Thank you for the opportunity to make a submission to the Productivity Review. I would like to offer as briefly as possible, four suggestions for further analysis.

1. What do we want “Made in Australia” to signify – innovative and risky, or top-shelf quality? Car making could be revived by convincing prestige car brands to set up production in Australia. Junk food manufacturers should not be allowed to print “Made in Australia” on their labels.
2. Urban planning: simplistic ideas about transport limit the ability of workers to choose where they live and work, to maximise their income and output growth. I propose that very large park-and-ride carparks could play a key role in a much more cost-effective transport strategy.
3. The human mind is the source of productivity growth. The mindlessness of Australia’s most tax-advantaged investment sector causes a brain drain from business and intelligent investment.
4. Capital gains tax double-taxes business investments and inhibits the turnover of residential land. It may be Australia’s most toxic tax and needs a fresh, hard-nosed review.

1. What do we want “Made in Australia” to mean – innovative and risky, or top-shelf quality?

Innovation sounds exciting, and Australia is a trailblazer in a few specialised areas of mining and medical technology, but as a broad national economic theme it does not play to Australia’s strengths. The factors that make it so successful in places like California and Germany are complex and difficult to duplicate. An increasing share of technological innovation occurs in Asian countries where operating costs are lower and businesses can afford to keep trying and failing until they succeed.

Innovation entails risk not only for venture capital but also for end users, and it creates demand in its wake for goods and services with reliable standards. Quality signalling is the counterweight to innovation because many markets for goods and services are risk-averse. Much of the consumer protection and reputational framework that we take for granted in the developed West, lags far behind the pace of industrialisation in developing or newly developed countries.

This is why many goods with a high degree of information asymmetry and risk for the end user, such as pharmaceuticals and medical equipment, are still produced in high-cost countries like Canada or France. There are plenty of factories in China that could make exactly the same things, but without strong and mature legal frameworks, or world-famous brands with reputations to protect, customers would be unwilling to pay the same trust premium.

New Zealand has recently become the country of origin for China’s most trusted brands of milk and infant formula, after China’s domestic industry lost the confidence of the public over the melaminie poisoning episode. Note that melamine additive was an innovation intended to make babies more healthy with protein supplements. New Zealand food marketing emphasises continuity of traditional farming values; innovation is not a selling point.

The key to earning brand trust is not so much to produce the best products, as to demonstrate a long history of never selling a bad product. In the mid 1980s, Honda’s reputation for reliable motorcycles, carefully built since 1959, almost came undone over a series of V4 engine models that no amount of recalls and modifications seemed to fix. The company made an interesting decision: judging its reputation to be its most valuable investment, Honda decided to spend whatever it took only to redeem its V4 but to make it the envy of the motorcycle industry. According to industry folklore the resulting model, the famous VFR750, was so expensively over-engineered that it never generated a profit in its own right, but it's often described as "the motorcycle that saved Honda".

In a world awash with innovation – dedicated just as much to cutting production costs as to improving product capabilities, so that die-cast or machined metal parts are never used where stamped or plastic parts are adequate – high quality craftsmanship is and efficient manufacturing that , where "hand made" has become a craftsmanship has become a more valuable luxury than ever before.

The Swiss watch industry specialises in mechanical technology which, by any rational prediction, should have become extinct after the mass-production of quartz crystal oscillators, digital time displays and miniature batteries that go for years. Yet figures published by the Federation of the Swiss Watch Industry show that exports doubled between 2000 and 2015. China produces accurate, long-lasting digital watches so cheap that chemists offer them as impulse purchases at front counters, so it may seem paradoxical that the steepest increase in Swiss watch exports was to China, from CHF 45 million in 2000 to CHF 1.3 billion in 2015.

The Asian appetite for Western luxury goods with prestigious brand names is often noted but rarely analysed. I became fascinated with it one day when I was at the Suzhou intercity railway station in Jiangsu province, watching new arrivals wait for a taxi while dozens of vacant taxis drove past. Why didn't they hail any of those taxis, I asked. I was told that they were all from taxi companies that were unfamiliar to the visitors; they were waiting for taxis of any national label that they knew and trusted. Who knows what could happen if you get into a taxi whose safety and ethical reputation you don't even know? Brands are not just a vain fetish in Asia; they fill a breach left by the social and legal dislocation of very rapid industrialisation on a very large scale. Overpriced, prestige-branded luxury goods send signals in the language of trust, to risk-averse customers and business associates who need to deal with strangers and don't want to be burned.

Australia has no prestige brands of its own, but I think it has an unrealised potential to join the exclusive club of countries that are famous for the trustworthiness of their products and can charge trust premiums. It is largely a Western European club, of which Switzerland as the leading exemplar, and it also includes Japan, Canada and in recent years, New Zealand.

For example it may be possible to revive car manufacturing in Australia, but not with ordinary brands like Ford, GM or Toyota. It would have to be prestige brands like Daimler-Benz or Jaguar Land Rover; brands that have a reputation to protect and need to have confidence in their production standards. There is no lack of excellent tradesmen and engineers in Asian countries; the problem is guaranteeing that that's who you'll get. It is easier to enforce high standards in countries that industrialised a long time ago, which is why most members of the prestige club are high-cost countries.

Smart regulation is an important step. Australia has second-to-none product safety standards, some of the cleanest farming soil in the world, and consumer protection laws that could be developed into quality standards in certain export industries. Switzerland strictly regulates the quality of watches, ensuring that no watch of less than top-shelf quality can carry the "Swiss made" label, making the country's name a prestige brand in its own right. New Zealand has tightened the regulation of milk quality in recent years – at the request of the dairy industry – in order to send trust signals to their export markets and increase the market value of New Zealand milk.

Australia, however, has a very large and politically well connected junk food industry that lets down the side. I suggest these junk food manufacturers should not be allowed to print "Made in Australia" on their labels. That country-of-origin label should be restricted to food of the highest nutritional quality. "Australian made" food should become the nutritional equivalent of "Swiss made" watches.

2. Urban planning:

Simplistic ideas about transport limit the ability of workers to choose where they live and work, constraining their productivity.

Very large park-and-ride carparks could play a key role in a much more cost-effective transport strategy.

Productivity growth requires workers and employers to have as many choices as possible, which is why big cities are the engine rooms of economic progress.

Many factors affect this. Employers cannot easily hire if they cannot easily fire. Workers cannot adapt to changing industries and skill demands if it takes longer than necessary (I think about three years on average) to retrain for a different job before they can even test their new skills in the job market.

I want to talk about inefficient transport systems which effectively fragment a city into small towns, because this places excessive limits on their choices of jobs and their scope to make the most of their abilities. My observations here are based on Sydney and may or may not be relevant to other Australian cities.

The prevailing school of thought in Australian urban planning appears to be that people should live either in high-density housing close to railway stations, or in mixed-zoning areas where they can walk or cycle to work.

Perhaps this thinking is informed by studies of industrial behaviour from an earlier time, when most households had a single income earner with fairly generic skills and one workplace was as good as another. A factory opens up down the road and suddenly all the local boys have new jobs. It doesn't work that way any more.

Some of the features of the modern workforce are:

- Hyper-specialisation, both of workers and of businesses
- Dual income households, typically of mixed specialisations
- Frequent changes of jobs and workplaces

It should be obvious that expecting people to solve transport problems by buying homes close to their or their spouses' workplaces is unrealistic. It's also a fallacy to assume people who live close to a railway station don't need to drive, because not all workplaces are accessible by rail.

The dispersion of workplaces is a fact of life (except in Canberra, thanks to the brilliant foresight of Walter Burley Griffin) but policies that actively encourage even more workplace dispersion and mixed zoning are part of the problem, not part of the solution.

As for pushing people to live in apartments close to stations and against their will, this is wrong on several levels. It means pushing uphill against physical limits and land value gradients. It still leaves many people out in the urban hinterland with limited access to their best job opportunities. It doesn't reduce the need for cars nearly as much as the planners think it does. It is largely a waste of the critical space around railway stations which could be used more strategically. And it denies the perfectly valid reasons many people have for preferring to live in low-density spaces, especially when they have children.

Consider a simple model of a city, with three locations:

A. Location A is a low-density suburb with no railway, buses that take hours to reach anywhere, and some industry and commerce
B. Location B is a hub with high-rise apartments, a railway station and shopping centre
C. Location C is the Central Business District and is connected by railway to locations B and C.

No matter which location you live in, at various stages in your life either you or your partner might find the best work opportunity in location A, B or C. If you live in B then the city is your oyster, but you'll have to pay for that privilege. If you live in B and work in A, or if you live in A and work in B or C, you'll have little choice but to drive all the way to work, or find a less productive job in a more accessible location.

Now imagine that instead of inviting developers to build yet another apartment block at B, the city built a huge carpark. By huge I mean that it would never, ever, fill to capacity. A commuter could turn up at 8:45 on Monday morning and be absolutely certain of finding a space. Roads would be generously designed and provisioned for very many cars to come in and out rapidly. Nearby areas would be reserved not for residential apartments, but for retail services to commuters such as childcare, dry cleaning, medical services, mechanical repairs and so on.

That would open up a much wider choice of job opportunities, especially for people either living or working in location A. But more productive workers create more opportunities for other workers, so those in location B would also benefit. The railways would become available to everyone, not just those who pay for premium land. There would of course be multiple location As and Bs, not just one as in my simple model, so commuters facing too much congestion to access their nearest park-and-ride location could find quieter roads to another one further afield. The system would have enough flexibility for people to find more efficient solutions over time.

Of course the increased load on the railways would require expensive capacity upgrades such as line duplications. But that's a lot cheaper than trying to tunnel new lines into every suburb, or limiting land release to areas within the public transport footprint, or pushing people to waste their income on a scramble for high density space that they don't really want.

And of course some commuters will always have to drive all the way, either because they work in a location A, or they carry tools to work, or for whatever reason. But a flexible park-and-ride system could relieve congestion and disperse it more evenly, allowing those who need to drive to do so in a much wider radius.

The NRMA ran a campaign for park-and-ride facilities in 2008, based on similar reasoning to that given here. The then NSW Premier Nathan Rees understood the logic of it and planned a huge park-and-ride program, but he was deposed by his party soon afterwards; the program became less ambitions and is largely limited to stations along the new North-West Link. It should be revived on a grand scale because it has the potential to release a great deal of latent productivity growth at a much lower price than the alternatives.

3. The human mind is the source of productivity growth. The mindlessness of Australia's most tax-advantaged investment sector causes a brain drain from business and intelligent investment

I have a friend who is very smart in practical ways, sensible, an excellent judge of risk, with the ability to get things done and to inspire confidence in others that he will get things done. Some years ago I suggested he should run a business. He replied that business offers poor reward for risk compared to residential investment, and in the current tax environment, he's right. It's a waste of a potentially fine business brain and there are many others like him.

I submit that the source of productivity growth is the human mind. Capitalism is a system that tends to concentrate the most influence over planning and resource allocation in the hands of those with the demonstrated competence to wield it to the greatest effect.

Dysfunctional, tax-distorted capital markets, such as the residential land markets in Australian capital cities, short-circuit this mind-sorting process and waste valuable mental resources on investment formulae by which any halfwit, if shown how, can outperform a skilled fund manager.

I am not saying residential property investment is bad. It is a natural and part of capitalism which, all things being equal, provides the secondary market necessary for new building to meet demand (like the secondary stock market). However, as I argue in the next section, the tax system only encourages buying and holding, not selling. When artificial tax and regulatory factors cause the simple act of buying property, holding it for decades, and borrowing capital gains in order to buy and hold more properties, to outperform every other investment strategy, it means those mental resources which could be building productivity are instead doing little more than staking a claim to the future incomes of future home buyers. At best it's a zero sum game, equivalent to the promise of a pension to be supplied by future taxpayers. At worst it's a severe distortion of the mental competition that could be driving capitalism forward, causing it instead to go around in circles.

4. Capital gains tax double-taxes business investments and inhibits the turnover of residential land. It may be Australia's most toxic tax and needs a fresh, hard-nosed review.

When applied to assets whose value derives from their earning power, the capital gains tax is a form of double taxation. The value of an asset such as a share can be expressed as the discounted sum of its future earnings after tax. If its value increases, that means the market believes its likely future earnings have increased, along with its future tax contributions. If future earnings could increase without a corresponding increase in future tax liabilities, the value of the asset would increase even more. That it doesn't, means that the investor effectively pre-pays the increase in future tax liabilities by selling the asset for a price that takes them into account. To then pay capital gains tax is to pay for that increase a second time.

When applied to residential land investments, whose value derives mainly from increasing scarcity rather than rental yield, the effect of capital gains tax is even more pernicious. Its chief effect is to drastically inhibit housing stock turnover and worker mobility, artificially boosting land scarcity and prices, in a similar way to that of conveyancing land tax which the Productivity Commission has already criticised elsewhere.

The rate of capital gains tax is based on the investor's income tax bracket at the time of selling, so it can be minimised (or within a SMSF, avoided altogether) simply by holding onto property investments until retirement and then selling them in a low-income year. Holding onto properties for so long is attractive compared with selling earlier and paying capital gains tax, because in the meantime it is easy to convert capital gains to cash via mortgage equity withdrawal, with negligible transaction costs. This is standard practice among Australian residential property investors, yet somehow overlooked by economists who recommend to broaden the capital gains tax base to include family homes. If you take into account the lock-in effect I have just described, capital gains taxing the family home would all but shut down the property market and turn most would-be home buyers into lifelong tenants, with no permanent stake in their local communities and little motive for community engagement.

The problems I've described could all be addressed by making yet more modifications to capital gains tax – for example setting it at a constant rate independent of income tax, and classifying mortgage equity withdrawal as a capital gains tax event – but it has been fixed so many times that at some point you have to ask if it's simply a lemon whose every repair will cause more problems elsewhere. And that still leaves the problem of double-taxing business investments as I described above. I believe capital gains tax was never about correcting economic distortions; it was always about envy, and the economic arguments contrived to justify it have never been subjected to hard-nosed analysis in Australia as they have in the US and New Zealand.

Conclusion

The central theme of my submission is that while innovation may be the leading edge of productivity growth, much of the heavy lifting comes from other activities of the human mind. These include making better use of existing assets and innovation, as well as building trust. All intelligent minds can play a part in advancing productivity if the conditions are right.

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