Resetting the Parameters to Enable a More Strategic Approach to Productivity Policy: Targets, Comprehensive Instruments and Quarterly Monitoring

Author Profile: Dr Bill Merrilees has a PhD in Economics from the University of Toronto, Canada; his research thesis focused on biased technical progress in Canada. He is a former (Professorial) academic, recently retired, and currently an Independent Scholar with an on-going interest in economic matters.

1. Background

The Terms of Reference acknowledge the acute problem of a slowing trend productivity growth. Submissions are invited to analyze productivity change; identify both challenges and opportunities for change; and couch recommendations in a policy-relevant way.

2. Recommendations

Recommendation 1. That the Commonwealth of Australia (Treasury) set a target range for productivity growth (quarterly, annual, and 3-yearly) in the same way that the RBA sets a target range for inflation.

Elaboration: Setting a target range would elevate the importance of productivity given that it is equally as important as inflation. Productivity is essential for (1) a rising standard of living, (2) a growing economy, which provides job opportunities and gradually reduces our fiscal debt, and (3) increasing trade security in terms of having more competitive exports. Currently, the Government can simply ignore or downplay productivity changes when reporting the quarterly national accounts. Official Treasury policy targets would demand increased fiscal responsibility, requiring serious policy analysis and action to report on and improve on productivity changes. A range allows for natural variations in the productivity measure and a three-year target allows time for major policy changes to be implemented and outcomes achieved and evaluated.

Recommendation 2. That the Government be encouraged to pursue specific economic reforms and structural changes, akin to the previous Five-Year Productivity Commission Review and updated in the Terms of Reference.

Elaboration: However, the Government made little response last time and so this ineffective response issue needs to be addressed. Indicatively, the Government should be strongly urged

to take responsibility by prioritizing and adopting, say, two of the suggested reforms to be implemented over say a 2-3-year period. Where possible the Productivity Commission suggested reforms should be "shovel-ready", that is almost ready for immediate implementation. This approach would get the Productivity Commission to focus on a short-list of no more than, say, four, suggested structural reforms (that lend themselves to doable, practical changes) and to develop these as much as possible. As the comments below strongly indicate**, structural reform recommendations must be supplemented by additional recommendations (See Recommendations 3, 4, 5, 7, 8, 9 below) which are more likely to impact on productivity growth.**

Recommendation 3. Additional sources of productivity could be acknowledged and supported with policy action. **The first additional source of productivity growth is faster economic growth**.

Elaboration: One of these additional sources of productivity is encouraging economic (GDP) growth in general. Surprisingly, the previous Five-Year Productivity Commission Review made little reference to that. Economic (GDP) growth is seen as vital for jobs and repaying fiscal debt. Additionally, economic growth stimulates productivity, with faster GDP growth stimulating increased capacity utilization, which directly increases measured productivity growth. Further, GDP growth stimulates investment which can be a vehicle for (embodied) technical progress and can raise productivity.

Recommendation 4. A second additional source of productivity is private and public investment per se.

Elaboration: Again, this factor received minimal attention in the previous Productivity Commission Five Year Review. Regardless of GDP growth, investment is a vehicle for technical progress. In part, this is attributable to capital widening, that is, increases in the capital to labour ratio. In part, it is also attributable to capital deepening, via embodied technical progress. The current rate of investment has been subdued in the recent decade or so, post GFC.

Recommendation 5. The Productivity Commission and Treasury, either separately or jointly, could conduct more technical studies into key aspects of productivity growth.

Elaboration: **Three topics stand out**.

Firstly, research is needed to understand the determinants of investment. Why has private and public investment been subdued over the past decade or more? One possible explanation is what several writers describe an age of uncertainty since the GFC. Global economies have not regained their full momentum since 2008, with speculation that there is an **aura of uncertainty** impacting business investment decisions. Research is needed to attempt to understand this uncertainty, partly triggered by the GFC, but exacerbated by unstable government parties or leaders; weak government policy especially on structural reforms; general distrust of politicians by the public; climate change uncertainty; Covid disruptions; and most recently, the Ukraine Crisis. Increased uncertainty adds a large risk premium to any investment ventures. A large risk premium swamps any benefits of lower interest rates. Studies are needed to test this phenomenon and indeed other possible factors bearing on the investment decision.

Secondly, research studies are needed to explicitly investigate the role of competitive intensity on productivity growth. An excellent and somewhat rare protype is the Treasury Working Paper 2022-01 entitled Researching for the Stars: Australian Firms and the Global Productivity Frontier by D. Andrews et al. Note, however, that Appendix 1 below provides some caveats to that particular study.

Thirdly, research can explore other determinants of productivity growth besides competitive intensity. It is possible that competitive intensity may explain just a minor part of the productivity slowdown. Greater public policy benefits might accrue from greater focus on these additional determinants of productivity growth, in addition to measures based on competition (such as greater powers to the ACCC or streamlining regulations). Note that Recommendations 6, 7, 8 and 9 below briefly address these additional determinants of productivity growth.

Recommendation 6. The Productivity Commission Report recommendations must be robust and comprehensive, covering policy action across several potentially major sources of productivity (such as Recommendations 3, 4, 7, 8, 9) and not confined to structural reforms (Recommendation 2).

Elaboration. Structural reforms are a means of improving productivity and dominated the First Five Year Review of the Productivity Commission. **Recommendation 2** above

reaffirms targeting such reforms, but perhaps with a greater sense of urgency and with more "shovel-ready" applications.

However, structural reforms alone are likely to have only a marginal effect on the productivity rate. *The Terms of Reference do acknowledge the potential role of and need for other determinants of productivity*. Additional sources of productivity growth need to be addressed if there is to be a discernible turnaround in the productivity rate. **Recommendation 3** above highlights increased (and more stable) GDP growth as a major source of future productivity growth. **Recommendation 4** above highlights increased private and public investment as another potential major source of future productivity growth.

These critical sources of future prosperity are unlikely to be sustained without a major commitment by the Australian Government to **treat economic productivity policy as an explicit Government target**. Such a need is addressed in **Recommendation 1** above. KPI's are a standard tool of private enterprise to set targets and measure quarterly performance against those targets. Governments need to be transparent and accountable. Their budgets greatly exceed most enterprise budgets.

Three additional sources of potential productivity growth are presented in Recommendations 7, 8 and 9.

Recommendation 7. An additional source of productivity is speeding the Slater Type diffusion of technology through embodied capital investment.

Elaboration: The Cambridge economist W. G Salter long ago emphasized the diffusion of technology through investment in plant and equipment. Best practice technology is gradually diffused through an industry via the renewal (lagged) process of replacing older (less technologically advanced) equipment when their economic life is reached. At any point in time, there will be a gap between best practice and average practice. Salter argues that it is not economical to instantly introduce best practice technology to all firms; firms need to calculate the net benefits and costs before making an investment decision. An advantage of this Salter approach is that the diffusion of new technology can be anchored into the practical

machinations of investment decisions and can facilitate policy actions. Thus, incentives (both financial, but also a more stable and optimistic policy framework which builds investment confidence) to stimulate investment will achieve firstly a potential increase in the capital-labour ratio which can increase labour productivity, and secondly, as a by-product, increase embodied technical progress (as the new capital replaces the old capital). An interesting aspect of such a framework is that even repair and maintenance activities can sometimes embody the latest technology, such as with the simple example of LED lights replacing traditional lights. Most investment decisions are likely to be more related to the best practices operating at a detailed sub-industry level, such as a blast furnace, rather than the more abstract global frontier level.

Recommendation 8. An additional source of productivity is increasing the level of entrepreneurship.

Elaboration: Entrepreneurship is a major source of innovation across many fronts. It can operate at many levels, including new technology, digital technology, new markets, new products and new processes. It is a potentially an important source of productivity and needs serious and deliberate research, especially in the explicit context of productivity change. For example, in the unexpected context of franchisor-franchisee systems, one might expect that franchisors would install a common and well-established business system across all franchisees. However, in reality, about a quarter of franchisees are able to achieve a much higher rate of performance/productivity through their own innovative/entrepreneurial skills [B. Merrilees & L. Frazer, Entrepreneurial franchisees have hidden superior marketing systems, Qualitative Market Research, 9(1) 2006]. A broader lesson here is that, especially in the service sector, skills and learning-by-doing can make their own contributions to productivity advance. The challenge is to propagate (diffuse) this learning to a larger proportion of firms in a given industry and for public policy to encourage the propagation, directly or indirectly, where possible and appropriate.

Recommendation 9. An additional source of productivity is investing more in human capital formation, such as education, training or skills development.

Elaboration: Such investment in human capital could indirectly influence productivity via building entrepreneurship skills for example (and linking to Recommendation 8 above). However, there could also be direct influences. Building our expertise in digital technology is

touted as a worthwhile investment. It is also useful and necessary to build expertise in existing leading industries, such as mining and agriculture, as well as emerging leading industries, such as advanced manufacturing (especially food and health) and the renewable energy sector (such as hydrogen).

Summary of Recommendations

Structural reforms remain a potential means to increase Australia's productivity rate. Notwithstanding, the last time (in the previous Five-Year Productivity Commission Review) the suggestions made by the Productivity Commission had limited take-up by the Government. Recommendation 2 provides some ideas (among other possibilities) on how to improve such a take-up.

However, structural reforms are unlikely to boost the annual productivity rate by more than, say, a couple of decimal points. **Other sources of productivity growth need to be seriously considered as part of a comprehensive productivity policy (see Recommendation 6) if we want to increase productivity growth in a sustained way by a sizable margin, say 0.5 to 1.0 percentage points.** The current submission outlines five additional ways to do this, without being exhaustive:

- Increase the rate of economic growth (**Recommendation 3**).
- Increase the rate of private and public investment (**Recommendation 4**).
- Increase the rate of diffusion of best practice technology (per W. G Salter) which advances embodied technical progress (**Recommendation 7**).
- Increase the level of entrepreneurship across all of its fronts, but particularly in the context of increasing productivity (**Recommendation 8**).
- Increasing investment in human capital (**Recommendation 9**).

All of the above recommendations, particularly Recommendations 8 and 9, could benefit from additional research, which would enable more targeted policy responses. Recommendations 3 and 4 are self-evident, though Recommendation 5 indicates that more research, over a phased time period, into investment determinants would be beneficial.

However, that research should not obviate some initial efforts to boost the investment rate. Encouraging greater investment would also benefit Recommendation 7, regarding speeding up the diffusion of best practice technology.

Most of these (and other) recommendations will probably fail unless the Government takes its fiscal responsibility seriously, which is addressed by the Treasury setting productivity targets, as outlined in **Recommendation 1** above. Governments talk about how good they are as economic managers, but good private enterprise managers set realistic, though stretching, objectives (KPI's; targets) and report performance outcomes on a regular (quarterly) basis. The RBA does this regards inflation, but such accountability is lacking in the more important fiscal arm of Government. Currently, Federal Government parties tend not to treat productivity with the respect or care which it requires. The productivity numbers are ignored or downplayed each time the quarterly GNP figures are released. From time to time, Federal Governments make some very relevant productivity announcements, but these are ad hoc and short-lived. A case in point is the Turnbull Government making some interesting innovation policy changes, which were quickly forgotten about. Such practices and examples reflect a lack of fiscal responsibility, which guarantees that we will fail to solve the productivity decline problem.

The bottom line is that the Productivity Commission must provide a more comprehensive, robust, radical, breakthrough Report, akin to disruption technology in the rest of the economy. The report needs to elevate productivity to a major policy goal of the Government, with targets and monitoring akin to the RBA setting and monitoring inflation targets (something akin to Recommendation 1). Such targets would force any Federal Government to establish appropriate productivity policy instruments (akin to Recommendations 2, 3, 4, 7, 8, 9). **Explicit productivity targets, a comprehensive set of productivity instruments and quarterly monitoring represent a more strategic approach to Government productivity policy**. The APC can continue to provide invaluable support, with relevant research, overall evaluation of the productivity policy and special inquiries as per its current mandate. The alternative would be a failure to confront the Government (of either Party) with a demand for greater fiscal responsibility regards productivity and to seriously consider additional sources of productivity growth. Failure to be more robust will ensure that marginal changes

(potentially worthwhile as part of a broader strategy) will be suggested (and largely ignored) and we will continue with short-lived, piecemeal Government innovation policies and continue to record very low rates of sustained productivity, with a reduced standard of living relative to potential. Australia will be less able to fund roads, social service improvements, health, education and defence. **The opportunity cost of weak recommendations is of the order of 10 billion dollars per year (based on a failure to lift productivity by 0.5 to 1.0 percentage points per year). We cannot afford another five years in the doldrums for productivity advance**.

Dr Bill Merrilees.
PHD (Econ) (University of Toronto), MA (Econ) (University of Toronto), BCOMM (Hons I) (Economics) (University of Newcastle)

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Note: Thank you for the opportunity to make a public submission to the Productivity Review. I welcome the opportunity to discuss my submission in greater detail.

Appendix 1: Critique: Some Caveats to Treasury Working Paper 2022-01.

Elaboration: Methodology-wise the Treasury paper seems strong and ranks highly for its overall quality. However, there are some major limitations of the Treasury paper in terms of its relevance for explaining the decade-long slowdown in average Australian productivity.

The **first** major caveat is directed to the concept of the "global productivity frontier", the central concept in the Treasury paper and refers to the productivity of the five most productive companies in the world. It is not quite clear what level of aggregation applies (is it total manufacturing or two digit level or what). While this concept recognizes the global nature of technology leadership and is inherently interesting, it may bear no necessary relevance to Australian enterprises. For example, if the top five global productivity firms are in say vehicle or aircraft manufacture, then their technology and productivity performance are not necessarily very relevant to Australian firms. It would be interesting to redo the analysis using the Australian frontier firms as the benchmark, which would be more relevant and be a more appropriate benchmark to undertake the same analysis.

Secondly, regardless, Australian firms may lack the scale to implement global frontier technology, and thus scale could also supplement competitive intensity as an explanation for the slow Australian diffusion of global frontier technology.

Thirdly, although suggestive, the Treasury Working Paper study does not directly contribute to an explanation of the slowdown in productivity growth in Australia. The Treasury study simply shows that the Australian speed of diffusion of global frontier technology has slowed, and that competitive intensity is a primary determinant of that slowdown. Explaining diffusion of global frontier technologies does not equate to explaining average Australian productivity growth. Different phenomena (concepts) are at play. The Treasury study findings are hypothetically consistent with no slowdown in productivity growth in Australia. combined with an exceptionally fast rate of progress in the global frontier firms (interestingly both trends are crudely consistent with the data in the Working Paper tables). Does it really matter that five companies have bolted ahead of the rest of the world? Certainly, no explicit evidence was provided in the Treasury paper on the extent, if any, that the slower diffusion of frontier technology has the slowdown in the average Australian productivity growth.