and in particular, because of course Canada is a series of provinces which are a little bit more disparate than the Australian states. Quebec went after this really hard. They used to have one of the lowest female workforce participation rates in Canada. That was the province that essentially made childcare all but free. They essentially had a rate of $5 per day. And their female workforce participation took off like a rocket and they now have one of the highest rates in Canada.

I think it’s one of those stories where you can very much point to a country that’s not that different to Australia, you can look at what they’ve done and then you can look at the Australian evidence, and this is the work that we did with NatSem, actually modelling what this looks like. I was surprised no-one has ever actually put together the simple chart that says as you’re thinking about working more hours per week for a given level of income if you’re working full time, what does it look like having taken into account childcare.

GEORGE MEGALOGENIS: We weren’t doing that, I know because I’ve done a bit of work for NatSem in the past and we were only looking at taxation and withdrawal of family payment.

JOHN DALEY: From the average family’s point of view that’s not how they think about it, they think about it net of childcare. You draw the childcare curve and this is in many ways one of the most disturbing findings about this; if you’d be earning $100,000 then bottom line is it doesn’t make that much difference because the cost of childcare relative to the hourly wage is not that high. But if you are earning $70,000 a year if you worked full time or worse still, $40,000 a year if you worked full time, the disincentives to going back to work are really high. One of the key ones we pulled out is if he’s on $70,000, and she would be on $70,000 if she worked full time, they’ve got two children in childcare. It’s not too bad. She keeps 40 cents in the dollar for the first three days she works. Don’t get me wrong, I’m not saying that’s great but it’s not that bad, so she goes to work days four and five, and she keeps 10 cents in the dollar of what she earns.

GEORGE MEGALOGENIS: Practically for free.

JOHN DALEY: We have presented this to a number of public sector audiences and every time we do, there is a woman at the back of the audience who puts up her hand and says that’s right I’ve got the spreadsheet and that’s why I’m working three days a week. Now, I’m guessing that the average Australian employee doesn’t necessarily have the Excel spreadsheet that’s worked it out, but they have a pretty rough idea whether they're going forwards or backwards and if they figure out they're going backwards working day four, they just don't do it.

GEORGE MEGALOGENIS: You mentioned that Canada started later than we did, but like we did in the '80s and the '90s in a sense what was driving us was the failure of the previous decade. A time of political tension and economic stress produced some pretty big reforms. One of the reasons why I think a lot of people agree now that we've sort of gone a bit slow on the reform front is the last 10 years or so especially have been pretty good for the household sector. They pretty much borrowed for a good five or six years of that previous decade in order to consume, not to invest but to consume, and it was very difficult for a government to confront them and say you have to give up something in the short term for this longer term gain. Are we at that point now because of the budget bottom line where we might start to dream some big grand bargain dreams again, from a position of stress? Having looked at the evidence around the world, do these things tend to come more in response to crisis or are these things that a country can think of when they're going well?

JOHN DALEY: We haven't methodically looked through what's happened overseas in terms of the political timing. I think your work demonstrates that to work that out is quite a substantial piece of work and not something we've gone to. I think what we can do is actually look at the Australian history. It's an interesting contrast that the Hawke-Keating Government didn't really have a particularly worse situation than was under Fraser, they just decided to do something about it.

By contrast you can look at Howard bringing in the GST in 2009. He didn't in a sense have to do it. There wasn't a disastrous time. If anything the driver behind some of this at the moment might be more there are things that we do want to do, we do want to continue to spend money on health, even though we've got more and more people demanding health services. We do have both sides of politics saying that they would love to do a national disability insurance scheme. We do have many people wanting to do a whole series of things for the environment which are without doubt going to be costly. At the same time we have government budgets, both at a Commonwealth and a state level, which are essentially under quite a lot of fiscal stress. Whereas the last decade all they had to do was keep the doors open and not massively reduce tax rates every year and they wound up in a better fiscal position than the year before.

We're now in a situation which the opposite is true. If governments do nothing at the moment in Australia, their fiscal position gets worse. One of the advantages of these three things is that they can help. Ironically they will only happen if we start to unpick some of the attitude of the last 10 years which is when we do reform we essentially have to completely pay off and over-compensate the losers. Because the reality is if you try to completely overcompensate the losers when you do tax mix reform, particularly if you're trying to broaden a GST so that you can pull down income tax rates and corporate tax rates, because there's a big economic payoff in doing that, if you try and compensate every single loser, then you will wind up essentially spending away the reform and you won't make progress.

GEORGE MEGALOGENIS: And of course the Hawke-Keating miracle didn't do the everyone is better off spreadsheet., The first time I actually heard in federal politics of the idea of everyone being a winner was Fight Back, because Peter Reith ran around telling everyone that everyone would be a winner. I thought he was about to join the band Hot Chocolate and start singing that song. In the Hawke-Keating days there were grand bargains going all over the place and if you'd reconciled them, well most people would be worse off for the first couple of years of implementation. But there was a sense that stuff was being done in the national interest. How does this stuff fit in the national interest? How do you energise a community to do tax mix reform to pretty much encourage people to hang on to their jobs for another couple of years and maybe take the decision to retire in their early 60s rather than their mid to late 50s? Especially on the female workforce participation side, government pretty much vacating one space which is the family payments making no family worse off and looking after the stay at homes as well as the part-time working mums, and moving to this other place where pretty much they take over childcare to be able to reduce the cost. How do you energise a population for those sorts of transactions?

JOHN DALEY: I suspect it varies by reform. With the female workforce participation, there's a very strong ultimately progressive element to this which is that the families who are under most stress from this are ironically those on low incomes. Those women who wind up essentially staying out of the workforce while they have small children inevitably then find it that much harder to get back in. There's a real social progressiveness to this that I hope will appeal to a number of people, plus the fact that obviously Australia is a place where female workforce participation has been increasing steadily over the last couple of decades.

GEORGE MEGALOGENIS: We're coming off a very, very low base though. We were much lower than the going rate in the '60s, but when social revolution started, and we've still ended up at the place a little below the OECD average. So we've still got a long way to go.

JOHN DALEY: That's exactly right. It's an opportunity and I think that that's how it may ultimately wind up being thought about, that these are necessary changes that we need to make so the people do indeed have incentives to go to work rather than what we have at the moment which is essentially barely any incentive at all for many people. In terms of older workforce participation, I think ironically it may well wind up being an appeal to fairness. I think this is one where it may well essentially simply feed into government budgets. This is one which unambiguously not only helps the size of the economy but it also helps governments, particularly Commonwealth Government's fiscal position. The essential argument here is if you retired at the pension age of 65 in 1975 you would expect to live about another 12 years. Today you would expect to live about another 20 years and that trend is continuing very quickly.

Essentially it's one that says that people at pension age of 65 today expect to live much healthier, much longer, much more wonderful lives. We've been trying to increase life expectancy, and we think of life expectancy as being a major success, as it is. The benefits of all of that are being received by people as they get older and indeed those higher for people aged 50 than for people aged 60 and they're probably going to be even higher for people who are today aged 40. The benefits are all going to that group who haven't yet retired. The costs are all falling to the Commonwealth budget because if people are staying alive much longer, there's much more in the way of age pensions to pay for. But none of the benefits are falling to the budget, and that's the hard choice we've got to make.

I would be the last person to say that this is going to be an easy debate to have. That said, Commonwealth Government has already increased the pension age from 65 to 67. We're advocating it goes to 70. They've already increased the age at which you can access superannuation from 55 to 60. We're saying it should go to 70. Governments have moved this already. It's clearly possible to do it and it makes a surprisingly big difference. I think this is one of those reforms where you say well we'll move the pension age from 67 to 70 and everyone goes that's really tough for me individually, I don't want to do that and how much difference can it make? To which the answer is, across an entire economy, a $25b difference. It's a big difference.

GEORGE MEGALOGENIS: It's a very big difference. Now, if I were Wayne Swan I'd say mate, how many times have I told you not to mention the GST. How do you get the tax mix reform debate going?

JOHN DALEY: You keep talking about it. I think one of the interesting reflections I had on your history was there is no Opposition which has succeeded in getting itself elected promising tax mix reform. There are governments that have succeeded in getting themselves elected promising to do tax mix reform after they've been re-elected. Interestingly, there are lots of governments that have succeeded in being re-elected after they've done tax mix reform.

GEORGE MEGALOGENIS: I've repeated this observation today because the capital gains, the fringe benefits tax was technically no mandate for it, the '84 election. Introduced in '85 and there was all hell broke loose and the then Melbourne Herald campaigned very heavily against that and also the assets test for the age pension. Bob Hawke got an increased majority in '87. At the '87 election campaign the then Opposition Leader, John Howard, was actually promising to abolish FBT and capital gains. Fast forward to 2000 with the introduction of the GST, very unpopular tax all the way through, Kim Beasley wanted to roll the thing back to just take it off electricity and gas, John Howard got an increased majority. People will argue the toss about what drove that, but basically that is the history. And of course you're right, the history from the other side is an Opposition moving tax mix reform has never been elected in its own name. Now where would you put the carbon tax or the carbon price on this matrix?

JOHN DALEY: We very deliberately didn't put it on this matrix for a couple of reasons. One, it's something that's already legislated and it might get repealed. But it's the law as of the moment. Secondly, we very much think of carbon pricing. Fundamentally it's an environmental reform. You don't impose a carbon price because you think it's going to increase the size of the economy. Manifestly it won't do that at least in the short run. What it will do is reduce environmental damage. That's why you're doing it. And in the same way that you wouldn't put protecting the Australian Great Barrier Reef on this matrix or creating a whole bunch of National Parks, you don't do those things because they increase the size of the economy per se, you do them because you've got a bunch of environmental objectives. One of the reasons that you do these kind of economic reforms is precisely so that you can afford those kind of environmental reforms. If you are going to try and reduce carbon emissions, then imposing a carbon price is a much more efficient way of doing that economically than any of the other options, and indeed we published work essentially arguing exactly that. But that's why it's not here. It's, number one, it's already done, and number two, the fundamental reason you are doing it is environmental. Economics tells you it's the most efficient way of achieving that environmental objective, you're not doing it in order to increase the size of the economy.

GEORGE MEGALOGENIS: Now you read that piece in *The Age* today, from Josh Funder with Per Capita. What do you say to that criticism, or that observation that you were just focused on the economic? And the reform story is much bigger than just the economic.

JOHN DALEY: I would agree with Josh. If we could write a piece of work that simultaneously prioritised Australia's economic objectives, its social objectives and its environmental objectives all at once, that would be a tremendously good piece of work. I'm frankly a little more human than that. I didn't think that that was a sensible thing to try. There's only so many things you can pick off and one of the reasons why economic reform is important is that it enables you to pay for those social and environmental reforms. I'd be the last person to say that increasing the size of the economy is the ultimate objective of government. It's not. Government is there, in the old fashioned constitutional words, for peace, order and good government. It's designed to make all of our lives better. This is one very important technique for doing that and if we're going to use that technique, we might as well do it better rather than worse.

AUDIENCE: Ken Aitcheson. Is our federal government creating another structure that will need reform such as NBN?

JOHN DALEY: We did very explicitly talk about infrastructure because I guess there's a view of the world that says if government spends money on infrastructure, the economy will go forwards. If you think about the Darwin to Alice Springs railroad, that is clearly not true. It is possible to spend a great deal of money on infrastructure and manifestly, not all spending on infrastructure winds up generating more economic growth than it cost you. We would argue there's quite a lot of infrastructure in that camp. Now I don't know whether the national broadband network is in that category. It does worry me a great deal that we are investing, as a country, whether it's private money or public money, a lot of money in a national broadband network without anyone having ever actually published a study that shows that the marginal gain as a result of that infrastructure is greater than the cost.

If we had no telecommunications at all in this country, then I'm sure building a national broadband network would absolutely pay for itself. But the reality is we have a huge quantity of telecommunications already and the question is whether the additional speed and volume that you can get through fibre to the home which is essentially the core reform of the national broadband network, is going to justify itself in terms of the additional economic growth that it creates. The fact we've never done a study worries me. The fact that the government describes it as a strategic piece of infrastructure really worries me because I used to be a strategy consultant and I learned that strategy is usually, or often in this context, a synonym for expensive. So, yes it worries me.

That said, one of the things that I think has really helped Australia in the last couple of years is Infrastructure Australia providing essentially a gate on major infrastructure projects in which it encourages disciplined cost benefit analysis to get done, and the Commonwealth essentially saying we're not going to put money into at least some infrastructure unless that cost benefit analysis work has been done. Now one of the interesting things about that is roughly speaking we have funded as a country pretty close to $10b a year in infrastructure. That stuff has had positive cost benefit analyses, but there's actually very little in the pipe. If there are indeed a whole series of high cost benefit projects where the benefits clearly outweigh the costs, state governments are being remarkably shy about telling Infrastructure Australia that they exist, which makes me at least a little suspicious that maybe they don't.

GEORGE MEGALOGENIS: The only other thing I'd add on NBN though, the government is structurally separating Telstra. So in a sense there's a second game going on and that is to reimagine the privatisation and reverse engineer the sale of Telstra with the retail arm being in private hands and the wholesale network basically been run by somebody else. The government in the short term and somebody else in the long term. So, I guess that that's where they blew the line on the cost benefit. They feel that other things being equal, they had to break the gorilla.

JOHN DALEY: That's true, although I think if you ironically look at the history of Australian telecommunications policy over the last two or three years, what it's actually demonstrated is those things were not in fact linked. Government has succeeded in breaking Telstra up, essentially independently of national broadband reform.

AUDIENCE: David Campbell. You touched on innovation briefly. There's an interesting graphic in the report on innovation. Do you want to elaborate on that, because that sort of turns on its head how a lot of people have been viewing innovation as just being R&D driven.

JOHN DALEY: I think one of the problems with innovation is it's a word that in fact has two meanings. And one of the problems is in a lot of the policy documents around this area we tend to jump from one meaning to the other. It's the kind of thing that philosophers get very excited about and it's because it's a fundamental logical error and it then leads you to do a whole bunch of things that sound plausible but in fact when you think about it, are not so plausible. So in particular what we do is we say innovation means doing things differently. One way or another, whether it's making a new product that the firm hasn't made before, whether it's making it in a different way, whether it's organising the firm differently, all of these things are innovation.

And then the economists look at that definition and say well essentially all productivity growth which ultimately drives economic growth must be the result of innovation. And that's essentially true as a matter of syllogism, you know, if you do something differently and better, then essentially you will increase productivity. That must be true. But innovation has a second meaning which is invention, ie, in the sense of doing something that no-one in the world has ever done before. So we say alright, well if we want that kind of invention, then we have to do lots of research and development and we have to be best in the world at whatever it is and invent something before the rest of the world does. We call that innovation, but I would argue it's a very small subset of innovation. It is by no means clear that the kinds of policies that drive invention actually always pay off. Indeed, the reverse is true. Brookings Institution in the United States has done a very nice piece of summary work essentially going through the literature on these kind of policies, whether they're research and development tax incentives, whether they're other forms of research and development support, asking what's the evidence that these things actually pay off? And the answer is, not much. Then when you actually go and look at where firms innovate, the answer is the vast majority of innovation in the first sense I mentioned, of things that increase productivity generally, by and large they do it by copying other firms, they do it by suppliers suggesting there's a better way of doing this, they do it because customers say you're producing these kind of widgets and it would be great if you could just make the widget slightly differently. That's actually what winds up driving an awful lot of innovation in practice.

If you look at the history of the genuine inventions in the world, the things that have really driven human prosperity in a big way, things for example like the steam engine, had nothing to do with research and development in universities. It was essentially about what happened inside businesses with smart engineers who are sitting there thinking what's a better mousetrap and what does our business need today? Often, ironically, the universities were catching up afterwards trying to explain what it was they had just done. That's why we argue that we've got to be very careful with innovation policy, firstly that most of the innovation we care about is not invention, and secondly, simply because something encourages invention doesn't necessarily mean that it will result in a greater boost to economic growth than the amount of money that we have poured into it. Maybe it does, maybe it doesn't, but the evidence, frankly, is not overwhelming, connecting up various kinds of invention policies with increased economic growth. It may be true. Certainly something that as Grattan Institute we're continuing to do some work on. But it's not something where there is a really close, well documented relationship similar to the kind of relationships we, for example, found on female workforce participation.

One of the points of this whole prioritisation framework was to say firstly look at what's the bang for policy dollar, and definitely political capital dollar, and then secondly, what's our confidence that this thing works, because we can find many things that might work but our confidence level as a policy community that this is going to pay off is relatively low. Why would you spend your political capital there when instead you could spend it on things that we are very sure will work and will make a big difference and have a big payoff.

AUDIENCE: The column you referred to in this morning's *Age* talked about your proposals as not enough emphasis on productivity. The report puts all major efforts to improve productivity in the too hard or too far away baskets. What's your response to that? Thinking about it, is that also a function of the timeframe, because you talked about 2022 versus 2042.

JOHN DALEY: To some extent it's a function of the timeframe. One thing that we do know has an enormous impact on productivity in the long run is essentially the quality of education. Without doubt, if you really want to improve Australian productivity in 2042, and therefore Australian economic growth in 2042, improving the quality of school education is an absolute winner and we should do it. We're not suggesting by this piece of work that governments shouldn't. They should just be realistic. It's not going to pay off in 10 years which for most politicians does seem like a really long time. In terms of other things that make an impact on productivity, one of the issues with the debate on productivity is it's very easy to say we'd all like it if productivity went up. I think one of the problems with that is, we'd all like it if there was more apple pie as well. Saying that you want productivity to go up is merely to state the problem, it doesn't actually state the answer.

One of the things we very deliberately tried to do in this report was go through all of the individual things that people think might increase productivity, whether that's infrastructure investment, whether it's invention policy, if I can call it that, whether it's industrial relations reform and just ask, well for each of these reforms, how good is the evidence that these things will really make a difference over the 10 year timeframe? And how big a difference? So I would absolutely agree with you that it's possible that we could make a big difference in 20, 30 years' time with school education factors to lay down there. The work that Ben Jensen's been doing for Grattan Institute gives us a pretty good idea of the kind of things we need to do. But inherently it's just not going to pay off that fast. All those other things, the evidence is not overwhelming that they're going to pay off that much, particularly over a 10 year time frame, and indeed for many of them the link is just not as strong as people often assume it is.

JOHN DALEY: If I can just wrap up, firstly George, by thanking you very much for an extremely stimulating conversation. I'd particularly like to thank the Grattan Institute staff who have worked on this report, particularly Cassie McGannon, Leah Ginnivan and Jim Savage. As you can see it's been quite a substantial piece of work. I'd also like to thank everyone else at Grattan Institute because the reality is, particularly given the scope of this piece of work, absolutely every single staff member has contributed to this one way or another – it's been very much a team effort. And to the extent that we succeed in shifting a bit of the debate, I think it reflects on their efforts.

We are acutely aware that the kind of things we are talking about in this report are not going to be politically easy. Australia has a history of doing the things that are politically difficult. Reform after reform over the last two decades, Australia has essentially pulled itself ahead of the world, and that's partly because we've had a series of terrific conversations as a community, and people have been prepared to argue with each other and talk about what's in the national interest. What will ultimately make us all better off as a community?

AUDIO: This has been a podcast from Grattan Institute. Want to hear more? Check out our website.

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