13 December 2004

NCP Inquiry
Productivity Commission
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By email: ncp@pc.gov.au

Dear Sirs/Madams

Submission to the Productivity Commission's Public Inquiry on the "Review of National Competition Policy Arrangements"

The Productivity Commission draft report could provide a more balanced presentation on the various factors that contribute toward growth in productivity in Australia. This is considered to be important because such an approach would increase the chance that policies are framed in a way that is targeted, measured, effective and efficient.

The draft report is dismissive of some issues or areas that could have an impact on productivity and economic growth. Such issues and areas should be considered by the inquiry. Presenting a selective account of the productivity story is not the way to generate confidence in an agenda relying on that story.

In the view of this writer, the problem with the PC's approach is that it reduces the likelihood that necessary reforms will be accepted and implemented.

Australia's recent economic performance and the role of NCP

The PC's draft report on NCP states:

Notwithstanding difficulties in establishing causality, a range of indicators confirm that microeconiomic reform in general, and NCP in particular, have been principal contributors to the improvement in Australia's productivity performance" (page 33)…Nevertheless, the PC points out that *"care and judgement are required in reaching conclusions on causality"* (page 34).

If assumptions about the source of productivity growth were only partly true, or flawed, policy formation, acceptance and implementation could be affected in an adverse way. This, in turn, could affect future levels of growth.

The PC's draft report on *"The Economic Implications of Ageing"* states that "it is important to be aware that small differences in assumptions about future productivity growth rates, compounded over many years, can greatly alter projected outcomes" (page 4.3 of the ageing report). The PC has acknowledged, however, that there are many uncertainties regarding the drivers of productivity (for example, refer to page 5.7 in the PC's ageing report).

The PC's draft report on the NCP seems biased in places (and appears to be a marketing exercise) when it focuses on the positive aspects of "Australia's recent economic performance" (page 36), without an equal treatment of some significant negative aspects. This particular section of the PC's NCP report raises the positive aspects of "uninterrupted output growth", a rise in real per capita incomes, low inflation, growth in employment, and "rapid growth" in exports. A more balanced discussion would also point out some very significant adverse developments, such as; a significant increase in household debts and dissaving by households (which seem to be of considerable concern to the Reserve Bank, among others), a current account deficit of significant proportions, a rise in foreign debt relative to GDP (above the "debt-truck" levels of 1996), and a significant decline in first home affordability (to record lows in some areas).

The coverage of "*Australia's recent economic performance*" in the PC's NCP report provides discussion of a trend toward part-time employment, which the PC states "has helped to deliver greater workforce flexibility and, arguably contributed to, rather than detracted from, Australia's recent productivity growth" (page 37). **The use by the PC of "arguably" in this context is pertinent because any assertion that a trend toward part-time and casual employment contributes to productivity growth in the long term is highly questionable (and potentially misleading)**, as the following illustrates:

- Coles' submission to the PC (for this public inquiry) states *"over the past four years Coles has moved away from the traditional heavy casual component of our supermarket workforce, and increased our reliance on full time and permanent part time employees… We have done this in order to provide a better quality service to our customers through a more committed and reliable lower turnover workforce seeking greater job security"*

- According to Richard K Lester: *"The flexibility to hire and fire at will that such a strategy offers (as well as its generally lower costs) has proved very attractive to many American firms. But this path, too* (i.e. as well as outsourcing), *has its drawbacks. Firms that follow it are often constrained to producing low-end products and services because the human resource base on which they depend lacks either the skills or motivation to achieve the levels of innovativeness, quality, and service needed to compete in higher-value, more profitable products markets"* ("The Productive Edge", Richard K Lester, page 270).

The PC's draft NCP report states: *"Importantly, the Australian economy has seemingly become more able to adapt to changing circumstances and 'external' shocks"* (page 37) and provides examples of some external shocks that the Australian economy has braved over the last 10 to 15 years. **But is this a backward looking observation, without due attention being paid to other potentially transient factors that may have acted to soften external shocks in the past, but may not be available to soften future shocks.** An incredible expansion of household credit in Australia, promoting growth in domestic demand, may at least partly explain this resilience. Indeed, the Economist magazine published an article in November 2002 ("Houses that saved the world") that argued that rising housing prices "held the world economy aloft". And Australia would appear to be no exception. The housing credit spiral has helped boost housing prices in Australia (and visa versa) and promoted domestic demand as the external economy waned. But there is a limit to this credit spiral.

In August 2003, the Governor of the Reserve Bank told the House of Representatives Standing Committee on Economics, Finance and Public Administration *"… if over the next 18 months the world economy does turn out to be much weaker than we expect, there is no recovery and it just sinks down further, and if the speculative activity in house buying and borrowing – the credit driven house spiral – also continues over the 18-month period, then you would be setting yourself up for a very nasty explosion, which would cause a huge amount of financial distress and, almost certainly, a large recession"*. More recently, the Governor of the Reserve Bank has expressed concerns about credit quality in Australia.

The productivity story is a complicated one and wrong assumptions could be drawn from historical data. Is there a long-term trend decline in productivity, albeit with a decadal upsurge? Growth in labour productivity in Australia in the period 1990 to 2001 (what the PC calls the "the miracle years") was, nevertheless, lower than that experienced in the period 1950-73. The same is true across most of the countries in the OECD.

Australia implemented significant economic reforms in the 1980s and 1990s. There was also dramatic technological (productivity enhancing) advances over this period, and Australian businesses were early adopters of many such advances. So the question is: why was productivity growth in the "miracle years" slower than it was in the periods 1950-1960 and 1960-73?

Determinants of Australia's Productivity Revival

The PC draft report states: *"In broad terms, productivity growth stems from factors such as technological advance (through, for example, new knowledge gained from R&D), better organisation of production (for example, specialisation and elimination of waste), investment in plant and equipment and human capital development (including skill formation through education and training)."*

a) Technological advance

The importance of R&D and innovation should not be understated. Business Review Weekly's "Fast 100 report" (October 14-20, 2004 edition) provided some background information on some of Australia's fastest growing businesses. The report found that 77 per cent of respondents agreed they would not grow without innovation, 90 per cent of respondents agreed they were highly innovative, and 67 per cent of respondents agreed that R&D was extremely important to their success.

In its draft report on “the Economic Implications of Ageing”, the PC acknowledged its uncertainties about future changes in technical change, and emphasised the importance of technical change on productivity growth. The PC’s ageing report stated: *“The direct impacts of ageing on productivity are swamped by uncertainties about the future rates of productivity growth associated with technical change, increased efficiency and capital deepening”*.

BusinessWeek magazine states*: “some Fed policy makers are questioning how much longer the efficiency miracle can go on. They see signs of a slowdown in the torrid pace of technological innovation in the computer and chip industries, advances that propelled productivity in the last decade. And they wonder if those are harbingers of less vigorous gains ahead… Economists admit there is much they don’t understand about productivity”* (as quoted in The Australian Financial Review, “US efficiency miracle may be fading”, 15/11/04). In the same article, BusinessWeek does say that others (including policymakers in the Fed) are *“upbeat about the long-term outlook”* (on productivity).

The IT revolution has been pervasive and offered productivity gains to industries across the whole economy. There are, however, a few crucial questions. How much has the IT revolution contributed to productivity growth in the past? If the gains were significant, can the productivity enhancements brought forth by this revolution be sustained indefinately? In the view of this writer, the answer is NO.

Information technology has already allowed businesses to either introduce or improve accounting systems, benchmarking, business and financial analysis, business planning, marketing management, field workforce management, electronic funds management, online banking, online shopping, robots, supply chain management, bar-coding, cad-cam etc. The marginal productivity returns that will become available from future IT advances are likely to decline over time (as it has for other innovations).

How will the longstanding low levels of investment in R&D in Australia affect productivity, international competitiveness and economic growth in the next forty years? Business expenditure on R&D in Australia has long been, and still is, very low as a percentage of GDP (the OECD ranks Australia 14^{th} in a list of 21 OECD countries in 2002-03, with Australia’s spending as a percentage of GDP one-third that of United States). Government expenditure on R&D in Australia is also very low as a percentage of GDP (the OECD ranking Australia 11^{th} in a list of 17 countries in 2002-03, with Australia’s spending representing 61% of that of the United States).

Foreign-owned companies are a significant contributor toward business expenditure on R&D in Australia. In this case, the benefits of innovation in Australia are more likely to be transferred to other countries, with little ongoing benefit to Australia.

The PC’s draft report *“The Economic Implications of Ageing”* projects a significant decline in government expenditures on higher education, due to the effects of ageing. How will this affect spending on R&D and innovation in universities? How will it affect the level of infusion of know-how into the business and government sectors of the economy?

Low levels of R&D in Australia may reduce Australia's ability in future to be a first or early adopter of technology and a first or early mover in emerging businesses or industries.

b) Better organisation of production
Government reforms have obviously helped to better organise production. However, the reforms have produced some one-off gains that will be difficult to replicate.
Sunday trading can only be deregulated once.

Woolworth's submission quoted findings of a 2000 report by the Parliamentary Joint Select Committee, which found that economies of scale and scope were accrued by major supermarkets; and findings of William Lewis of the McKinsey Global Institute that *"large efficient retailers have driven large productivity gains for the economy as a whole"*. Ownership of food retailing in Australia has become very concentrated (the largest 4 food retailers accounted for almost 60% of the market in 2000-01). Large bulky good retailers have emerged.

Some reforms have had negative effects on productivity. Mr Ergas pointed out to the PC at proceedings on November 30, 2004 that toll roads have resulted in diversion, congestion, social costs, and multiple tolling technologies. Another contributor at the same proceedings pointed out that toll roads will make a move toward a more uniform system of road pricing that much more difficult to implement.

A global study by Proudfoot Consulting found that three quarters of lost time in Australian businesses is due to inadequate supervision and insufficient management planning and control (The Australian Financial Review, "Productivity suffers as bosses fail to lead", 29/10/04).

Concerns are regularly expressed that Australia's infrastructure is being run down, and that this will threaten future productivity growth (and also transfer the burden of restoring infrastructure to future generations). The Business Council of Australia stated in its March 2004 report Aspire Australia 2025: "But behind the façade of prosperity, the country's problems are building. Not enough is being spent on key economic infrastructure and services".

c) Investment in plant and equipment
Investment in equipment, plant and machinery grew at an average nominal rate of 3 per cent in the eight years to 2003-04. However, due to a decline in the unit prices of such plant and equipment, growth averaged 8.3 per cent in real terms over the same period, which is a very strong rate of growth. Can or will this rate of investment be maintained?

Investment is affected by interest rates and the supply of equity and credit to the productive sectors of the economy. In its report on "The Economic Implications of

Ageing", the PC seemed uncertain about the effect of ageing on household savings (which are currently negative in Australia). The PC was clearer that "public savings are expected to decline" over the next 40 years (page 4.21 of the draft ageing report). If national savings decline in the future (and/or global savings decline with global ageing) interest rates will tend to be higher than they would otherwise be. That being the case, investment will be adversely affected as will productivity growth. The PC stated that the mining sector "may face greater obstacles to growth if interest rates or capital flows are adversely affected by global ageing" (page 4.26). Governments could potentially raise taxes to fund the cost of ageing, which could also adversely affect investment, productivity, and workforce participation.

d) Human capital development

Education and training is a major driver of productivity growth. The PC's draft report on "the Economic Implications of Ageing" has forecast a significant decline in government spending on education (due to population ageing). If student numbers decline, that must result in there being fewer people holding more recent education and training qualifications in Australia. How will that affect productivity?

Education is a corner stone of productivity growth. Yet it appears many businesses lack the initiative or inclination to train staff. The business sector is now talking about skill shortages. This has occurred despite relatively slow growth in hours worked by the Australian workforce, due apparently to a greater reliance on casual, contract and part-time workers (many of whom receive little, if any, training).

Since the mid-1990s there has been a significant increase in Australian citizens working overseas (largely young and highly trained Australians).

Population ageing will also have implications for productivity (refer to the writer's submissions on the PC's draft report on the economic implications of ageing).

Growth in casual and part-time employment will not positively affect human capital development. Compared with full-time employees, casual and part-time employees tend to receive less training from their employer, are less likely to be imbued with a corporate culture, and are less likely to innovate. An employee is less likely to be innovative if they are uncertain about the future.

Measuring productivity growth

Measurable productivity gains often occur with an upturn in the economy (i.e. in domestic demand and/or exports), which can be heralded by a fall in, or low, interest rates, associated credit growth and resulting spending. The reality is Australia has experienced extraordinary growth in credit since the early 1990s, far exceeding growth in GDP. Low interest rates have been associated with low inflation and as Robert J. Samuelson reports: *"The (U.S.) economy must now move ahead without the powerful afterburners of soaring stocks or rapidly falling interest rates. These were the final* *chapters of the Age of Inflation. It's over. What comes next is anyone's guess"* (Washington Post, Robert J. Samuelson, "the End Of the Age Of Inflation", 2/12/04).

During the 1990s, reported levels of productivity growth was relatively high in the wholesaling, finance, business and property services industries, which are all industries that are very sensitive to volumes. It is also interesting that these industries were also significant beneficiaries of the IT revolution.

Changes in Australia's industry structure can potentially affect measured productivity growth. If these changes cannot be sustained in the long-term, then this may affect future levels of measured productivity. For example, when manufacturing capacity is transferred offshore that may have the effect of increasing the measured level of productivity growth in Australia. But the opportunities to transfer production offshore will obviously decline as production capacity progressively moves offshore.

If spending on R&D and training and education has been low, that may boost measured productivity, although low investment in these areas will ultimately have a negative effect on productivity.

Growth in outsourcing and contracting out may initially have a positive effect on productivity growth but may adversely affect innovation and productivity growth in the longer term (refer above to Richard K Lester's view).

There are other trends which may have promoted productivity growth during the last 10-15 years, but such trends may slow or reverse. These trends include:

- Low energy costs
- Limited government response to global warming
- Limited costs of land degradation
- A rise in industry concentration in some industries
- A young workforce
- Franchising
- Infrastructure sharing (e.g. back office functions)

There are major questions that need to be considered in relation to the sustainability of productivity growth. These questions include:

- Will the productivity gains flowing from past micro-economic reforms become exhausted?

- Will the gains flowing from future micro-economic reforms be comparable to the gains flowing from past reforms?

- Will past and future advances in information and other technologies contribute to productivity to the extent they did in the "miracle years"?

There was phenomenal growth in productivity in the 1920s, but the economy came to a grinding halt in the 1930s.

Specific Competition Issues

Banking policy: This writer believes that strong regulation of deposit taking institutions, in spite of competitive neutrality concerns, is of the utmost importance in the current economic environment. There are currently a number of areas where policy does not adequately acknowledge risks – for example, risk weightings for undrawn housing loan limits and for housing loan amounts that are drawn but set-off against amounts deposited in at-call accounts. There is no requirement for institutions to conduct formal valuations. Lenders approve and extend loans on the basis of today's incomes (and debt-serviceability), without taking into account the sustainability of serviceability (e.g. a 30-year loan to a 50 year old). There are no debt-service covenants for home loans, as there are for commercial credits (even though some housing loans exceed the size of some business credits). Credit assessment is undertaken at the approval stage of a housing loan only (except when there is a repayment default), which could mask any slow deterioration in debt serviceability (in contrast, commercial loans are often reviewed annually). Housing loan limits are increased to fund the purchase of discretionary goods (such as a car), so that loan balances amortise over a longer period. Loans are often written by mortgage brokers who may not fully apply the credit standards of the lending institution. The non-conforming market offers housing loans without requiring any proof of income.

Piecemeal deregulation can be detrimental to overall reform goals. Toll roads, for example, are inequitable (some have to pay to use roads, while others don't) and may adversely affect the ability to introduce wider ranging national competition reforms in the transport sector.

Institutional arrangements. Closer attention could be paid to Australia's institutional arrangements and structures to determine whether they are optimal in promoting innovation within institutions and in promoting policies that encourage innovation outside the institutional framework. If these arrangements are not optimal, consideration should be given to making changes. For example, would there be advantages in splitting the PC into two separate organizations, each competing for work and funding? Should the Commonwealth Government also seek competing bids from other government and private economic advisers? Should the PC and like institutions be forced avail the services of private contractors?

The PC stated in its final report on First Home Ownership: "In the limited time available for this inquiry, it would not have been possible for the Commission to address comprehensively each of the many influences on house prices and affordability". The PC gave no indication that it utilised outsourcing to help it to produce a more comprehensive final report.

Schools funding. Competition in the school market is limited by the following:

- Many parents do not consider private and government school education as interchangeable (i.e. not substitutable services, and hence separate markets).
- Many parents do not have the financial means to send their children to a private school.
- The use of parents' funds (and government funds) to pay scholarships to attract high achieving students to promote the reputation of a school. These students are often being attracted away from the public system, which can reduce performance levels in government schools.
- Some existing schools have accumulated significant infrastructure (e.g. sporting facilities) that could not be duplicated by other schools (or a new entrant) in the same area. Some private schools have infrastructure that is underutilised. This infrastructure could be better utilised, for example by leasing to other schools, which could potentially drive down school fees.
- There are existing schools which have significant numbers of alumni who are predisposed to, and capable of, providing significant gifts and grants and to sending their own children to the same school.
- Some existing schools have a greater ability to market themselves on the basis of their alumni (i.e. important persons).

Government funding to private schools is usually based on the socio-economic base of students. Yet, students who have parents of greater financial means also receive the benefit of this funding. Moreover, some students at government schools are from families with significant financial means, and government schools in wealthier areas usually have access to additional private funding. For these reasons, consideration should be given to a change in the way governments fund school education, i.e. by government funding going directly to the student's parents (on the basis of means) rather than directly to the school.

Other education reform: The Commonwealth Government's proposed involvement in technical colleges, and its increased involvement in funding private schooling would appear to increase the level of "overlapping" in education.

Workforce reform: According to Richard K Lester: *"The United States is generally regarded as having one of the most flexible labour markets of any advanced country…benefits should be made much more portable. Individual skill grants, or tax deductible individual training accounts modeled after today's individual retirement accounts would also help flexibility"* ("The Productive Edge", Richard K Lester, page 282).

Health funding. There are no price signals for many health services (e.g. due to the availability of bulk billing, public hospitals, community health etc), and low price signals in other areas (e.g. subsidised health insurance, Medicare subsidies and health expenditure safety-nets). This results in over-servicing, which is unproductive, inequitable and unsustainable in the longer term.

Health services: There are significant opportunities to promote the use of less qualified, and lower cost, personnel in providing many health services. Greater effort should be applied to free up training places in some professions.

Competition in retailing: According to the Shopping Centre Council of Australia, shopping centres account for 41 per cent of retail sales in Australia. A significant proportion of the largest shopping centres are held by a few owners, and these owners can exert significant power over retailers. Shopping centres have many of the attributes of essential infrastructure. These centres often attract large retailers with cheap rent, and then charge smaller retailers with higher rents. Moreover, smaller tenants often have access to less favourable areas, and have less secure tenancies (i.e. compared to larger tenants). This may reduce the ability of some smaller and innovative retailers from growing.

Regional policy. What impact does the distribution of Australia's population and economic infrastructure and activity, along with the level of policy focus in this area, have on competitiveness, productivity and economic growth? According to the House of Representatives (all party) Standing for Long Term Strategic Report of August 1992 "Patterns of Urban Settlement – Consolidating the future":

"Urban planning in Australia is separated from economic policy making and fragmented across and within State jurisdiction. There is no system for setting national priorities and no mechanisms for coordinating the various arms and levels of government. <u>Planning occurs by default, with national policy goals and priorities imperfectly reflected in the separate and uncoordinated actions of the separate agencies of the government such as roads, public housing and hyrdraulic services. The nation pays dearly for this lack of coordination".</u>

Workers compensation. This involves obvious cross subsidies that distort markets. For example, the premiums for a home-based business can be ridiculous in relation to the risks being assumed by the insurer. Businesses are usually run from home to reduce costs, so that when other costs are driven up it may reduce the incidence of such businesses being established.

Other small business costs. Accounting costs can be significant for a small business. The cost of preparing a tax return can be high for a small business, even when the accounts have been prepared by the business at, or close to, tax return scrutiny levels. There are opportunities for the government to reduce the complexity of preparing small business tax returns, to reduce this cost.

Yours faithfully

Nigel Fitzpatrick