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Dear Mr Brennan

Re: Productivity Inquiry

Thank you for the opportunity to provide a response in relation to the interim reports of the Productivity Inquiry (the Inquiry). KPMG was pleased to provide a response earlier this year to the Inquiry's initial call for submissions, outlining several potential reform areas that the Inquiry could consider.

As the Inquiry's overall interim report *A competitive, dynamic and sustainable future* states, competitive and dynamic markets drive productivity growth. Several factors have contributed to a slowdown in Australia's productivity growth, including relatively slow investment growth, especially outside the mining sector, limited competitive pressures and an associated slowdown in the entry and exit of firms.

In this response KPMG is addressing issues raised in the interim report *Innovation for the 98%*. This report points out that "business entries and exits underpin a culture and uptake of innovations" (p. ix), and yet it identifies in Australia "generally falling rates of firm entry and exits" (p. ix).

The Productivity Commission's report *Innovation for the 98%* finds that the existence of so-called "zombie businesses" has not been a significant factor in the slowdown in business entries and exits and hence in the diffusion of innovations:

> "Some evidence suggests that the number of businesses at the edge of financial viability ('zombie' businesses) has not risen as a share of businesses since 2007, and that these businesses have had limited adverse effects on aggregate firm performance (Bowman 2022)" (p. 17).

KPMG agrees with the conclusion that zombie businesses have not been a significant factor in the slowdown in business entries and exits but notes that measures might need to be introduced to help wind up a growing number of these businesses. During the pandemic, government support measures - including the temporary relief for directors from any personal liability for trading while insolvent[1], while necessary, impeded creative destruction. It is important that market forces are allowed to return so that capital and labour flow to their highest and best use.

[1] Fact_sheet-Providing_temporary_relief_for_financially_distressed_businesses.pdf (treasury.gov.au)

KPMG's most recent report KPMG Financial Performance Index Volume 11, looked at the end of the reporting season for the six months to December 2021. Following the sharp fall in financial performance in early 2020 due to the pandemic, subsequent KPMG FPI reports observed markets recovered strongly over the next 18 months. However, in the most recent report, KPMG finds that there are early indications of distress caused by interest rate and inflationary pressures, uncertainty caused by the Ukraine / Russian War, high fuel prices and ongoing supply chain disruption.

High-level findings

- The Australian economy has a larger proportion of its economic activities associated with economic rents – resource rents, land rents and oligopoly rents.
- The large-scale development of hard minerals such as iron ore, coal and bauxite is carried out by large corporations. Entries and exits from these industries are not as prevalent as in industries dominated by small and medium-sized businesses
- The growth rate of non-mining employee wages and profits has fallen to just 4.6% per annum, and once inflation (c. 2.5% p.a.) and employment growth (2% p.a.) are considered, the implied profile for productivity growth falls a long way short of the 1.5% per annum seen in earlier decades.
- Market concentration in non-export businesses is likely to lead to less entries and exists and a reduced level of innovation and diffusion.
- Policy makers should focus on several measures to increase economic dynamism and productivity including:
  - establishing strong trade and investment relationships with a focus on enabling trade in the services sector, through the alignment of regulations and accreditations (particularly labour qualifications) and further reforms of the migration and visa system;
  - developing policies that reduce barriers to entry in non-export businesses; and
  - enacting measures that help boost labour mobility by addressing structural rigidities in the labour market as well as reforming stamp duty and addressing the lack of cross-state recognition of formal qualifications.

Structure of the Australian economy

KPMG has focused on the structure of the Australian economy as a possible partial explanation of the problem identified in *Innovation for the 98%* of a slowdown in the diffusion of productivity-raising innovations. For example, compared with other advanced economies, the Australian economy has a larger proportion of its economic activities associated with economic rents – resource rents, land rents and oligopoly rents. The presence of these rents may distort economic incentives for innovation and diffusion within the economy, and so limit productivity growth.

Resource rents

The large-scale development of hard minerals such as iron ore, coal and bauxite is carried out by large corporations. While the companies developing these resources typically develop and adopt leading-edge technologies, entries and exits from these industries are not as prevalent as in industries dominated by small and medium-sized businesses. The same is true of the production and processing of Australia's natural gas resources. A consequence might be that for a similar level of overall economic activity in advanced countries that do not have abundant endowments of mineral and petroleum resources, there are many more firm entries and exits.

A country such as Australia with an atypically large share of its national income created by the development of resource rents can experience so-called Dutch disease. This occurs where a booming resources sector causes the real exchange rate to appreciate, which damages other sectors, specifically import-competing goods and services and non-tradable goods and services. It is possible that this impact on these sectors could slow the rate of diffusion of technology in those sectors.

As supporting evidence for this outcome, when the mining sector is separated from the rest of the economy, the performance of non-mining profits and wages growth is somewhat disappointing. Over the last 20 years, the growth rate of non-mining employee wages and profits was 5.3% and 5.4% per annum respectively, and over the last five years these growth rates have fallen to just 4.6% per annum. Once inflation (c. 2.5%) and annual employment growth (2%) are considered, the implied profile for productivity growth falls a long way short of the 1.5% per annum seen in past decades.

Land rents

Land rents are especially important in Australia's major cities. Along with tax efficiency considerations, the prevalence of land rents in cities such as Sydney is a reason for various proposals to replace stamp duty on property transfers with land tax. The prevalence of large land rents naturally increases the relative importance of activities associated with exploiting those rents, such as real estate sales and purchases and applications for favourable rezoning. A relevant question is whether these activities are less prone to firm entries and exits and associated diffusion of innovations than economic activity in countries where land rents are of lesser relative importance.

Oligopoly rents

Oligopoly rents arise from market concentration and there is some evidence that this has been increasing in Australia. See, for example, 2019 Australian Government research paper on Trends in Market Concentration of Australian Industries.[2] To the extent that this is occurring in export industries, it does not appear to be adversely affecting productivity, given that these businesses must compete in the global marketplace. However, it is likely to be of concern in non-exporting industries where market concentration may allow them to be less productive due to barriers preventing other firms from entering and competing, leading to the slowdown of firm entries and exits and the consequent diffusion of innovations.

Driving the diffusion of ideas and technologies

KPMG agrees that the diffusion of new technologies, processes and ideas is fundamental to enabling broad-based productivity growth. How to best support this will vary depending on the sector, and the nature of the innovation. Further, combining different mechanisms can have a multiplier effect.

The increasing importance of the services sector in Australia's economy will require new policies and supports to enable diffusion. Intangible capital has become vital, as it embodies the technical knowledge and understanding people need in order to work productively.

Furthermore, the type of machinery and equipment needed to fully harness the benefits of intangible capital is changing. Reliable and secure access to IT networks in multiple locations (homes and workplaces), connectivity, and the ability to process data tractably and tangibly are all key to fully unlocking the latest innovations in most parts of the service economy.

Unlocking these benefits requires continuous investment in the telecommunications network, and targeted policies to support continuous upskilling of the workforce, as discussed below. But on many global metrics Australia has fallen behind in recent years. For example, 90% of Australians regularly access the internet, but this is below the UK (95%), the US (91%) and NZ (92%) to name a few examples. Aspects of the country's IT infrastructure also lag behind; Australia had 0.04 secure internet servers per person in 2020, well below the high-income economy average of 0.065.[3]

It is also vital for business and organisation leaders to recognise the need to continuously investigate and implement the latest techniques and improvements in their fields. The need to focus in these areas is reinforced by Australia's natural features, in particular its geographic isolation and commodities endowment. As identified in *Innovation for the 98%*, Australia scores poorly on management capability,

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[2] https://www.industry.gov.au/sites/default/files/2019-09/trends-in-market-concentration-of-australian-industries.pdf
[3] https://data.worldbank.org/indicator/IT.NET.SECR.P6?locations=AU

suggesting further effort is needed to equip business leaders with the skills that will enable the adoption of the latest technologies.

As a small geographically isolated market, businesses in Australia are not subject to the same competitive pressures as those operating in economies that are larger and/or more connected, such as the EU and North America. The pay-off for foreign businesses for entering the market are relatively modest and together with the natural geographic barriers this dissuades entry and protects local firms. The relatively late arrival of Amazon and other e-commerce businesses is an example of this. As discussed below, a focus on establishing trade and investment relationships would help to push against this tendency and increase productivity diffusion.

The broader business environment

As identified in the previous section, Australia's geographic isolation provides local businesses with a degree of protection from foreign competition, which naturally lessens the imperative for firms to adopt the latest techniques and innovations. Further, opening of the local economy, through trade agreements and other economic relationships, would help to push against this tendency. Furthermore, any new trade agreement should have a strong focus on enabling trade in the service sector, through the alignment of regulations and accreditations (particularly labour qualifications) and further reforms of the migration and visa system.

Dynamism and churn through the labour market are also crucial to ensuring that productivity and technological improvements are diffused between businesses. Workers moving through the economy take new skills and techniques from organisation to organisation. This is a major benefit of skilled worker migration. But the annual rate of churn through the labour market has been declining since the early 1990s, from 12-15% of workers changing jobs to less than 10%.[4]

The ageing of the workforce as a result of Baby Boomers moving into the later stages of their careers might explain part of the slowdown in the churn rate; older workers are more likely to stay in their current roles than younger employees. There are also several structural rigidities in the labour market that encourage workers to stay in a role, such as employee benefits that are linked to length of service. Employee benefit 'portability' schemes have been introduced in some sectors such as community services, security and contract cleaning and it might be worthwhile considering the merits of these schemes across other industries.[5]
These rigidities are further reinforced by barriers to movement, such as stamp duty on property transfers and a lack of cross-state recognition of formal qualifications.

[4] https://www.abs.gov.au/statistics/labour/jobs/job-mobility/latest-release, prior to the twelve months to February 2022, the churn rate fell to a low of 7.5%.
[5] Portable Long Service Authority | Victorian Government (www.vic.gov.au)

Please do not hesitate to contact us should you have any additional questions or would like to discuss the contents of this letter further.

Yours sincerely

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