

**CREATING THE RIGHT INCENTIVES FOR
INDIGENOUS DEVELOPMENT**

**ADDRESS TO THE CAPE YORK INSTITUTE CONFERENCE
“STRONG FOUNDATIONS – REBUILDING SOCIAL NORMS IN
INDIGENOUS COMMUNITIES”**

CAIRNS

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I would like to begin by acknowledging the traditional owners of the country on which we meet - and I pay my respect to their elders and ancestors. I would also like to acknowledge the traditional owners from other places who have travelled to be here today.

Thank you to the Cape York Institute, and to Noel Pearson in particular, for organising this conference and inviting me to speak. It was an invitation I was honoured to accept.

Some 18 months ago, I had the opportunity to visit a number of the Cape communities with Noel. That was an eye-opening experience. It brought home to me the extent of impoverishment suffered by our Indigenous people, notwithstanding the record levels of average prosperity we have experienced as a nation, especially over the past decade and a half. At the time, I suggested that *'unless and until we have a clearer understanding of our objectives in Indigenous development, we will always be in trouble'*.

This is a matter I would like to come back to today.

There has been considerable goodwill in tackling Indigenous disadvantage – but the fact that progress has been slow, and

success patchy, indicates that all of us – Indigenous leaders and communities, government and the business community – need to continue to focus on working together to find better ways to move ahead.

Some might ask what a Treasury economist can offer in this space – especially one who, on his own admission, has much more to learn than he knows. Well, let me chance my hand, if I may.

If you were to take your guide from the media, you would probably think that economics is all about models and forecasts, budget surpluses, current account deficits, inflation, employment and interest rates. And it is about those things. But the description is superficial, and misleading.

Economists may be distinguished from anthropologists, yet they share an interest in the drivers of human development.

Economists may be distinguished also from sociologists, yet they share an interest in the factors that explain the development and functioning of human society. Economics explores especially closely the way in which human development, including societal development, may be explained by the essentially atomistic responses of individuals to the set of signals confronting them.

By signals I mean those various factors that influence people's decisions on a daily basis. Economics is concerned with individual responses to those signals, and the way in which those responses affect other individuals and society at large.

When Governments spend money in certain areas, individuals respond. When tax rates are changed, individuals respond. When interest rates change, individuals respond. And all of these individual responses combine to have aggregate consequences. Some of these are labelled 'macroeconomic'; others 'distributional', including intergenerational consequences.

Signals are critical to the way people, communities and societies develop. Broadly, economists would hope that the mix of signals in the economy draws individual responses that enhance the wellbeing of all Australians over time.

The life experience of the individual contributes to the shaping of a community psychology – a culture, including social norms – that, in turn, affects the experience of all individuals in the community. As Noel observed yesterday, some social norms will be supportive of individual growth and achievement. But, as I observed at first hand growing up across the river from the Indigenous community of Purfleet on the mid-north coast of New South Wales, some social norms actually shackle people –

imposing severe limitations on what they might aspire to achieve in their life.

In extreme cases, the social norms of the community can be so powerful that they effectively determine the complete set of all feasible life experiences of all of its members.

In an excellent recent essay in the *Griffith Review*¹, Noel has again emphasised the critical importance of individual responsibility in shaping community cultures that might permit the cycle of disengagement to be broken – to foster development; to defeat disadvantage.

I understand Noel to be saying that for communities to be capable of delivering opportunities for a better life, individuals will have to take responsibility for the cultures of their communities – including their ‘social norms’. I also hear him saying that Indigenous communities should pin less on the idea that a ‘rights’ agenda, by itself, can deliver Indigenous development.

But while Noel promotes the concepts of human agency and responsibility, he doesn’t deny that there is ‘a structural dimension to black problems’.² And, as an economist very much from the

¹ Noel Pearson, “White guilt, victimhood and the quest for a radical centre”, *Griffith Review*, Winter 2007, pp. 11-58.

² *Ibid.*, p.53.

mainstream, I would have to concur. In particular, I would emphasise the very important role of policy design in creating a set of structural signals that guides human behaviour.

With this context, today I would like to share with you a few personal observations on the types of signals that are likely to contribute to the improved wellbeing of Indigenous Australians – wherever they might live.

A Strategic Framework for Addressing Indigenous Disadvantage - Overview

The core reason for the limited success in Indigenous policy over many years, in my view, is that too little of this policy has been focused on addressing the underlying causes of disadvantage. I know that this has been central to the mission of the Institute, so today I'm really continuing a conversation on identifying the nature of the underlying causes.

I would suggest that there are three key interdependent foundations of Indigenous disadvantage:

- Poor economic and social incentives;
- The underdevelopment of human capital and of capability in general; and

- An absence of the effective engagement of Indigenous Australians in the design of policy frameworks that might improve social and economic incentives and build capabilities.

Perverse incentives – those which encourage undesirable behaviours - are having a negative impact on many Indigenous communities, reducing self-reliance, self-development and also the commitment to caring for families and communities. Of particular importance here are the two issues that dominate this conference. The first is the effect of the combined incentives in the welfare system, which have resulted in disengagement and, in many cases, a passive reliance on welfare payments - and also done little to encourage Indigenous Australians to invest in education and participate in employment. And the second relates to the breakdown of foundational social norms in Indigenous communities.

I share Noel's view that while incentives are important, they will not be effective in the absence of the human capital (in particular, good health and education) that is needed to take advantage of positive incentives. So a second key component of addressing Indigenous disadvantage involves human capital development. This concept is strongly related to Amartya Sen's view, which I fully endorse, of poverty as capability deprivation. Essentially, we must create a society in which all Australians have the opportunity

to build a powerful set of capabilities – capabilities that allow all of us the freedom to choose to live our lives in ways that have real meaning and real value. This is not only vital for individuals, it is critical for our economy.

In my view the third major reason for continuing Indigenous disadvantage has been the limited engagement of, and opportunities for, Indigenous people to shape policies that affect their destiny.

International literature suggests that Indigenous engagement in policy development is key to achieving better results, and I strongly believe that Indigenous engagement has to become the norm.

The Need for Holistic Reform

These foundational underpinnings to addressing Indigenous disadvantage – positive incentives, well developed human capital and effective policy engagement – have much the same functioning as the legs of a three-legged stool (not to be confused with Noel’s pedestal and staircase!). All three must be strong and supported together to ensure that our approach to overcoming Indigenous disadvantage is well-balanced. Weaken or remove one leg and the stool collapses.

Better incentives won't deliver high workforce participation if people don't have the health status, education and labour market capabilities needed to get good jobs. Without facing incentives to engage, individuals' human capabilities may lie untapped. And without effective engagement in the development of the policy frameworks that affect one's future, members of a community will not have the capacity to establish healthy social norms and to paraphrase Noel from yesterday, they may be prepared to tolerate a 'class dynamic' that gives people a distorted, tragically destructive, perception of self-interest.

A Strategic Framework for Indigenous Disadvantage

(i) Incentives

In respect of incentives – the first leg of the 'stool' – there is a clear need to focus on welfare reform. Decades of passive welfare provision have delivered dependency, not capability; indeed, dependency that has eroded capability. I am aware that there remains some controversy over statements like these. But I believe we will never make progress – in any area of policy – unless we are prepared to deal honestly and analytically with the underlying causes of the problems we face. Indigenous welfare has been provided passively. It has encouraged a state of dependency. And that dependency has contributed to the

undermining of Indigenous development. These are propositions on which we should be able to agree. And the sooner we can reach agreement on these propositions, the sooner we can start the work on more effective means of securing Indigenous development.

If we can agree on these propositions, then we should also be able to agree that a clear policy goal should be to create a system of welfare incentives – in tandem with services that build capability and foster employment – that discourages disengagement and rewards active participation.

In examining the disincentive effects of passive welfare, you need to consider the combined effects of a number of poorly-aligned incentives. If welfare payments are high relative to the wages a person can expect to earn in the workforce, we have a disincentive to workforce participation. That's pretty obvious. Less well understood are the disincentives caused where high effective marginal tax rates take a large proportion of people's income when they work; where people have an entitlement to income support without having to seek work; where people can enjoy more leisure time from being on welfare or doing a couple of days on CDEP than they can from full-time work; and where employment opportunities in the local area are sparse or even non-

existent. If you put these things together, you have a very considerable disincentive to workforce participation.

And when, on top of all that, you factor in limited education opportunities and difficult social conditions and the courage it takes to move to take up work in towns or cities away from families, friends and country, the wonder is not that so few people are participating in work, but rather that anybody is.

We have a system of adverse incentives driving the outcomes we observe. That system is complex, and it can appear a little daunting. So let's unpack it a little by considering some of the individual components.

The level of income support can discourage people from entering the workforce. The higher the base income support payment, the less likely it is that a person will enter or re-enter work after they become unemployed. Currently, a couple with three young children can access about \$36,500 a year in income support payments and family tax benefit, without working. That fact affects workforce participation decisions all around Australia, in all sorts of communities.

Now no one is suggesting that families on welfare are well-off; nor are they suggesting that they should be made worse-off.

Ensuring an acceptable minimum standard of living for all Australians is a crucial part of Australia's welfare system. However, providing a level of welfare payments that means people can struggle through without working puts a premium on ensuring that other elements of the system are creating a strong incentive to work.

Governments have also allowed many income recipients to receive support without being required to seek work. For instance, in the past, many Indigenous Australians were granted Remote Area Exemptions, people with disabilities could avoid work obligations unless they were assessed as being able to work for 30 hours a week at award wages for two years, and parents didn't have to seek work until their youngest child was aged 16.

Governments that designed these policies were no doubt motivated by compassion. In practice, they were consigning many Australians to a life of economic and social exclusion. And there is increasing evidence of these impacts affecting successive generations in some families³. Noel speaks of the deterioration in positive social norms within communities compared to the days of

³ Pech, Jocelyn and McCoull, Frances: "Transgenerational welfare dependence: myths and realities", *Australian Social Policy*, 2000/1.

The Social Policy Evaluation, Analysis, and Research Centre at the Australian National University is currently undertaking an ARC-funded project on intergenerational welfare receipt and parents on low incomes. Results of this project should be available later this year.

his parents and grandparents. We hear of the way older generations have had to take primary responsibility for nurturing children as a result of this decline. The sad fact is that, in times to come, today's grandparents will not be here to play that role. Which puts an absolute premium on tackling the problem now. It really comes down to a question of the survival of future generations. If we don't tackle the problems now, today's children can have no hope.

Passive welfare has also done little to encourage people, particularly our young, to embrace education. In particular, participation in CDEP has often yielded more disposable income and plenty more leisure time than finishing school.

On top of these incentive effects, limited employment opportunities can create another barrier to greater participation by Indigenous Australians, especially in remote areas. During my visit to the Cape in 2005, I visited a number of communities in which only a small minority of people earned income from paid employment. It's pretty hard to gain work if there are few viable options in the local community.

Finally, if we throw in the fact that many Indigenous people are living in difficult social conditions – characterised by poor housing, crime and a lack of services – then the result is an

avalanche of imposing disincentive effects destroying any incentive to work.

My point should be clear. Even if there were plentiful employment opportunities, good quality housing, low rates of crime and high quality services, we would still have a welfare system that undermined workforce participation. To achieve better outcomes, there is a need to ensure that we have a welfare system that rewards work and study above a life of passivity and dependence.

The Government has taken a number of steps in this direction in recent times – both in the broad but also specifically in relation to Indigenous welfare arrangements. It has improved the incentive to work through reducing taper rates on welfare payments, lowering taxes on low income earners and providing a low income tax offset.⁴ It is in the process of removing Remote Area Exemptions, reforming CDEP and providing Indigenous people with the services needed to move from welfare to work. And it has required parents to seek part-time work when their youngest child

⁴ The maximum taper rate on Newstart and other allowances was reduced in the Welfare to Work package from 70 percent to 60 percent and the income at which the maximum taper rate applies was expanded from \$142 per fortnight to \$250 per fortnight. The Government has also reduced the taper on maximum family payments by 30 percentage points from 50 per cent. And in the Budget, the Government announced that from 1 July 2007 the 30 per cent income tax threshold will increase from \$25,001 to \$30,001, and the low income tax offset (LITO) will increase \$600 to \$750 per year, with the income threshold at which the LITO begins to reduce increased from \$25,000 to \$30,000.

turns six and required people with disabilities to seek part-time work where they have the capacity to work 15 hours a week.

Over time, more will have to be done in this area. The CYI's recent report proposes further change in the Cape communities as a response to the consequences of passivity.

As we make the transition from passive to active welfare, we will need to keep investigating potential disincentive effects in the welfare system; and we will need to be vigilant in ensuring that we don't inadvertently create adverse incentives as a by-product of other interventions.

(ii) Human Capital

As I have said, improving economic and social incentives alone will not raise Indigenous Australians from the depths of disadvantage. To be able to respond to positive incentives – to be in a position to make decisions that enhance their own lives – all Australians need to be able to draw on relevant skills and capabilities. They need to be able to leverage their human capital – the second leg of our foundational 'stool'.

Human capital is a term economists talk about quite a bit.

Essentially, it refers to the intangible knowledge-based assets we develop that help us become productive members of society. High

levels of education and physical and mental health are the hallmarks of strong human capital.

As with incentives, human capital places individual agency at the forefront of addressing disadvantage. While disadvantage has many causes, and while government has an important role to play in education and health, it is individuals, not governments, and not communities either, who make the first steps towards overcoming disadvantage. As Noel put it so eloquently yesterday, ‘there are no mass movement elevators for entire peoples’.

Education can help transform social and economic opportunities, with particularly strong gains for those from disadvantaged backgrounds. People who are better educated are better placed to participate in the labour market and earn higher incomes.

Indigenous education is, therefore, an important ‘means’ of securing development. But, more fundamentally, people who are educated have much greater freedom to choose lives of real meaning and real value. Indigenous education is, therefore, important for its own sake; a valuable ‘end’ in itself. It should be seen as a key component of Indigenous development. As Amartya Sen has suggested, education is not only an instrumental freedom

– a means to an end – but also a substantive freedom, a constituent component of development.⁵

Incidentally, Sen stresses that also fundamental to development is the removal of major sources of ‘unfreedom’. Damaging ‘unfreedoms’ include the lack of effective institutions for the maintenance of peace and order. In other words dealing effectively with crime and violence in a community is a critical precondition to development – in both an instrumental and deeper constitutive sense.

The private returns to education can be high; but so too the social returns. Higher levels of education are associated with lower rates of incarceration and increased engagement in civic life. The education of individuals is, then, a ‘means’ of securing community development.

Health is also a key strategic factor in breaking cycles of poverty. Healthier individuals are physically and mentally more energetic and robust and, as a result, more likely to be active in all areas of life. Healthier children, in particular, are more likely to attend school, and are better able to learn once they are there. Healthier people are likely to have greater opportunities open to them, and

⁵ Sen, Amartya, *Development as Freedom*, Oxford University Press 1999, pp 292-298.

are more likely to be in a position to take advantage of such opportunities.

Education and health are co-dependent. Research by Fiona Stanley and others clearly demonstrates that poor health outcomes in early life are associated with ongoing cognitive impairment, but equally draws a link between education and preventative health. For example, better educated mothers are less likely to engage in behaviors which cause low birth weight, that automatically puts a baby at greater lifetime risk of a range of diseases, including heart disease.

Along with policies which improve incentives, measures that raise the education and health outcomes of Indigenous Australians are fundamental to overcoming Indigenous disadvantage.

In education and health, it's not only the amount of money spent that matters, but also how effectively it is spent. In short quality matters. If outcomes are poor, doing more of the same is rarely the most effective strategy.

We certainly need to allocate significant resources to running schools and health clinics which serve Indigenous Australians. Perhaps we have to spend a good deal more than we are presently spending. However, no matter how much is being spent, if we

spend that money better, it's going to produce better outcomes. So that needs to be a focus in itself.

The challenge is to make sure that Indigenous Australians get the most out of the resources that are being allocated to improving their capabilities. Importantly, policies must seek to encourage participation in, and engagement with, the services that are offered. That is, in addition to designing good quality programmes for Indigenous Australians, governments must also put in place measures to encourage people to tap into these programmes – to build their capabilities. And this takes me back to the importance of incentives.

Parents need to face the right incentives to ensure that their kids attend school – especially where the rewards from education might not be as clear as they might be in the future. Families need to have the right incentives to visit their local clinic regularly – to manage their health so that they have a realistic chance of accessing life's opportunities.

Government has a role to play here, to remove impediments caused by the existing incentive regimes that Indigenous Australians face. But I would also contend that, in some cases, the best thing governments can do is to step back to allow room for individuals, families and communities to take responsibility for

their own outcomes in life. Believe it or not, this often proves to be the hardest thing for governments to do. The reason is that the removal of government assistance is likely to result in an initial deterioration in the wellbeing of people newly denied the assistance. But by taking this difficult initial step, it may be possible to achieve a greater and more sustainable improvement in wellbeing than could ever be achieved through ongoing government intervention.

Before I move on to discuss the third leg of the stool – effective policy engagement – I should address a question that I’m sure will be in many people’s minds; and that is: ‘What’s the point of improving incentives and building human capital if there are no job opportunities in the local area?’ This is clearly a legitimate question.

Part of the answer is to note that almost three-quarters of Indigenous Australians live in cities and regional centres, the vast bulk of which have thriving labour markets. In these places, improving incentives and building human capital are the essential steps to enabling Indigenous people to gain employment or start their own businesses.

But what about remote locations? Part of the answer here is to ensure that local people can access employment opportunities

where there are thriving businesses nearby. Often, we have the perverse situation of proximate strong labour markets and opportunities, yet Indigenous people gaining little or no access to employment opportunities.

This is why the five-year Memorandum of Understanding between the Australian Government and the Minerals Council of Australia, signed in June 2005, is so important. There's a lot more to be done, but the early signs are promising. I understand that in the Pilbara region, plans are being established to place more than 170 Indigenous people into employment over the next 12-15 months through the Structured Training and Employment Projects programme.

And what about locations where only a small minority of the community have jobs and there are few local employment opportunities? I can see three avenues that might shorten the gap between the demand for employment and the available supply.

The first avenue is incremental and modest. In many communities, even given modest local incomes, there is clearly scope for more retail and service activity. With appropriate incentives and capability building, some of the gap can be addressed through development of businesses in areas such as grocery stores, pharmacies, clothing stores, cafes, hairdressers,

shoe repair and other businesses providing products and services the community needs.

The second avenue is bolder. Many communities have scope to develop a raft of businesses around a particular industry, creating a suite of employment opportunities for local people. A good example is Mossman Gorge, just up the road. Perched right at the entrance to a spectacular walkway in the Daintree, there is great potential for tourism and service businesses to capitalise on the more than 600,000 visitors who travel through the community every year. Significant progress has been made in developing plans for a car park and tourism and service businesses. Where such clear potential exists – be it in art, mining, agriculture or tourism – governments, the business community and local Indigenous communities can do better to capitalise on the potential. We are not talking ‘white elephants’ here – rather, removing impediments to genuine commercial opportunities.

A third avenue involves mobility. I know this is controversial, but it can’t be ignored. Where remote locations simply can not produce sufficient job opportunities for local people, there is no point in relying on miracles. A better strategy is to ensure that people have the opportunity to move to take up work if that is what they want to do. Noel talks about ‘orbits’, where people

spend part of the year earning income in other places, returning to live part of the year on country. This seems a sensible model to me.

Again, there are some good examples of what's possible. For instance, I understand that, at Christmas, the Yarrabah Community Banana Industry Employment Project was launched, with more than 30 Indigenous people being bussed to Innisfail for the working week to help plant and rebuild the banana industry following the devastation of Cyclone Larry. Again, this showed what can be achieved when local communities, businesses and government (in this case through employment services) work together.

So, along with getting the economic incentives right and building Indigenous capabilities, it is important to think about strategies for securing employment opportunities. But we should not accept that they do not exist.

(iii) Participation in decision-making

The third leg of our foundational 'stool' is ensuring that Indigenous people are effectively engaged in the decisions that affect them.

To achieve progress in Indigenous development, there is a need for increased ownership, by Indigenous people, of both the problems and the policy solutions. Without wanting to get too entangled in the ‘rights’ versus ‘responsibilities’ debate – I’m not that courageous! – could I offer the modest thought that it is in this area, of policy ownership, that the two concepts must, quite naturally, come together. People who are affected by policy have a right to be involved in its development – that is no more than a statement of the primary rationale for democracy. And, for all of the reasons given earlier, people who are affected by policy also have a responsibility to be involved in its development.

Getting the incentives right and building human capital will best come through Indigenous engagement in policy development – it is essential to achieving better outcomes. Policy reforms are more likely to be successful where they are informed by those affected – those who are uniquely placed to understand their own needs and preferences. More than that, the opportunity to participate in policy development is, like education and good health, a development outcome in itself, contributing directly to higher levels of wellbeing.

Research suggests that Indigenous groups with more autonomy in decision-making fare better in key socio-economic indicators.

The Harvard Project in North America outlines that Indigenous tribes with greater decision-making powers experience less poverty and higher levels of economic development.⁶

We need to get to a situation where Indigenous people initiate, catalyse and help to shape the policies that impact on them and have ‘skin in the game’ (as Noel would say) so are willing to take responsibility for ensuring that policies succeed. Individuals need to be active agents of change rather than passive recipients of the status quo.

Governments are recognising the need to engage Indigenous people on issues from Indigenous housing to broader economic development. For example, there is understanding that it would be counterproductive to attempt to address overcrowding by continuing to build houses that are not suited to Indigenous needs. A better approach would be to ensure that Indigenous people are involved in every part of the process, from identifying the real problems with existing housing design, to determining the preferred mode of housing, to electing the best method of delivery, to actually building the houses. Such a strategy of whole-of-policy engagement would create a greater sense of policy

⁶ Cornell, Stephen and Kalt, Joseph, *Sovereignty and Nation- Building: the Development Challenge in Indian Country today*.

ownership, augment individual skills and provide economic development opportunities in the local community.

Indigenous engagement, at both local and national levels, is key to achieving both short-term goals and long-term visions. The Ministerial Taskforce on Indigenous Affairs recognises in its vision statement that:

Indigenous Australians, wherever they live, should have the same opportunities as other Australians to make informed choices about their lives, realise their full potential in whatever they choose to do and to take responsibility for managing their own affairs.

The CYI has also recognised the importance of this in the development of its welfare reform project. I'm sure that many of you have been involved in the consultations. The project seeks to build policy prescriptions around social norms that the participating communities have determined they want for their people. The Institute has spent many months engaging with communities in the Cape on the key drivers of disadvantage and responses that – in the words of the Institute's charter – seek to 'ensure that Cape York people have the capabilities to choose a life they have reason to value'.

The CYI report proposes major changes which I consider should be seriously considered. They would certainly give greater responsibility, and greater policy ownership, to all involved. And, for the reasons I have outlined today, this would be no bad thing. They would need to be supported by government services – effectively delivered – in line with those expected in disadvantaged non-Indigenous communities. And, very importantly, and unlike so much that has gone before, they offer an expectation of community take-up – of communities accessing real opportunities for a better way of life.

I wish the Institute and the people of the Cape the very best in your reform efforts. I am confident that through governments and Indigenous people working in partnership, we can achieve so much more by - say - the 50th anniversary of the 1967 Referendum. At the very least, we will have crafted a sturdy stool that might allow all of us to step up to a better future.