# From Recovery to Prosperity: Australia's productivity challenge revisited

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It is a pleasure to be invited back to *Minerals Week* to talk about the opportunities and challenges of productivity reform.

This is not my first such appearance; nor, as some of you will appreciate, the first time I have addressed this topic! Indeed I seem to have spent almost as much time talking about productivity reform since I left the Productivity Commission nearly a decade ago as I did when I was there. That no doubt reflects its continuing vital importance to our living standards, but also the fact that there is still a lot our governments should be doing about it.

At this point it is customary to cite Prof Krugman's aphorism that 'productivity isn't everything, but in the long run it is *nearly* everything' – possibly the least controversial over-statement he has made. In fact, when it comes to *labour* productivity and per capita income growth, it is virtually a truism.

As the Productivity Commission reaffirmed in a recent study, productivity growth has accounted for most of the considerable rise in real per capita income in Australia since Federation – and all that this has made possible, including the social programs and welfare systems that are now taken for granted.

Moreover, as Queensland's own Productivity Commission explained in another excellent recent study, the sort of policy environment conducive to productivity growth also enables an economy to become more adaptable and resilient in responding to change and, dare I say it, *crises.*

It might therefore seem surprising that in the 'time of COVID', so little policy attention appears to have been devoted to this key reform area. It was particularly puzzling not to hear the word 'productivity' mentioned by the Treasurer when presenting a budget that is essentially *predicated* on it. That is, a budget delivering unprecedented deficits and debt, the sustainability of which depends on the proposition that Australia will 'grow itself out of debt'; but a budget containing little to promote this.

The reality we indeed face is that, unless the Government reneges on its promise not to raise (indeed to lower!) *taxes* – or another government is elected that labours under no such obligation (pun intended) – or political courage can be summoned to cut excessive but structurally embedded social *spending*, economic growth is the only possible route to fiscal stabilization, if not 'sustainability'.

If anyone is still bemused by the siren call of so-called *Modern Monetary Theory* – a term coined by an Australian academic who might with more justification have labeled it '*post*-modern' monetary theory – you can be assured on better authority than I that it offers false promise. Boiled down, it is essentially based on the existence of a *free lunch*, the non-existence of which is one of the few iron laws of economics.

As a further aside, rising terms of trade can of course provide windfalls to top up the fiscal dividend from underlying growth, as we have been fortunate enough to experience again over the past year or so. The combination of surging iron ore prices on world markets and pent-up domestic demand 'roaring back' to life under the stimulatory monetary and fiscal regime, has boosted income growth and tax revenue. But as past such episodes have taught us, what goes up invariably comes down, and macroeconomic 'sugar hits' tend not to last.

## Where will *real* growth come from?

In assessing the outlook for 'sustainable' economic growth, we need to look below such short-term, demand-side phenomena to the underlying supply-side components. Under the '3Ps' framework adopted in Treasury's Intergenerational Reports (the fifth edition of which is due out shortly) the fundamental determinants of Australia's GDP over time are (a) the size of our working age population, (b) their participation in work and (c) average labour productivity.

Looked at from this angle, it is hard to be optimistic about our prospects.

Taking the *population* component first, Australia's relatively high rate of population growth – among the highest in the OECD – has been a key driver of the growth in aggregate GDP. Unusually for an OECD country, this was not due to domestic fertility, which is relatively low. Rather, it has been due to historically high net immigration, accounting for two-thirds of overall population growth, before COVID brought things to a halt.

Treasury's budget forecasts envisage net immigration getting back to its previous annual peak of 235,000 by 2025, which would provide a significant boost to tax revenue. But this depends, among other things, on pandemic-related risks virtually being eliminated; there is a plausible case that COVID could end up being a 'long tail' phenomenon, even with widespread vaccination. There are also reasons to doubt that foreign student numbers will simply resume their previous trajectory, especially from China.

More importantly, one has to question whether, federal budget repair aside, attempts to revive immigration *to the extent forecast* would be sensible from a national interest perspective. While Treasury is perhaps understandably bullish, the Productivity Commission has provided a more nuanced assessment. This suggests that, under realistic assumptions, immigration does little for either participation or productivity nationally in the long term, with income gains in per capita terms small and largely skewed to migrants themselves. Moreover, while highly skilled migrants are good for the economy, and sectors like mining in particular, and should be encouraged, the average skill level for the intake as a whole in recent years has not been high.

When externalities such as congestion and housing affordability are taken into account, I'd suggest that the optimal level of net immigration for Australia could be closer to Treasury's forecast in the first IGR of 90 000 than the latest one. Where it ends up is unclear. But what is clear is that immigration policy is too important to be devised primarily on fiscal grounds or in relative seclusion.

Coming to labour force *participation*, this currently sits at record levels in Australia. This came as bit of a surprise to forecasters, given the ageing of our population, and is due mainly to increased older-age participation and a further increase in the participation of women in the workforce. However, considering the circumstances influencing each of these, the scope for participation to rise much further is in doubt, notwithstanding the increased subsidy for childcare in the budget.

*Productivity matters most*

Which brings me to the third P, *productivity*. This is the only one of the three able to 'keep on keeping on' – and, as noted in the Productivity Commission study, with a track record to prove it when it comes to growth in per capita incomes.

The projections in the budget assume that economy-wide labour productivity growth will attain the 'long run average' rate of 1.5 per cent, the only question addressed being how long this might take. The trajectory is shown to make a significant difference. For example, if it takes 5 years longer than the ten year base case, real GDP would be nearly 2 per cent smaller in 2031-2 and gross debt nearly 4 per cent higher (on a very large base number).

Of greater moment, however, is whether the assumed productivity growth rate is *achievable at all* under current policy settings.

The budget's 1.5 per cent rate is based on the 30 year average. But that period takes in the 1990s 'reform era', when annual labour productivity growth averaged nearly 2 per cent. For the productivity cycles since 2003, the average has hardly exceeded *one per cent*. If that were to continue over the next decade, future GDP would take a hit much bigger than the 'slow' scenario in the budget papers and the outlook for debt would be significantly worse.

Yet it is not clear why Australia's productivity *could* be expected to do much better than it has over the past decade and a half. Indeed, the conclusion of a large literature associated with respected economists such as Robert J Gordon is that slower productivity growth may well have become the new normal globally.

If so, this would up the ante even further for pro-productivity reforms. For if the 'productivity frontier' is destined to expand more slowly than before, it becomes even more important that a country operating *behind* the frontier takes every policy opportunity it can to at least realise its own productivity potential.

That Australia is such a country seems clear. Yet there has been little public acknowledgment of the heightened productivity challenge now facing us and its reform imperatives, either in the budget papers or in the pronouncements of our political leaders. Indeed at Senate Estimates last week, the Finance Minister suggested that current policy settings would be sufficient.

**The policy 'drivers and enablers'**

One often hears claims that particular policy proposals will boost our economy's productivity, but it is not always apparent how this would come about, and in many cases the anticipated gains appear illusory.

An analytical framework long utilized for this purpose by the Productivity Commission is founded on the proposition that national productivity begins in individual workplaces. The 'headline' numbers for our economy, or key sectors within it, represent little more than an accumulation of the results achieved by the myriad enterprises and productive organisations in all sectors of the economy.

Policies that encourage organisations to be cost-conscious and innovative, while not inhibiting stronger performers prevailing over weaker ones ('creative destruction') can legitimately be called 'pro-productivity'. Policies having the opposite effect, that inhibit efficient adjustment, or unduly constrain or distort managerial decision-making and raise costs, are 'anti-productivity'.

A key insight from the Productivity Commission's framework is that both kinds of policy operate through one or more of *three channels of influence*.

One is by affecting the *incentives* for an organization to perform well. Policies affecting market competition are obviously the pre-eminent example, at least in the private sector, and the main reform target has been government regulations that inhibit competitive forces. In the public sector, the ongoing challenge is to find ways of promoting cost-effective service provision in the absence of market pressures, still very much a work in progress.

Governments can also influence the *capability* of organizations, such as through services that enhance human capital or through publicly provided infrastructure, such as energy, telecommunications and other network services that are essential inputs to productive activity across the entire economy.

Last but certainly not least, are policy measures that affect *flexibility* – the ability of organisations to modify and adapt their activities and processes in response to changes in their operating environment. These are generally regulatory in nature and motivated as much by social or environmental objectives as economic ones, requiring prior assessments of their net impacts, which are rarely done well.

It follows that in policy terms there can be no 'silver bullet' to raise an economy's overall productivity. What is needed is a policy approach that embraces all three channels of influence and is consistently applied.

**An agenda in waiting**

The good news is that notwithstanding the extensive structural reforms of the 1980s and 90s – and isolated advances since then – there remain rich reform pickings in each of these areas. That is not to suggest that they represent 'low hanging fruit'. But most do have the advantage of being laid out in evidence-based reports from independent public reviews by the Productivity Commission and others, affording them a certain legitimacy and credibility.

The bad news is that while most such reform opportunities are therefore known, few have been taken forward and, where they have been, the success rate for legislative measures has been low or initiatives so modified as to compromise the original objectives. Worse, in a number of areas, instead of building on or at least maintaining earlier reforms, things have gone backwards.

As a result, and despite earlier gains, the productivity and competitiveness of Australia's economy remains handicapped by:

- An *industrial relations* system replete with Byzantine complexities, rigidities and perversities that foster adversarial relations within workplaces and militate against productivity enhancing innovations and adjustment.
- A *taxation* system that, notwithstanding recent modifications (and those in train), continues by OECD standards to place too

much reliance on distortionary and incentive-killing taxes, particularly on business income and economic transactions.

- An *energy* sector rendered increasingly dysfunctional by a proliferation of *ad hoc* and uncoordinated interventions by all governments, such that in the space of a decade we have seen Australia's comparative advantage in low cost energy forfeited for no discernable gain.
- *Resource sector* regulatory regimes that, for the most part, remain unduly complex and duplicative, with approval processes that are uncertain and far too lengthy.
- *Infrastructure* and *procurement* spending blighted by weak assessment processes, in which value for money can still take second place and cost blow-outs of 30-40 per cent have become the norm. Infrastructure services themselves often lack sufficiently independent governance, with many assets poorly managed and lacking cost-reflective pricing.
- *Land use*, zoning and planning regulations and processes that unduly inhibit and distort development in both urban centres and regional areas.
- *Public sector services and programs* that lack design features and incentive systems conducive to cost-effective provision and have a poor record of achievement. A topical example is the NDIS, the costs of which are spiraling out of control due to permissive criteria and poor gatekeeping. More generally, that the whole 'non-market' part of the economy has been growing so fast, aided by the recent budget, makes it more important than ever to spend well and eliminate waste.

The potential economic (and fiscal) gains from reforming even some of this anti-productivity policy morass, enabling the economy to get nearer its potential, are large.

A just-released study by the Centre for International Economics considers the possible gains from what is seen as a modest subset of the reforms on offer, including lowering somewhat the tax rate for large businesses and addressing some of the most widely recognised anti-productivity features of the Industrial Relations framework. It finds that under a selection of reforms yielding a rise in labour productivity growth of one percentage point -- restoring it to something closer to what was achieved in the 1990s – Australia's GDP in a decade's time would be around 10 per cent greater than otherwise (nearly $10 000 per person). The CIE has calculated that these gains from improved productivity growth would be equivalent to another mining boom.

## Why not more reform success?

The issue we have to face up to is why Australia has done so poorly on pro-productivity reform relative to the 1980s and 90s. Comparisons of this kind are often dismissed (if not derided) in Canberra with the observation that the political obstacles are far greater today, particularly for anything that requires passage through the Senate.

The political asymmetries that militate against reform – perversely resulting in more power for vocal minorities opposing it than passive majorities benefiting from it -- have long been a fact of political life. It could be described as a 'business as usual' problem that all reformist governments have had to overcome. And of course many have done so, including in our own country.

That is not to deny the difficulty of securing growth-promoting reforms at a time when electorates increasingly value notions of equity over efficiency, the environment over the economy and the 'world' over the nation. Or where political leverage in parliaments increasingly resides with 'independent' representatives in the upper house who fancy themselves more in the role of policy maker than reviewer, and have proven a soft target for special-interest groups.

By the same token, as everyone is very well aware, the last decade and a half has been marked by two global crises. Crises could normally be expected to have made it easier to gain support for reform. The much-heard slogan '*Never waste a crisis'* is based on the observation that in creating a sense of urgency, crises lead people to think differently about policy tradeoffs and become more receptive to changes in the *status quo*.

Unfortunately, Australia wasted the first crisis and is in danger of wasting the second – which if realised would make this a bi-partisan achievement.

*Keys to our past successes*

If reform has indeed become more challenging, this would suggest that more effort has to be put into approaches or methods found effective in the past. Of fundamental importance among the various observed success factors, according to the OECD's report '*Making Reform Happen'*, are what it terms an electoral 'mandate' and the key role of effective communication.

During the two decades known as the 'reform era', Australian governments took pains to convince the public that reform was urgently needed, by explaining the costs and risks of the *status quo* and the potential gains on offer. Considerable effort also went into building coalitions of support and countering the arguments and influence of those resisting reform.

Achieving greater community support for, or at least acceptance of, proposed reforms, has the practical benefit of facilitating the passage of measures putting these into effect. A striking feature of the earlier period was the existence of bi-partisan support for a number of key reforms. More generally, it is hard to think of many legislative proposals having broad community acceptance that have failed to get the numbers, even in the Senate.

Integral to the capacity to 'bring people along' during the reform era was an overarching political narrative about the importance of a more competitive and productive economy, not only to household incomes but also to the achievement of desired social and environmental outcomes. This narrative was consistently promoted and enduring. It helped build credibility and trust, and made it easier to gain support for individual reforms allied to it.

As the OECD notes, there are other, more distinctive elements in the Australian story, particularly the extensive use of independent reviews to build a credible, evidence-based case for change. By and large that part of what the OECD calls the Australian Model for reform has continued. The key difference with the earlier period is how such reviews have been handled and, in particular, how the communication side has been addressed.

*What narrative?*

For a start, the more recent period has been notable for the lack of a strong narrative in support of productivity-enhancing reform. That is not to say that its role has been ignored, particularly early in the pandemic. For example, the Prime Minister remarked in April 2020 that the Government was actively reviewing policy options to enhance Australia's productivity potential. And a month later, the Treasurer made clear its importance when he said:

*Supply-side reform can actually help create jobs and strengthen the economy, and that is what we are determined to do – to provide a boost to aggregate demand where appropriate, but to encourage supply-side reform because that will be important to the recovery.*

Since then, a boost to aggregate demand has certainly been in evidence. But there has been little policy action on the supply side of the economy, apart from further spending initiatives that have been mostly of a short-term nature.

Governments can't do everything and political capital is always in finite supply. Given the special features of the COVID recession, it was perhaps inevitable that fiscal measures would get most of the attention, though the quality and scale of spending remains contested. But with sections of the economy 'roaring back' from their induced hibernation, and fiscal policy assuming a less stimulatory role, political advocacy that supply-side reforms are now needed to strengthen the economy beyond the recovery seems overdue.

Indeed, at this point the public might be forgiven for concluding that government spending was the key not just to recovery from this unusual recession, but also our long-term growth and prosperity. They may even believe that governments actually *create* wealth rather than redistributing it. (As an aside: when was the last time we heard a politician admit that a new government program was to be funded by *taxpayers*?)

## Better times ahead?

The virtual disappearance of a pro-productivity reform narrative could be interpreted as an overly cautious approach to the coming federal election. As we saw with the GST, advocating reform in an election can challenge even the best political communicators. This might explain why some initiatives known to have been underway, such as the 'Regulation Taskforce' and reforms to environmental approvals, seem to have dropped off the radar. If this is indeed the case, then the sooner the election is held the better!

*What prospects of a reform revival?*

As to what might be expected when (or if) the time is finally deemed right for a reform push, there are reasons to 'curb your enthusiasm'.

Such a move would essentially be taking place from a standing start, without the benefit of having been foreshadowed through the crisis. Also, any sense of urgency associated with the crisis will have lessened. Recent surveys show that consumer confidence is already rebounding. JobKeeper payments and low mortgage rates, plus ongoing restrictions on travel, have helped build savings and left many households in a financially better position than before COVID.

That said, earlier periods of reform in Australia were arguably driven more by a sense of *impending* crisis than the real thing. Coming up with a comparable narrative today should not be difficult. It would of course require a tonal shift from the triumphalism of the Budget speech, but given the authenticity of the fiscal repair challenge and the prospect of further real wage stagnation, it should not take much to be convincing.

A good place to start would be Treasury's forthcoming Intergenerational Report, where less upbeat scenarios for productivity and immigration would help reset expectations. And the second installment of the Productivity Commission's five yearly Productivity Review, due out next year, offers a further opportunity to take stock and identify reform priorities, including in areas discounted previously based on presumed political infeasibility.

The more important issue is whether there is sufficient political will to rise to the occasion and successfully promote the sort of reform program that would make a difference. Former Treasurer Peter Costello has reportedly observed 'you cannot lead reform if you don't believe in it'. It has to be said that the signs at the Federal level (as well as in most states other than NSW) are not encouraging.

To the extent that there has been a political narrative about reform, it has tended to downplay its significance. Serious reforms in areas considered more challenging, such as taxation and energy/carbon, have been dismissed as 'vanity exercises', while other proposals in train have been abandoned when faced with opposition.

It remains to be seen whether the extreme pragmatism that has become the Government's hallmark, and arguably served it well during the pandemic, is up to the reform task that its fiscal response has now made imperative. The experience thus far, and in particular how the new 'pragmatic' approach to reform performed in the crucial industrial relations domain, provide few grounds for optimism.

*Paper for Minerals Week conference session 'Outlook for investment, jobs and growth', Canberra, 2 June 2021*.

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