Increasing Australia's future prosperity: response to the Productivity Commission Discussion Paper November 2016

This submission argues that the focus on growing productivity is a misplaced approach to improving Australia's future prosperity. Productivity is a poor measure because it is fundamentally a derivative measure of the real area of interest which is GDP growth. It is a poor measure because most methods of quantification are flawed. And it is a flawed measure because it leads to an incorrect conclusion that economy wide productivity is a function of firm level efficiency.

There are more direct measures that can be applied to encourage growth. The paper recommends a revision to inflation targeting and programs directly designed to address inequality by raising incomes.

Introduction

It has been a given of policy papers for over a decade now that the extreme level of productivity growth experienced in the 1990s has stalled. The Productivity Commission (the PC) has been tasked by the Treasurer to commence a series of five yearly reviews of Australia's productivity performance and provide recommendations on productivity-enhancing reforms.

This submission is made in response to the Discussion Paper (the Paper) issued in November 2016 at the commencement of the first review (the Review).

Productivity at its simplest is any measure of how much output is produced for a given quantity of inputs. The productivity of the economy is measured by comparing output measured by GDP to the inputs of labour and capital.

However the measurement of productivity is flawed. The first section of this paper addresses the measurement question and identifies some interesting correlates to declining productivity performance.

The second section of the paper examines more meaningful measures of prosperity. It also examines the factors that contribute to prosperity.

The third section then recommends some reform measures that are not merely doing more of the same.

Measuring Productivity

The task seems relatively simple until it is recognised that GDP is a flow as is the amount of labour used in a year. Capital refers to a stock – the aggregate amount of capital employed. Unlike labour which has measurable physical quantities of man hours worked or available, capital only has a monetary value and then only at the time of initial purchase.

Productivity measurement typically, as in the Australian system of accounts, resolves this issue by converting the capital stock into an equivalent rental stream. Unfortunately, this introduces circularity into the calculation because the rental values are based on the expected return from the capital. Hence, if the capital employed is being more intensively used or the value of the final product is increasing, then the rental value of the capital will increase. When that rental value is used it makes it look like a unit of capital is no more productive than it was before.

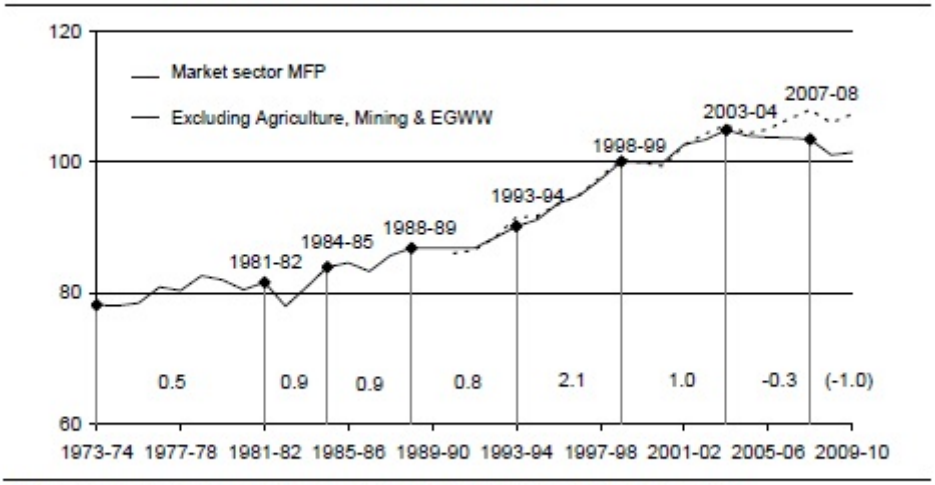
Whatever measure of inputs are used the improvement in productivity can be decomposed into improvements in labour productivity, in capital productivity, and finally of multi-factor productivity.

The latter is the "secret source" of economic growth models. It is a measure of the rate of technological improvement, of our ability to do more with less. It is the measure most commonly used to refer to the slowing of productivity growth.

As mentioned in the introduction concern about slowing MFP growth is not new. Figure 1 is taken from the PC's 2010-11 annual report. In that diagram the slowing of MFP growth is clearly identifiable as starting in 1998.

Figure A.1 **Market sector[a] MFP, and the impact of poorer performing sectors, productivity cycles, 1973-74 to 2009-10**

Index 1999-2000 = 100 and per cent per year



[a] The market sector consists of 12 selected industries (ANZSIC06 Divisions A to K and R).

Data source: Based on ABS (*Experimental Estimates of Industry Multifactor Productivity, Australia: Detailed Productivity Estimates, 2009-10*, Cat. no. 5260.0.55.002).

Figure 1Extract from Productivity Commission Annual Report 2010-11

In the Paper focus is placed on the slowing since 2004, but as Figure 2 shows the levelling

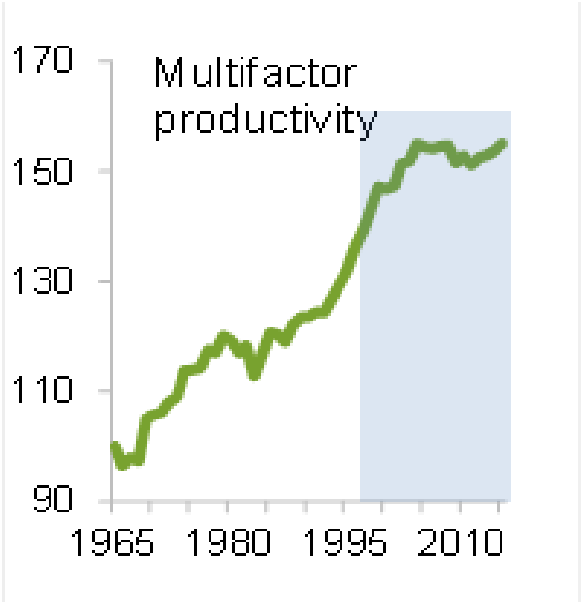


Figure 2: Extract from Figure 2 in the Paper – highlight added

off in MFP growth still is best identified as the late 1990s.

In a scientific inquiry the question that would be posed is what events correlate to the period from 1998 to today.

The first and most obvious is the creation of the Productivity Commission itself by Treasurer Peter Costello. It is an embarrassing fact that the slowdown in MFP growth exactly corresponds to the period of the existence of the PC.

The PC could be expected to respond by arguing that the fault lies with successive Governments for failing to act on recommendations. There are, however, other potential reasons for the correlation.

The PCs reports and research are typically essays from a very narrow band of economic theorising. This economic theorising pays no or little attention to concepts such as behavioural economics, institutional economics or evolutionary economics. This is economic theorising based on models that depend on a number of assumptions, none of which apply in the real world.

Under the previous Chair the PC approach focussed on a general "de-regulatory" thrust with the language of "red tape reduction" sometimes substituting. This rhetoric has not been matched by any sophisticated approach to the wider concept of regulation which understands that there is no such thing as "the market" absent the actions of government to create standards, money, property rights and legal enforcement. All markets are different and the function of government is to design them.

While Government resources, and many good graduates, have been poured into the PC, real policy making areas have been denuded of policy development capability. This results in the interesting dilemma that no policy body has considered the implications of the digitisation of more and more economic activity, while the Productivity Commission itself has not looked at issues relating to ICT and productivity since 2004.

Indeed, the Productivity Commission is the kind of centralising economic bureaucracy against which their own theories rail.

At the same time Treasury itself as a central agency has become increasingly less engaged with its core function of creating the conditions for the market economy to work. Instead it has become, like the PC, a critic rather than agent.

However much the correlation between the PC and slowing MFP growth might be attractive, it can only really highlight the failure of the PC to do anything to rectify the situation; the PC can't be blamed for the slowing.

The other event that happened in the late 1990s was a significant change to monetary policy. In common with many Governments around the world the control of interest rates was divested in the Reserve Bank of Australia with a specific policy remit to achieve an inflation target of 2-3%.

The policy has been a success in curbing inflation, but that success has corresponded to slowing growth.

More recently suggestions have been made that central banks should be given a different objective – a growth rate or an unemployment rate. Later in the paper we will return to this question and propose an alternative approach.

Measure what really matters

Our prosperity isn't measured by esoterica like the rate of technological improvement. It is measured on one simple basis, how much "stuff" we produce per head of population.

GDP is the accepted measure for the amount of stuff we produce. There are questions raised over whether it includes all the things that are produced. The Paper raised two of these whose impact remains unclear.

Firstly Government services like health care and education that are provided for free will not appear in the consumption data. But they will appear in the government expenditure data and should actually be counted in the estimate of GDP.

Secondly other intangibles like the loss of leisure time due to transport congestion are sometimes claimed not to be included. They aren't included directly, but they are indirectly through the substitution effects that occur. The loss of time in travel affects other patterns of behaviour which do show. Similarly increases in product quality are measured, either because there is less spent per unit of similar quality and hence more available for expenditure elsewhere, or the higher quality (e.g. a smartphone) enables other activity.

Not mentioned in the Paper is the issue of "unpaid" work, often carer work. To include this is problematic because all the growth from tribal society to today has been the consequence of substituting market transaction for private provision. The growth in the services economy includes an ongoing increase in meals prepared outside the home.

The output – the GDP – provides the "material comfort" for the citizenry, old and young alike. So the most meaningful measure of growth is the growth in GDP per capita.

If that growth occurs through capital deepening that is a good thing. The whole premise of market capitalism is efficiency gains from specialisation creating surplus which is then reinvested in further improving efficiency.

One of the difficulties in assessing MFP, as touched on in the paper, is the changing nature of the capital investment. When new processes (technological progress) requires expenditure in new short lifetime capital most of the gain from the technology change will appear to be a result of capital deepening rather than technology change.

Not only is a clear focus on growth in GDP per capita more reflective of the real measure of prosperity it avoids an error that occurs from relating economy wide productivity to firm level efficiency.

The most significant error in this type of analysis is ignoring the importance of business enterprises making the goods and services people want to buy. I can increase the efficiency of my firm by reducing the inputs I use in making my current output. But I can also increase it by keeping the level of input the same and making more output (that is actually purchased rather than adding to inventory). The latter case will always contribute to economy wide productivity improvement; the former will only do so if the resources released are productively used.

This has particular resonance for one of the favoured solutions to productivity improvements promoted by business executives – the desire to reduce wages. Wage reduction will increase firm level efficiency but not national productivity. As we shall see in the next section there is a significant second order effect of paying labour less.

In summary, the PC and policy makers should spend less time talking about productivity and more just talking about outright GDP growth.

Going for Growth

Income Inequality and Growth

The other trend that is observable is the growth in income inequality and the decline in average earnings in real terms. Domestic growth requires households with income to

spend; a fixation on limiting wages growth is a process for increasing shareholder returns not growth.

This confusion in part arises from conflating firm level productivity – more correctly efficiency – with country level productivity. The latter is not simply the sum of the former. The whole theory from gains from trade, the value of specialisation and comparative advantage is built around the premise that the economy can grow by doing the right things – making what you can sell – rather than just doing things better.

Holding wages down is the equivalent of leaving a tariff in place; the firms are getting the wrong price signals about how they should be investing. Low wages discourage firms from identifying market opportunities that can sustain high wages.

Similarly, offering businesses tax cuts – especially when the headline corporate rate is actually below that in the US – sends the same message.

Nothing would be better for economic growth than a small wages break-out. The Government can trigger one by awarding all public servants a one-off 2% pay rise. This will work its way through the economy just as the public sector pay increases under the Whitlam government did. The flow through of the pay rise will raise tax receipts by more than the cost in public service wages.

The spurt to growth will create more demand which in turn will ensure the small wage increase does not result in an increase in unemployment.

The risk with a short wages break-out will be that the RBA response will be to rapidly increased interest rates. To ensure that doesn't occur, the error of interest rate targeting needs to be rectified and the upper bound lifted to 4%.

Inflation and Growth

Higher inflation has an additional benefit, in that it is technically a devaluation in the dollar. This means that it should have a corresponding effect in foreign exchange rates and help the terms of trade and hence overall growth.

It also has a budgetary benefit because government (and household) debt becomes less as a percentage of nominal GDP and nominal incomes through the change in the price level alone. The much reviled baby-boomers remember that the flip side of high interest rates and high inflation (and matching wage increases) was how rapidly mortgage repayments declined as a proportion of income.

Conclusion

The Paper is right to suggest that the next stage of economic reform requires bold thinking.

It is clear that the policies that served us well in the eighties and nineties to correct from the consequence of the oil price shock on the post war growth period have outlived their usefulness.

The stalling of growth that started at the turn of the century and flattened even further after the Global Financial Crisis will not be restarted by simply more of the same prescriptions.

Focussing on growth itself rather than productivity is the key. Two principle mechanisms will be reversing the wages decline and raising the upper bound of the inflation target.