Making Australia productive

CEDA Council on Economic Policy (CCEP)
Summary from meeting held 6 December, 2012

Guest presentation:

Productivity Commission, Chairman, Gary Banks presented *Productivity policies: the 'to do' list* on economic reform to improve Australia's productivity

Summary of meeting

Growth in Australia's productivity is a critical focus of public debate as it is a key determinant in improvements to national income growth and international competitiveness. Paul Krugman has famously stated:

> *"Productivity isn't everything, but in the long run, it's almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker."*

Put simply, productivity is the nation's output divided by its inputs. It is an attempt to proxy improvements in the ability of a nation to produce goods and services and has a strong relationship with a nation's income per capita. While it was considered positive that the public debate is focused on productivity, it was noted that occasionally what gets lost is that productivity is not important in and of itself. The importance of productivity growth is that it underpins collective improvements in standards of living. Income per capita is a broad proxy for improving quality of life, but is not necessarily the same thing.

Interestingly, CEDA Council on Economic Policy (CCEP) has observed that more explicit measures that focused on the national wellbeing, including proxies for other elements of wellbeing, did not materially add to the information provided by per capita measures of economic activity.

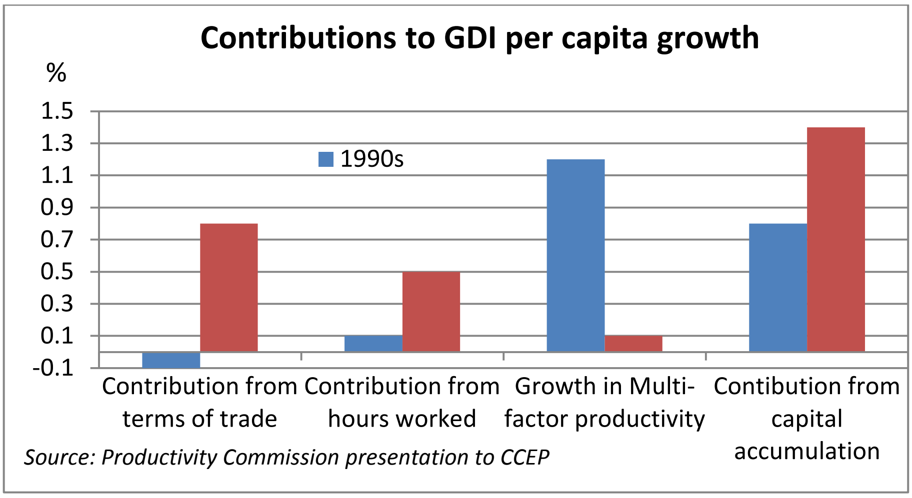
Throughout 2012 CEDA has repeatedly examined the issues surrounding the recent decline in Australia's productivity growth and how to reverse it. In CEDA's 2012 *Economic and Political Outlook* Saul Eslake described a long decline in Australia's productivity that was evident throughout the 2000s. As the terms of trade normalise, productivity growth will be a key source of ongoing income growth.

At the May CCEP meeting Reserve Bank of Australia (RBA) Board member and Lowy Institute Visiting Fellow Dr John Edwards suggested that if Australia could return to long term average levels of productivity then the nation could achieve an additional decade of continuous economic expansion.

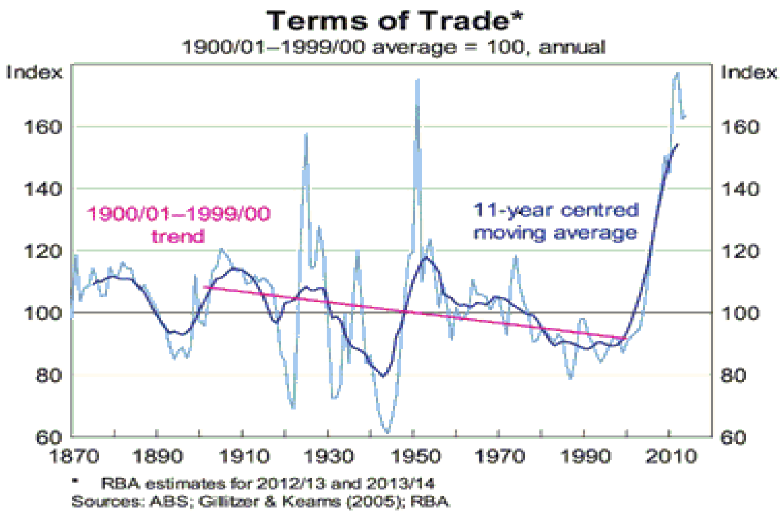
Gary Banks Presentation

Productivity: Trends and causes

Discussion began with an examination of Australia's productivity performance during the 1990s and 2000s. The difference in contribution that productivity growth made in both periods is quite stark. During the 1990s the main contribution to gross domestic income (GDI) per capita was productivity which contributed 60 per cent of the total improvement experienced over the decade. However, during the 2000s the key driver of GDI per capita was capital accumulation, which added half of all improvement to GDI per capita. In contrast, productivity growth added just 3.5 per cent to GDI per capita.



The rapid growth in capital accumulation is a clear result of the unprecedented international stimulus provided by Australia's current terms of trade. The relatively unprecedented magnitude of this stimulus was recently described at CEDA's Annual Dinner by RBA, Governor, Glenn Stevens, as detailed below.



Mr Banks outlined the view that Australia's productivity performance has been significantly influenced by cyclical factors, climatic influences and the pronounced build up in capital stock associated with business exploiting these favourable international conditions over the course of the last decade. For instance, extracting agriculture, mining, and certain utilities from market sector multi-factor productivity (MFP) significantly improves the recent productivity performance, from a decline of one per cent to a decline of 0.3 per cent. Somewhat ironically, the end of the incredible terms of trade conditions may result in an improvement in mining productivity as new investment subsides and higher output associated with past investment comes on stream.

While cyclical and external factors may have influenced Australia's multi-factor productivity performance, extracting these influences finds that MFP has still declined during the 2000s.

Small changes in productivity growth rates have very significant implications for the nation's standard of living in the long term. Consider the changes in assumed labour productivity growth projected in the first and third Intergenerational Reports a decade later. A revision of just 0.15 per cent in assumptions about labour productivity growth rates represents a difference of $7000 per capita by 2050 in real dollars. If, on the other hand, productivity was raised to the two per cent achieved during the 1990s, per capita income would be $18,000 higher and the Australian economy 20 per cent larger by 2050.

If Australia achieved the two per cent target set by then Prime Minister Rudd in 2010, each individual in the nation would gain $18,000 per capita on average, while GDP would be nearly 20 per cent greater than otherwise by 2050.

The policy framework

Productivity improvements result from just two things: innovations in economic activity and resources being allocated to their most productive use. These decisions are intrinsically linked with the decisions of individuals in terms of their daily activities and where they decide to allocate their resources, their physical and financial capital. The choices individual people make, be they in business, the not for profit sector or in government, will all have an influence on the national capacity to produce.

It is also important to note that while productivity is important, it not something that government can explicitly influence. Instead, governments have an influence over national productivity growth through three main channels. These include:

- Providing the right *incentive* structure through fostering competition, regulation and budgeting processes;
- Nurturing the *capabilities* of the nation, through the role of skill and infrastructure provision; and
- Allowing *flexibility* in the economy through control of the workplace and other regulation.

The Productivity Commission views the *incentives* channel as a driver of productivity improvements while the other two are enablers. However, the three influences interact closely.

A challenge for improving the influence of these channels is that what constitutes reform has become confused. The observation was made that some recent government initiatives purport to be reforms reinforce inefficiencies in the status quo.

The economics is easy, the politics is hard

To provide a robust basis for discussing meaningful reform, the relevant residual recommendations from the Productivity Commission's 110 inquiries and commissioned studies were outlined. While there may have been disagreement with some of the minutia of the reform agenda, CCEP was in complete agreement on its merits and the broad improvements it would deliver to the nation. The complete list of reforms can be accessed here. However, key points discussed were:

- The need to remove the remaining tariffs. The economy has made the painful adjustments to being open and competitive in most areas while the few remaining tariffs support strong vested interests. Meanwhile anti- ‘dumping’ actions were acting like de facto protectionism;

- The benefits of undertaking a focused national competition policy review with the intent of exposing all areas in the economy to greater competitive pressures. This included pharmacy ownership restrictions and taxi licencing among other areas; and
- The importance of effective policy making underpinning political decisions. This extended from infrastructure through to individual regulations as all areas had the potential to undermine the national productivity unless they were underpinned by effective decision making.

It was observed that the economic answers to Australia’s productivity question are simple. The politics of making them happen are hard.

CCEP discussed how difficult it was to reform areas where the benefits of the status quo were concentrated in a relatively small group of people, while the benefits of reform were diffuse. This creates significant challenges to creating a political consensus by which to challenge vested interests.

The Pharmacy Guild was cited as an example of a group extracting substantial rents from the rest of Australia and had a strong incentive to be a very vocal advocacy group. It was noted that CEDA’s current research project on healthcare reform had identified policy failures that have contributed to Australia paying considerably more for generic drugs than in equivalent countries.

The observation was that successful reforms were frequently built by coalitions of different interests advocating for change. Community acceptance of reform was more likely when diverse interest groups advocated for change. This creates a platform for political action to be taken. CEDA will examine the elements of successful policy making, and some of the myths associated with it, in 2013.

A Big Bang not a silver bullet

Another significant observation was that periods of major reforms focused on a large number of areas simultaneously rather than focusing purely on individual microeconomic reforms. By undertaking multiple reform initiatives at once, almost everyone benefits from an element of the program whereas multiple interest groups share the down sides of reform.

It is important for Australia to revisit the key factors contributing to productivity. The nation cannot rely on the terms of trade to boost national income over the course of the next decade as it has over this one. To this end, CEDA is undertaking a major research report into *Australia Adjusting* that will examine the economic factors influencing the nation’s economy between now and 2025 and what can be done to improve our economic performance.