

Australia adjusting: Productivity, innovation and the future of work

CEDA's Contribution to the Prime Minister's
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Introduction

Australia has largely weathered global economic turmoil in recent years due to the strong economic reforms implemented in the 1980s and 1990s, the contribution of the mining industry and arguably fiscal and monetary policy working in tandem. If future generations of Australians are to have the same safeguards in place, it is vital we continue to review reform options to ensure economic prosperity.

A fundamental question facing Australia is whether it can reasonably continue to deliver ongoing economic success for the next decade and beyond. While recent statistics for GDP growth and employment paint a picture of an economy on steroids, there are some lingering questions about the current and future contribution of various sectors to the nation's long-term economic sustainability.

These questions go beyond the easy options of discussing Australia's minerals boom and associated investment and the so-called two-speed economy, as significant as these are. It is more than insincere assertions that productivity can be restored by adjusting in some undetermined way Australia's workplace relations system. And it is the requirement that all participants, be they government, business or unions, understand cooperative relationships will deliver the key outcomes Australians expect in a first world economy.

It is the conversation we need to have about the nature of the Australian economy in 10 to 15 years' time, its fundamental structure and the nature of work.

The Committee for Economic Development of Australia (CEDA) recently brought together some of Australia's leading economists to examine these issues. The discussion was led by Dr John Edwards and was based on a paper he prepared. That paper is the basis for CEDA's submission to this Economic Forum¹.

Australia's economic performance has been outstanding compared to other advanced nations for two decades, and this can continue. However, there are a number of key conditions needed for this strong economic growth to continue.

This includes a return to a strong reform agenda to improve productivity, in particular in the services sector, a poor productivity performer but a likely area of jobs growth in the future.

Productivity

The first key condition is that continued economic growth in Australia rests on productivity growth returning to around 1.5 per cent per annum. While this is higher than current levels it is still below historical norms.

¹ *Australia 2022*, prepared for CEDA by Dr John Edwards, Reserve Bank Board member and Lowy Institute Visiting Fellow.

A core observation is that moderate but possibly below average performance in productivity and business investment could still result in another decade of robust economic growth for Australia.

One perspective is that Australia's productivity growth rate will return to historic levels as business investment comes on stream. This view suggests that as the capital expended in resource-related investments starts to make a positive contribution to output, the current relative decline in productivity growth will reverse.

The alternative view is that Australia's decline in the productivity growth rate is a consequence of a lack of significant reform over the last decade. As wealth increases have flowed from the positive terms of trade, it has diminished the willingness of business and government to make the difficult decisions necessary for ongoing improvements in productivity. We are in fact living in 'a complacent country'.

At the same time there has been growth in regulation and changes to industrial relations laws contributing to business becoming less innovative. Returning to a reform agenda may be needed, and can add further to growth even if investment payoffs are strong.

A return to a strong reform agenda would be prudent regardless of the scenario, and can add further to growth even if investment payoffs are strong.

Productivity challenges

Regulation

Increasing levels of regulation are recognised as a challenge for Australia's productivity. While regulation may seek beneficial outcomes, the way it is developed and enforced can create unintended and detrimental consequences. One potential option is to adopt a regulatory focus on core principles or desired outcomes rather than proscriptive definitions of allowed activity.

A challenge for Australia's future prosperity may be that employment growth will be focused in sectors that have not historically exhibited high levels of productivity growth. When resource-related investment diminishes, the employment opportunities of the future will most likely be in the services sector. This sector is not as productive, at least not as measured by official statistics, as other areas of the economy. Australia's future level of productivity growth may be significantly lower than it has historically been. This may have consequences for ongoing measured productivity growth and continued economic prosperity.

Regulation underpinned by core principles or desired outcomes rather than proscriptive definitions of allowed activity would be a key first step.

The international environment

The international environment will significantly influence the ability of Australia to maintain robust economic growth over the next decade.

It is assumed that current elevated terms of trade will return to more normal conditions while business investment will continue for a number of years to support GDP. However many of these assumptions are based on Australia's continuing trade relationships with our Asian neighbours, specifically in commodities, to continue at current levels.

Obviously a key factor to consider is the sustainability of China's growth and whether a rapid decline in demand for Australia's resources may occur if there is a drop in China's economic activity.

It is critical to note in this respect that the actions of other resource-rich nations, particularly in Africa are also relevant. While Australia has a 'first mover' advantage in exploiting resources, in the medium term the exploration and investment underway elsewhere will have a major influence on the terms of trade and the willingness of business to continue high-level investment in Australia. If Australia becomes a high cost investment destination, with regulatory uncertainty, it may price itself out of future business investments.

Australia's economic prosperity has been supported by policies that have focused the nation on its international competitive advantage. As a consequence, Australia has benefited significantly from the expansion of manufacturing capacity in China, whereas the United States and Europe have been undergoing an extended period of readjustment.

However, Australia's future capacity to innovate could be hampered because the nation may lack critical mass in key technical and managerial skills.

Continued technological advances are expanding what constitutes tradeable goods and services. While this represents a potential opportunity for a highly educated nation such as Australia, it also represents a potential challenge to sectors of the economy that have not been globally integrated or exposed to international competitive pressures in the past.

In particular, the fact that the National Competition Policy reforms largely ignored major services sectors may mean Australia's economy is not as well positioned to adjust to changes in those areas as it should be.

The opportunity: Efficiency and equity

Australia's current economic prosperity owes much to the reforms that embedded flexibility, adaptation and responsiveness into the economy.

While the economic reforms of the 1980s and 1990s were sweeping, a number of areas have been ignored then and since.

These include the large employing sectors of health and education. With an ageing population and improving prosperity in Asian nations, it is more important than ever that these sectors be exposed to meaningful reform to enhance their effectiveness and capacity for innovation. The reform should focus on building competitive capability.

One of the lessons from the 1980s and 1990s was the sense of urgency and priority that political leaders were able to generate from adverse economic circumstances. At the time a strong group of community leaders articulated and supported the reforms that were in the long-term national interest.

The importance of creating objective evidence that underpinned both efficiency and equity-based arguments was also recognised. Equity issues were viewed as being more important than historical and distributional effects of change must be factored into any potential reform agenda.

There are many areas where efficiency could be enhanced through improvements to the policy setting process, the tax system and regulatory frameworks.

Lack of a rigorous and transparent systematic review of public spending is a special weakness. Improving governance arrangements is vital for ensuring ongoing dynamic competitive pressure.

Towards a reform agenda

In establishing a future focus of reform, it is important to identify where the largest economic returns reside.

Successful reform will involve not only improving the performance of individual areas, but would embed dynamic factors to encourage ongoing incentives to innovate and change.

To provide perspective, preliminary research from general equilibrium modelling suggests that the benefits from reforms vary: from implementing the Henry Tax reforms that have been accepted (0.07 per cent increase in GDP) through to the complete Henry Tax reforms (2.5 per cent increase in GDP) and the Bradley Higher Education Review Reform Package (6.1 per cent increase to GDP).

It is important to focus future reform agendas on areas with the most substantive benefits.

Over the previous 20 years Australia has frequently questioned the ongoing viability or sustainability of its economic success. While it is important to build in appropriate policy risk management, it is also worth recognising that actions and institutional arrangements that enable success to occur have been shown to be feasible.

Innovation will play a key part in any reform agenda. In particular, innovation in Australia must consider:

- Education and skills;
- Technology, including the NBN, opportunities provided through enhancements to mobile phone technology and other communication advances; and
- Incentives to innovate.

An equally critical outcome of these considerations will be the nature and composition of Australia's future workforce. With structural adjustment continuing to occur in the

manufacturing sector, online behaviours creating an uncertain environment for traditional retailing, and export-oriented opportunities developing for Australia's services sector Australia, must consider the future of work and any government incentives to support a desired outcome.

In particular, these issues should consider:

- Transitioning to the jobs of the future;
- Educational needs- higher and vocational education and training;
- Meeting employment challenges of demographic change, geographical shift and labour mobility; and
- Structural adjustment in manufacturing, including subsidies versus strategic implications, moving towards high value manufacturing, regional implications.

Conclusion

While the above provides policy risk management options to ensure future economic growth, it is important to remember that historical reforms have embedded incentives in the economy that have encouraged the adaptation necessary to take advantage of emerging national and international conditions, while minimising the adverse outcomes of challenging circumstances.

As Dr Edwards notes, Australia's economic growth has been able to:

"...survive a depression in South East Asia and Korea, the Russian and Long Term Capital Management crises, the 2001 tech wreck and advanced economy recession, the quintupling of oil prices, several wars in the Middle East, the global financial crisis and subsequent advanced economy recession, and now the euro crisis. It is not easy to contend that bad news in the global economy will necessarily terminate Australia's economic expansion."

Appreciating the magnitude of this accomplishment, and the action that delivered it, it is critical in the development of future reforms.

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