

BCA

Business Council of Australia

# Submission to the 2022 Productivity Commission Productivity Review

March 2022



# Contents

1.	<b>Overview.....</b>	<b>2</b>
	Drivers of productivity growth.....	2
	Productivity matters for living standards.....	3
	Investment matters for productivity.....	3
	Investment is weak when Australia needs it most.....	4
	Foreign investment is turning away.....	5
	What are the drivers of weak investment?.....	6
	Box 1: The decline of Australian competitiveness.....	7
	The case for investing in Australia has been made more difficult.....	8
	Global investment landscape is changing.....	9
	Human capital will become more critical.....	9
	Climate transition will be a new source of productivity growth.....	9
2.	<b>Lifting productivity growth.....</b>	<b>10</b>
	The role of the Productivity Commission.....	12

# 1. Overview

This submission responds to the call for submissions as part of the Productivity Commission's 2022 Productivity Review.

Productivity is no longer just an issue for the longer term. It has become a red line issue impacting on inflationary pressures that are building on the supply side of the economy, the need to revive lacklustre wages growth and the need to start tackling a trillion-dollar public debt. Every additional 1 per cent GDP increase means the economy is around \$20 billion larger and delivers around \$5 billion extra tax revenue.

Future governments cannot afford to ignore this productivity review.

The list of possible productivity-enhancing reforms is long. This submission does not attempt to list them all but focuses on the key priorities from a business perspective needed to turn around Australia's productivity performance.

## Drivers of productivity growth

The Business Council agrees with the Productivity Commission's assessment that "lifting productivity growth rates is the only sustainable way to ensure Australians experience income growth similar to that of the past few decades."<sup>1</sup>

Productivity growth has slowed and plateaued for two decades. This is at the core of the recent weakness in GDP, real incomes and real wages growth in Australia. The weakness in labour productivity growth is even more pronounced on an employment basis compared with an hours basis. This is due to falling average hours worked and points to the importance of lifting participation.

**Figure 1: Rolling 10-year average labour productivity growth, hours vs employment basis**



Source: ABS

The only way to sustainably grow real wages is through faster GDP and productivity growth. This relies on an ongoing process of improvement in our human and physical capital, and innovating to produce existing goods and services in a better way or developing new ones. It is also about allowing our resources to be allocated where they can create the most value.

That in turn means lifting investment and making Australia a more competitive economy. To do this, Australia must have competitive tax and regulatory settings, and remain open to global markets for goods, services, talent

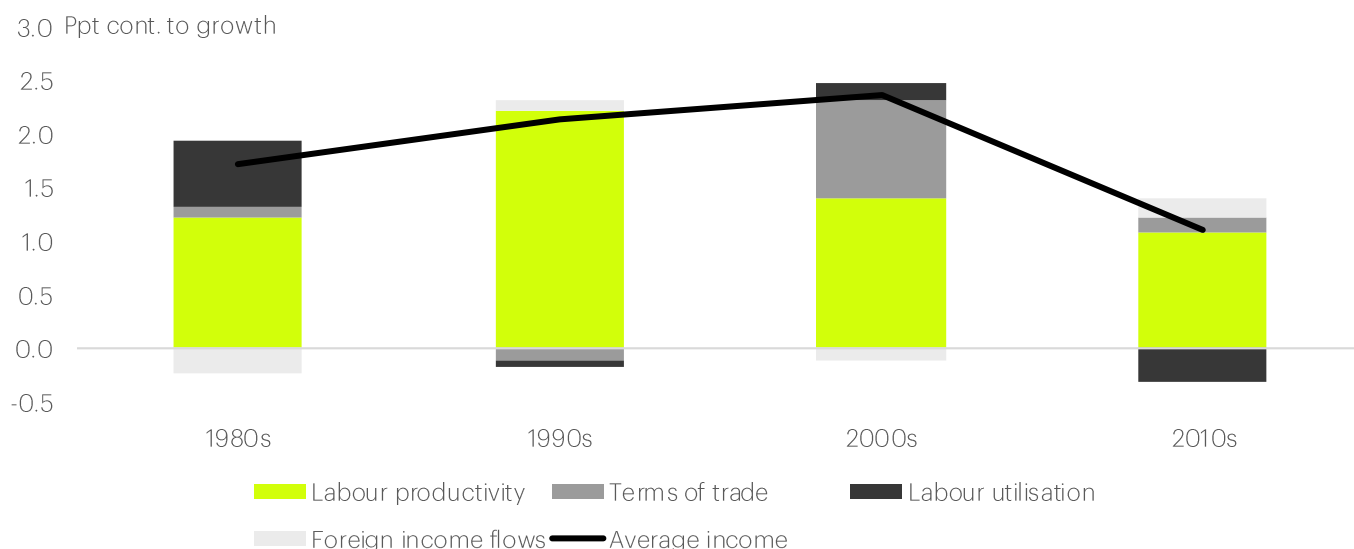
<sup>1</sup>Productivity Commission, Australia's productivity performance: Call for submissions, February 2022.

and new capital – critical elements for promoting innovation. It also means making sure our education and skills system is set up to help young people prepare for their future and for all workers to undertake life-long learning. Another element means ensuring we remove barriers to participation in the workforce, ensuring all our working age population have the opportunity to make their best contribution to the economy.

## Productivity matters for living standards

The 2010s were the worst decade for growth in living standards in 60 years. On projections released by the Treasury, the 2020s will be even worse. Labour productivity has been by far the single most important driver of Australia's economic growth over the long term. It has accounted for 80 per cent of the improvement in average income growth over the past 40 years.

**Figure 2: Contributions to growth in average real per capita incomes**



Source: ABS

## Investment matters for productivity

While productivity drives growth it is investment that drives productivity.

Both the Productivity Commission and the Treasury have acknowledged the importance of investment – capital deepening – for Australia's long-run growth prospects. Over the past 40 years, investment has been the main driver of labour productivity growth, accounting for two-thirds of the growth.

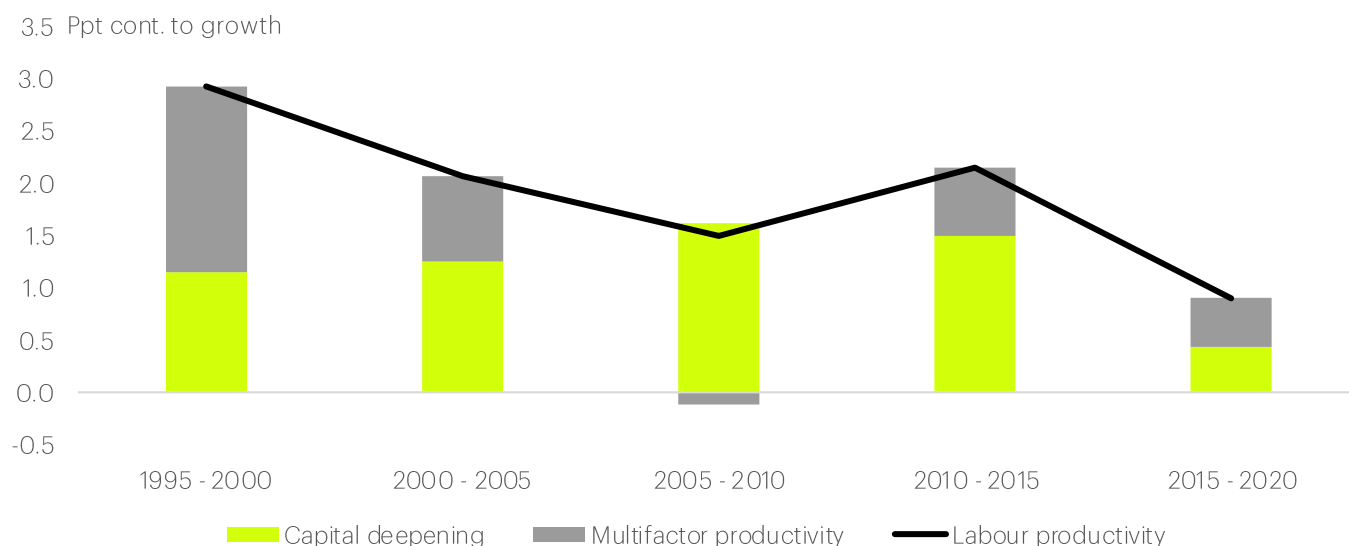
- This means investment has driven over half the improvement in living standards (average income growth) over the past 40 years.

Labour productivity growth has been below the long-term average of 1.5 per cent for several years. And for the five years prior to the pandemic, it averaged growth of less than half a per cent a year. When looking at the individual components driving labour productivity growth:

- Capital deepening (i.e. how much companies invest) has declined as new business investment remains weak due to a broad-based decline and in 2021 was at a record low as a share of GDP.
- Multifactor productivity (i.e. how innovative companies are) has not grown since 2001-02, and fell the past three years.

This weakness in the core drivers of labour productivity growth should therefore be of paramount concern. To illustrate, the contribution of capital deepening to labour productivity growth fell significantly the past five years. If it held up at its 20-year average, then average incomes would be around 5 per cent higher today, or around \$4,000.

**Figure 3: Over time, business investment has been the main driver of labour productivity growth**

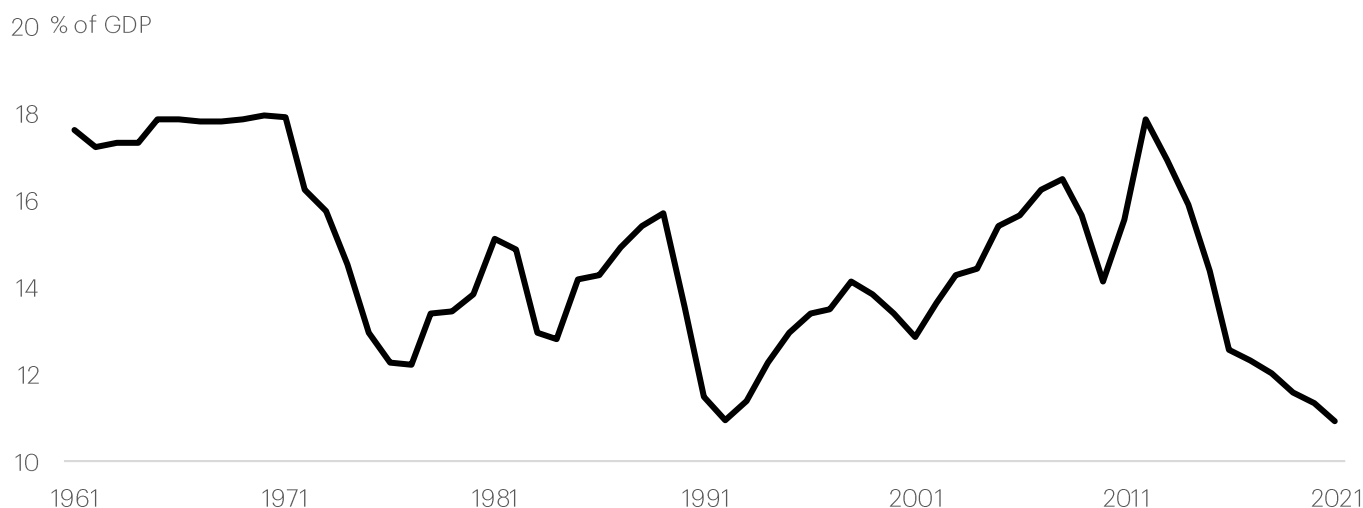


Source: ABS. Note: years refer to financial year ending.

## Investment is weak when Australia needs it most

New business investment was at a record low in 2021 as a share of GDP. Prior to COVID-19, business investment was already on a weak trajectory. In part, this reflected the fall from the peak of the resources investment boom, but it also reflected weakness in non-mining investment. Non-mining investment averaged around 11 per cent of GDP from the mid-1970s to the onset of the global financial crisis. It subsequently fell to around 8 per cent of GDP and is yet to recover to pre-crisis levels.

**Figure 4: New business investment as a share of GDP**

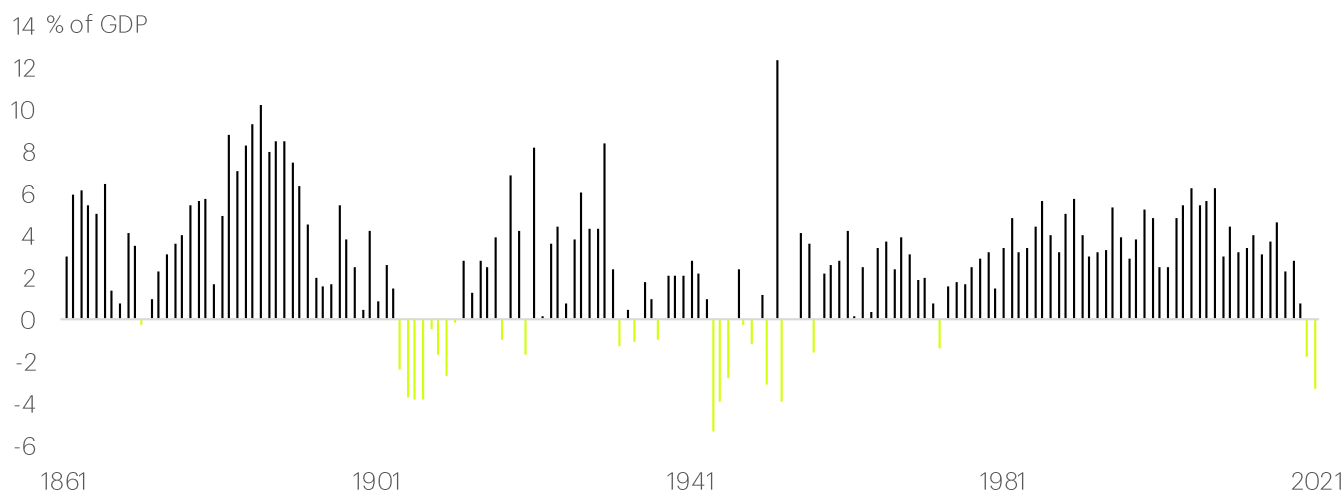


Source: ABS

Investment is also flowing out of Australia when we most need it. Australia has been a net capital importer for most of the past 200 years. That is, foreign investors have tended to invest more in Australia than Australians have invested offshore. Those investors have brought with them technology and new ideas that have helped drive our productivity growth. However, in 2019-20 there was a net outflow of capital for the first time since the 1970s and another outflow in 2020-21. The two consecutive years of outflows are a first since the late 1940s.

The capital account deficit is a mix of both falling investment into Australia and increased investment offshore. If direct investment into Australia had held at the average of the previous decade, Australia's capital account would almost have been in balance in 2019-20 and surplus in 2020-21.

**Figure 5: Australia's capital account balance**



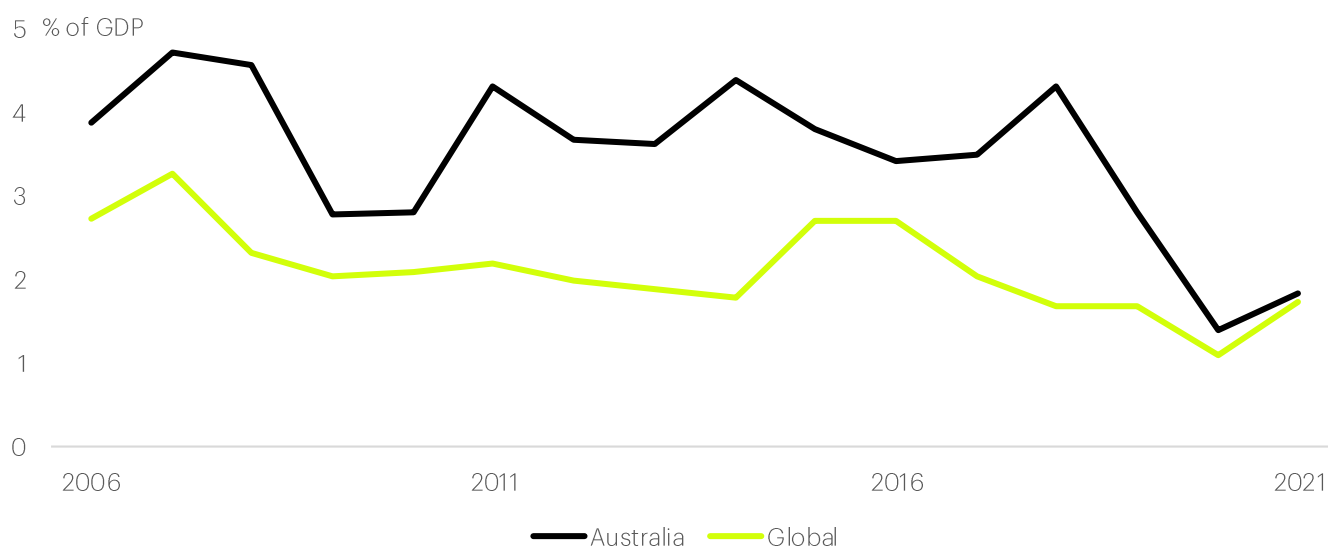
Source: ABS and Productivity Commission

## Foreign investment is turning away

There are many factors that influence foreign direct investment (FDI) inflows into Australia. From a macroeconomic perspective, Australia's economy has outperformed that of many other advanced economies the past two years. Indeed, this is reflected in FDI data with FDI inflows bouncing back in 2021. However, while global FDI inflows have recovered globally, they remain well below pre-COVID levels in Australia.

Looking ahead, there are no guarantees that global capital flows will return to previous levels any time soon. The COVID crisis has turned many countries inward, and rising geopolitical tensions may further discourage cross-border capital flows. This could raise the bar on attracting global capital and Australia cannot assume that capital will flow here in the same way that it did in the past.

**Figure 6: FDI inflows as a share of GDP**



**Source: ABS, IMF and UNCTAD**

Australia must send clear signals to foreign investors that it is open for business. Poorly designed foreign investment screening can dampen investment. The pervasive nature of Australia's foreign investment regime is increasingly putting sand in the wheels of even Australian firms making domestic investments – simply because they have interactions with a foreign-owned business. The Business Council's recent [submission](#) on the foreign investment reforms provides further detail.

## What are the drivers of weak investment?

There have been a number of government reviews of the weakness in investment, including Treasury's 2017 *Intergovernmental Review of Business Investment*. There has been a tendency to explain away weak investment – and productivity – as due to a 'mix of factors' and influenced by global factors outside of our control. While there has been a global decline in investment and productivity growth, there are many factors that are within the control of government and levers that have not been pulled to shift the dial on investment. And we need to think more carefully about the global factors affecting investment and how we respond to them.

Business Council member companies have identified the cumulative burden of regulation as a significant issue. Investors wanting to bring innovation and investment to Australia face a regulatory 'house of horrors' with the front door being an increasingly formidable FIRB process. Attracting the investment we need and protecting our security and sovereignty are not mutually exclusive. Once through the front door investors are faced with duplication/inconsistencies across the Federation, frequent changes to laws and regulations, and a poor understanding from policymakers and regulators of the complexity, time and cost to implement changes. For example:

- A major retailer with a national presence must deal with over 500 different laws, regulations and inquiries. In addition, there are more than 500 local councils with their own sets of rules.
- There were almost 400 public health orders issued as at the height of the Delta outbreak across all states and territories last year.
- The regulatory costs of our cross-border trading system are \$4.3 billion every year, due to complex, duplicative or manual regulatory requirements. Around a fifth of cross border trade regulations are duplicated in some way across agencies.

The patchwork of regulation that exists across Australia has a chilling effect on investment and dynamism, adds significant costs to businesses operating across multiple jurisdictions, creates barriers to entry for new firms, and is ultimately a barrier for companies growing and expanding – let alone trading across state lines or overseas. For

example, in 2018 SMEs accounted for 14 per cent of Australia's exports compared with a G7 average of 25 per cent.

The COVID-19 pandemic has also had a significant impact on investment, such as through elevated uncertainty and measures to contain its spread. It has also changed the way we live, work and consume, while fiscal support measures such as temporary full expensing and loss carry back sought to arrest the decline and support the transition. While these measures have supported a recent uptick in investment in real terms, it has been concentrated in the types of investment that benefit from temporary tax incentives. This will involve an element of bring forward and investment could go backwards when they expire. There will be a need to drive a sustainable increase in investment in the medium term.

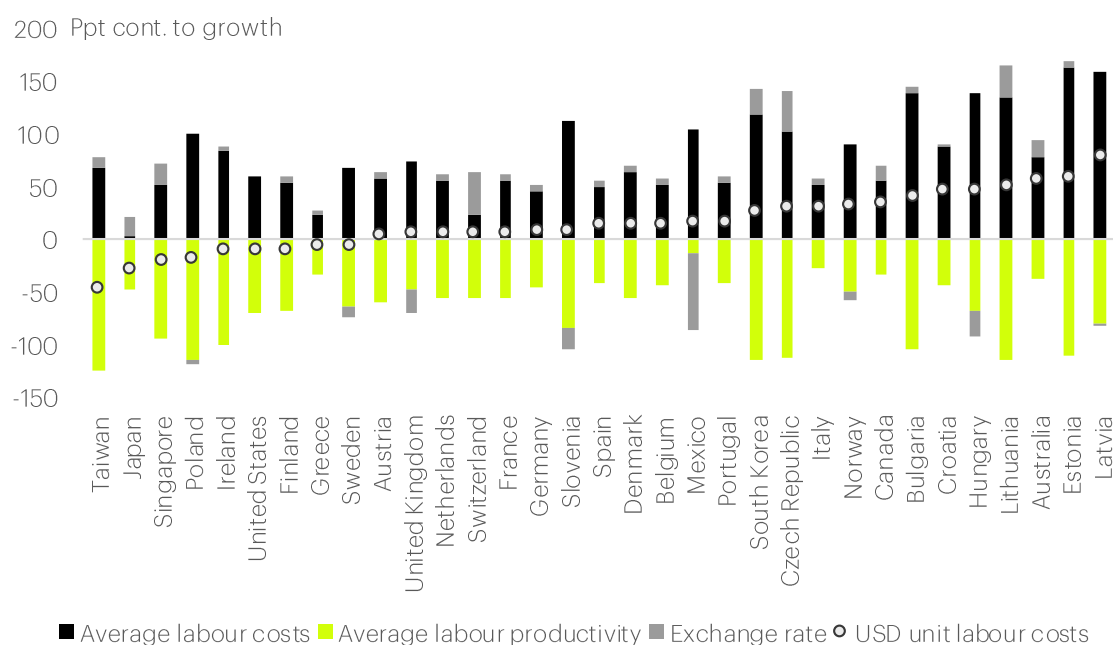
## Box 1: The decline of Australian competitiveness

A key indicator of business competitiveness – and a measure closely related to productivity performance – is the measure of real unit labour costs. Simply put, this is the cost of labour adjusted for labour productivity.

Unit labour costs will decrease (or increase by less) as workers are supported by more capital and as multifactor productivity increases. In Australia, real unit labour costs have been falling the past several decades but this consistent downward trend has changed since the global financial crisis.

An international comparison of manufacturing unit labour costs reveals Australia has experienced one of the biggest increases in unit labour costs the past two decades. This means the competitiveness of Australian businesses has fallen relative to most other countries. It highlights the vital importance of lifting investment and productivity growth and shows that what Australia is experiencing is not just a global phenomenon – other countries are performing better on a range of metrics.

**Figure 7: Growth in manufacturing unit labour costs 1998-2018, USD basis**



Source: The Conference Board



## The case for investing in Australia has been made more difficult

The equation a company and a board goes through when making investment decisions revolves around assessing the portfolio of potential investments across different entities, projects and countries. These investments compete for a finite pool of capital within companies. Questions are raised about the risk and return from each investment, which in turn is based on factors such as regulatory conditions and approvals, operating costs, certainty, and after-tax returns. The planning approvals system in particular can create significant uncertainty and risk around a project's outcome – in addition to substantial additional costs and delays.

The less competitive Australia is on any of these factors, the more roadblocks stand in the way of companies investing in Australia. That takes jobs and investment that could have been in Australia and puts them somewhere else. We do not know all the investment Australia may have missed out on as it is not typically broadcast – but it is felt through less new investment and slower jobs growth.

For more than a decade, regulation and intervention are increasingly the first resort of policy makers to deal with a perceived market failure and cost-benefit assessments of new policies are either by-passed or given mere lip service by governments. For example:

- over the past five years, around half of regulatory impact statements (RIS) were considered 'best practice'
- between 2009-10 and 2012-13 there were 31 RIS exemptions given.

Recent years have seen governments abruptly change the rules of the game, increasing risk premiums for future projects. There has also been a long line of 'one-offs' and measures that give broad scope and power for unnecessary and excessive interventions in business practices such as around energy divestiture and critical infrastructure. When taken together, they are increasing risk and chilling decisions to invest in Australia. Fines have also been dramatically increased, for example:

- a one-day late income tax return can attract a \$111,000 penalty for a large business
- failure to lodge a Payment Times Reporting Scheme report can attract a \$66,600 penalty per day
- not providing a point of contact under the news media bargaining code can attract a penalty of up to \$1,332,000
- minor breaches of the increasingly complex FIRB legislation can carry fines of over \$300,000 while major breaches can attract fines of up to \$555 million.

Businesses with the largest balance sheets have been the target of ad hoc tax increases, additional compliance measures, increased reporting requirements, and additional/higher penalties. While business acknowledges the right of governments to regulate in the national interest, the cumulative effect of changes and their broader impacts on economic performance (also part of the national interest) can be overlooked.

All things considered, these actions undermine the incentives that drive businesses to invest and innovate in Australia, drive a compliance culture and are not conducive of rekindling confidence.

## **Global investment landscape is changing**

Australia also faces challenges in respect of how it attracts investment in the new industries that will drive productivity and growth into the future.

These opportunities will be less focussed on traditional areas of strength. Instead, the global push towards clean technologies and the revolution in digital technology will present significant opportunities for new investment. Australia has some natural strengths in these new and emerging areas but also faces challenges.

Environmental social and governance (ESG) investing has also gained traction in recent years as investors increasingly consider long term outcomes and alignment with climate and sustainability objectives. In turn, this will impact productivity growth in both the short and long term. Australia must ensure it is on the right side of the shift to ESG investment, leveraging it as an advantage not a new source of disadvantage.

The small size of our domestic market and distance from key markets in North America and Europe is a disadvantage in getting new technologies to scale. In addition, our relatively small domestic talent pool makes it more difficult to compete in emerging industries where human capital can be more important than physical capital. Market participants have also suggested that our ability to deploy capital quickly relative to other markets can be held back by policy and regulatory constraints.

We need to ensure we have a tax and regulatory system that overcomes some of our areas of disadvantage and helps us be more competitive. And it becomes even more important that we develop our human capital to succeed in new industries. This means getting our immigration settings right and getting the most out of our workforce through raising participation (e.g. improving access to child care) and skilling up the workforce.

## **Human capital will become more critical**

The global trend towards lower investment as a proportion of GDP reflects in part a transition into less capital-intensive businesses, especially in the technology sector. Whether new less capital-intensive industries expand rapidly in Australia depends on several factors, including having ready access to the human talent required to build the companies. This means building an onshore talent pool but this will require reform in our skills and education systems. It also means being able to recruit relevant employees from offshore to work in Australia as it will continue to be the case that much of the innovation occurs offshore, and the new skills supporting that innovation will first be developed offshore.

## **Climate transition will be a new source of productivity growth**

Australia's response to climate change can no longer be considered a discussion about environmental values but has become a central economic issue. Australia's economic fortunes will increasingly depend on how well it manages the energy transition associated with a lower carbon economy. This transition will provide opportunities for investment into new technologies. Cleaner, cheaper technologies can help shift the dial on our productivity performance.

This transition will not happen organically. It will require public and private investment in the technologies that will drive cleaner energy. It will also require investment in the skills needed to support the transition which comes back to the question of human capital.

## 2. Lifting productivity growth

It is possible to write a very long 'To-Do List' of the reforms needed to improve Australia's productivity performance. But such a list will be of no value without a change in mindset. The starting point of that change in mindset is recognising that the productivity challenge is an urgent priority, not something to worry about sometime in the future.

The Business Council considers the game-changers for turning around Australia's investment and productivity performance as:

**Maintaining an open economy that is more competitive on the world stage.** Fundamental to this is keeping the borders open. It also means building relationships to advance Australia's economic integration in the Indo-Pacific. We have a small domestic market and will only ever reach efficient scale by accessing global markets. It also means sending a more positive message to foreign investors.

A very practical concern is **securing international supply chains**. While Australia cannot control the global shipping and freight crisis that is hampering supply chains, it can reform at home to reduce costs and remove pressures. The Productivity Commission inquiry into Australia's Maritime Logistics System will help in this regard, as will continuing to progress the work of the Simplified Trade System Taskforce. Australia should also consider removing remaining tariffs which now raise minimal revenue but create a massive bureaucracy and impose significant red tape.

**Tackling tax reform.** The current tax system is a handbrake on investment and productivity. Without re-prosecuting the arguments in this submission, it is sufficient to note that problems with the tax system have been shown in multiple reviews and tax is a major lever governments can use to promote productivity growth. Addressing issues such as the over reliance on direct taxation, the mismatch between federal and state taxes and spending, the volatile and inefficient state tax base, a globally uncompetitive tax rate for companies with turnover above \$50 million, and fragmented payroll tax regimes all need to be on the table for reform.

Undertaking **reforms of government services** to improve productivity in the public sector and manage funding pressures in key programs. The Productivity Commission's last productivity review in 2017, *Shifting the Dial*, made a series of recommendations to improve delivery of government services.

**Changing the regulatory mindset.** All governments should commit to delivering best practice regulation making by being clear about the problem to be solved for, ensuring Regulatory Impact Statements identify risks and ensure they are tracked over time, and reviewing the existing stock of regulation on a regular basis to ensure it remains contemporary and fit for purpose. Business and the public sector should work collaboratively to solve the right problem, with the right regulation in the right way.

As part of this, National Cabinet should commit to a regulatory reform program focused on encouraging governments to reform their regulations in line with the best performing jurisdiction and a focus on improving the ease of doing business. The Productivity Commission should be charged with informing and prioritising this agenda, for example this could include planning approvals and road user charging/electrical vehicles. In this context, the Business Council notes that even smaller reforms can produce significant cumulative benefits. To illustrate:

- A move to a paperless cross border trading system could lift GDP up to \$1.7 billion a year.
- Reforms to allow companies to hold virtual meetings, distribute electronic documents and electronically execute documents are estimated to deliver savings of around \$450 million a year or \$4.5 billion a decade.
- The NSW Government evaluated and announced it will make permanent the relaxation of many regulations that were temporarily eased during COVID, helping to realise benefits of \$3.1 billion over a decade.

As outlined above, regulation should also be considered as part of the barriers it creates to risk taking. Consideration could also be given as to the impact of Australia's insolvency framework for risk taking and

business dynamism. A more flexible and streamlined system was recently introduced for small businesses, and consideration should be given as to how the insolvency framework could be improved for all businesses.

**Investing in human capital** to develop the capability for success. Technological and economic changes will provide opportunities for new and better jobs, but only if the nation has an agile education and skills system that keeps pace. In schools, performance in literacy and numeracy, which has been slipping for too long despite sustained increases in funding, needs to be urgently turned around.

In respect of higher education, the National Skills Commission projects that 90 per cent of the million new jobs created out to 2025 will require a post-secondary school qualification, with over half requiring a bachelor degree or higher. As it stands, close to 30 per cent of the labour force lacks these post-school qualifications. A stronger emphasis is also needed on lifelong learning so that Australians can refresh and update their skills through their careers.

Continued commitment to our **migration program** will also be important to ensuring we attract individuals with new and emerging skills. This means maintaining migration in sufficient numbers to bring in these skills but also thinking carefully about the composition of the migration program to ensure it targets the right skills and provides enough flexibility for employers to access those skills.

Ensuring the **workplace relations system** encourages the new investment and innovation needed to drive productivity growth. Right now, the outdated and clunky nature of the system acts as a handbrake on labour productivity. This has seen a significant decline in the use of enterprise bargaining, which was introduced in the 1990s so employers and their teams could work together for mutually beneficial productivity improvements. The Productivity Commission's 2015 report on the *Workplace Relations Framework* set out a roadmap for reform.

Actively **supporting new industries** to modernise and diversify the economy. If Australia is to shift to a path of higher growth and higher wages it needs to find new sources of productivity growth. This is fundamentally tied to the question of how we attract investment in the new industries that will drive productivity and growth into the future.

As is well understood by the Productivity Commission, modern industry policy cannot be about propping up unsustainable industries. The world has moved on and we need a more sophisticated debate. The challenge is one of adapting to a changing environment and producing to scale to be globally competitive. It is about creating the conditions for industry to adapt and for good ideas to be commercialised and scaled up through collaborative research and development. It is about finding adjacencies and value add opportunities in existing industries where we have a comparative advantage in global supply chains.

In practice, Australia needs to build consensus around the priorities identified in the Modern Manufacturing Strategy. A focused and concerted effort in these key sectors will be needed over a decade or longer to give businesses the certainty to make the long-term investments needed to grow and create jobs.

## The role of the Productivity Commission

The Productivity Commission must be empowered to examine priority areas impacting on Australia's productivity. The Productivity Commission was originally established to take a step back from the more complex issues impacting productivity and provide the balanced and expert advice needed to help governments solve difficult problems. It is important that it again plays this role.

There are a range of emerging pressures that will impact Australia's productivity performance, as well as its ability to deliver key services. These include:

- provision of child care and early education
- addressing reform of Federation in the delivery of critical services like health, aged care and vocational education
- a focus on harmonisation across the Federation with state and territory governments encouraged to reform their regulations in line with the best performing jurisdiction, such as for planning approval systems
- reviewing the structure and funding of major programs like the NDIS and aged care.

The Productivity Commission is uniquely placed to work through these issues and provide the impartial advice to inform different levels of government.

Mission creep on the part of regulators has seen regulation and intervention increasingly seen as the first resort, without sufficient scrutiny of the additional regulatory burden being imposed.

To really shift the dial on productivity it is important the Productivity Commission is able to give this advice and that this advice is listened to and acted on by governments.

BUSINESS COUNCIL OF AUSTRALIA

42/120 Collins Street Melbourne 3000 T 03 8664 2664 F 03 8664 2666 [www.bca.com.au](http://www.bca.com.au)

© Copyright March 2022 Business Council of Australia ABN 75 008 483 216

All rights reserved. No part of this publication may be reproduced or used in any way without acknowledgement to the Business Council of Australia.

The Business Council of Australia has taken reasonable care in publishing the information contained in this publication but does not guarantee that the information is complete, accurate or current. In particular, the BCA is not responsible for the accuracy of information that has been provided by other parties. The information in this publication is not intended to be used as the basis for making any investment decision and must not be relied upon as investment advice. To the maximum extent permitted by law, the BCA disclaims all liability (including liability in negligence) to any person arising out of use or reliance on the information contained in this publication including for loss or damage which you or anyone else might suffer as a result of that use or reliance.