Competition, dynamism and productivity

Opening statement to the House of Representatives Standing Committee on Economics *Inquiry into promoting economic dynamism, competition and business formation*, Friday 15 September

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Thank you for the invitation to appear again before this Committee, and for the opportunity to make an opening statement.

When we last appeared before this Committee, our *Advancing Prosperity*[1] report had not yet been publicly released, so today I will spend a bit of time discussing that. I will also discuss some recent productivity trends, the relationship between productivity and real wages, and some trends in indicators of market dynamism as set out in our submission. I will conclude by touching upon the topic of competitive neutrality.

My main messages today are as follows:

- Australia's productivity performance has been anaemic for quite some time.
- Productivity growth is a key driver of real wages growth.
- Competition and business dynamism are, in turn, important drivers of productivity growth.
- Several aggregate indicators suggest that competition and dynamism in Australia may be declining.
- However, these aggregate indicators should be interpreted with care, particularly when it comes to the menu of policies that might address those trends, and the tradeoffs that might be involved.
- There is no single policy silver bullet in relation to competition, dynamism and productivity.
- A comprehensive microeconomic reform agenda – of the kind outlined in our recent *Advancing Prosperity* report – is needed.
- Finally, we consider there is scope to improve Australia's Competitive Neutrality policy and make it fit for purpose for the years and decades ahead.

Recent productivity trends

In March this year we released our 5-year productivity report, *Advancing Prosperity*. The report emphasised the fact that over the decade to 2020, Australia's productivity growth averaged just 1.1% per year – the slowest growth rate in 60 years.

Since that report was released, there have been several disappointing data releases on productivity. The recent data underscores our earlier key messages.

[1] PC (2023a)

For example, the most recent National Accounts data from the Australian Bureau of Statistics shows that over the year to June, Australia's level of productivity went backwards, declining by 3.6%.[2] That data also shows that productivity has declined in four of the last five quarters. As a result, GDP per hour worked is now at its lowest level since March 2016.

The outgoing Governor of the RBA recently warned that Australia's living standards could stagnate in the face of our weak productivity performance.[3] Another view is that on current data trends, we would be lucky to achieve stagnation – it could turn out be another optimistic, "glass half full" prediction from the former Governor.

My own view is that Australia's productivity challenge is urgent – but it did not happen overnight. It has been an urgent problem for many years. We can and must do better, but there is a way forward.

Productivity and real wages

Why does it matter? Productivity is about working smarter – not harder or longer. The recent data underscores this.

If the level of productivity is falling – as it has been over the past year – this means that on average, Australians had to work more hours just to produce and buy the same volume of goods and services.

In other words, over the past year, Australians on average have been working harder and longer – in effect, running to stand still. Real wages have also been going backwards, and this is no coincidence. Indeed, one of the very first findings in *Advancing Prosperity* is that in Australia, almost all sustained increases in real wages are underpinned by improvements in labour productivity growth.

Productivity Commission research released today[4] confirms this. This research examines so-called 'wage decoupling' – defined as average annual labour productivity growth minus average annual producer wage growth. We find that since 1995, only two sectors have exhibited strong wage decoupling: mining (4.9 percentage points) and agriculture (3.4 percentage points).

These two commodity-exporting – and highly productive – sectors account for just 4% of total employment, but around 18% of total value added. They therefore have a disproportionate impact on economy-wide estimates of wage decoupling.

If we strip them out and examine the rest of the economy, average decoupling since 1995 has been just 0.1 percentage points. And in more than half of the sectors outside of mining and agriculture, decoupling was zero or negative.

In other words, since 1995 the wages of over 95% of Australia's working population have risen very closely in line with productivity. And the average income gain from a productivity lift is more than eight times the potential gain from eliminating the limited decoupling across most of the economy. So productivity growth remains the main policy game.

[2] ABS Cat No. 5206.0 https://www.abs.gov.au/statistics/economy/national-accounts/australian-national-accounts-national-income-expenditure-and-product/latest-release

[3] https://www.rba.gov.au/speeches/2023/sp-gov-2023-09-07.html

[4] PC (2023d).

Indicators of market dynamism

Given this, what should we do about our weak productivity performance? This committee is rightly focused on competition and market dynamism.[5]

In a market-based economy like Australia, it is reasonable to expect that there would be a close link between competition, dynamism and productivity.

Business decisions are driven by the pursuit of profit and the avoidance of losses. Market prices guide those decisions, and are "a signal wrapped up in an incentive", providing information to businesses about hiring decisions, where it invest, what to produce, how much to produce, when to sell it, where to sell, and to whom.

Well-functioning markets and healthy competition between businesses lead to lower prices, higher quality goods and services, greater consumer choice, and ultimately higher living standards.

However, if competitive forces are dulled or distorted, this can lead to incorrect price signals being provided, and poor outcomes for consumers and workers.

Australia's economy and our markets are changing. Markets for services – which tend to be relatively labour intensive – now dominate, with 80% of activity and 90% of employment now in services. And many services are delivered without benefit of either the signal or incentives of markets. In many instances, labour is the service – think of health, aged care and disability care.

I will return to these points a bit later.

Our submission to this inquiry[6] focusses on a range of data which are proxies for market dynamism: firm entry and exit, concentration, price-markups, labour market mobility and investment.

Let me highlight some the key points of our submission in relation to these proxies.

- While aggregate firm entry and exit rates *can* be an indicator of 'creative destruction' in the economy, they are not necessarily suggestive of broader underlying trends regarding dynamism.
- Measures of market concentration – such as the four firm concentration (CR4) index or the Herfindahl–Hirschman index (HHI) – should be interpreted with a great deal of care, particularly at the aggregate level.
  - Indeed, the proposition that market concentration *by itself* must be negatively associated with productivity growth and economic well-being has been questioned by economists for at least 50 years.[7] As a matter of economic theory, it is straightforward to derive examples where a higher HHI (an indicator of greater market concentration) is associated with higher – rather than lower – overall economic wellbeing.[8] And in practice, as our submission discusses, the link between concentration and wellbeing greatly depends on the economic context.
  - In any case, at the industry level, our analysis of concentration dynamics shows that most Australian industries are not concentrated, and very few of became concentrated from 2006 to

[5] As set out in our submission, economic dynamism is concerned with "the efficient adaptation to new demand and supply trends and re-organisation of resources (labour and capital) across the economy, supported by the creation of new knowledge and its rapid diffusion."

[6] PC (2023b)

[7] See Demsetz (1973).

[8] See, for example, Robson (2011), chapter 10.

  2021. Moreover, the distribution of concentration measures across industries was relatively stable between 2006 and 2021.

- Thus, the claim that the Australian economy is as a whole becoming more concentrated does not seem to hold up. Most Australian industries are not highly concentrated, and this has not changed much.
- Related to this, firm mark ups – the gap between price and marginal cost – are often pointed to as indicators of market power and weak dynamism. There is some evidence that markups have been increasing in Australia.
  - However, this evidence is plagued by measurement issues. And, from a policy perspective, interpreting aggregate evidence on markups is not straightforward.
  - For example, if costs and prices are falling together (so that consumers are better off) but prices fall at a slower rate (so that markups rise), what is the appropriate policy response?
  - Or, to take another example, in the presence of large fixed costs (due, for example, to high up front capital costs), a gap between price and marginal cost may be required simply for a business to break even. In the presence of high fixed costs, higher markups could, in principle, even be associated with lower profits.
- Some have gone further and claimed that “greedflation” abounds at the aggregate level in Australia, with firms across the economy using the recent increase in inflation to ‘unfairly’ mark-up prices over costs and increase profits.
  - The Commission does not agree with this claim. As our submission notes, overall, aggregate evidence does not suggest that high price margins associated with exploitation of market power have played a significant role in accentuating the higher input costs and supply constraints that precipitated the current inflationary episode.
- Indeed, some may counter that the greedflation thesis seems to have been quickly overtaken by the facts.
  - Australia’s annual inflation rate appears to have peaked at 7.8% and has now declined to 6%.[9]
  - Company profits declined by 13.1% in the June 2023 quarter, and fell by 11.8% over the year to June.[10]
  - Some might ask: if there is greedflation, why were firms apparently greedy up until recently, but have now suddenly stopped being greedy?
- As discussed at our appearance before this committee earlier in the year, an inflationary environment should not give businesses new opportunities for sustained exploitation of market power – if they possess this power, they will exploit it at any time.
  - And, consistent with our work on wage decoupling, our submission to this inquiry notes that stripping mining out of the corporate profits data indicates that profits have been stable as a share of total factor income. In fact, overall profits as a share of factor income *declined* to 30.2% in the June 2023 quarter, the lowest level since December 2021.

[9] ABS Cat No. 6401.0 https://www.abs.gov.au/statistics/economy/price-indexes-and-inflation/consumer-price-index-australia/latest-release.
[10] ABS Cat No. 5676.0 https://www.abs.gov.au/statistics/economy/business-indicators/business-indicators-australia/latest-release.

To conclude on indicators of dynamism: while there are some indications that dynamism may be declining in Australia, it is difficult to draw specific policy implications from the data.

Advancing prosperity

However, the answer is not to sit back and declare that it is all too hard. On the contrary, there are several policy measures that the Commission believes would stack the odds in favour of greater competition and dynamism in Australia, and which would give us the best chance of meeting and overcoming our productivity challenge.

Some commentators have said that we should focus on a narrow set of policies – climate, technology and supply chains. These are obviously important, but we think the reform agenda is much broader.

In any case, it may come as a surprise to these commentators that the Commission and its predecessors have been thought-leaders in climate policy for more than three decades, with our first publication on the costs and benefits of emissions reductions appearing in 1991.[11]

For all the talk about supply chains, as far as I am aware, our 2021 report on *Vulnerable Supply Chains*[12] remains the only rigorous, evidence-based analysis of that issue in Australia.

And of course, our annual Trade and Assistance Review[13] – now in its 49th year – provides up-to-date and cutting edge analysis of industry assistance and trade policy developments.

Advancing Prosperity sets out 71 policy recommendations across 29 reform directives. Our policy recommendations fall into five general areas:

1. Building an adaptable workforce to supply the skilled workers for Australia's future economy.
2. Harnessing data, digital technology and diffusion to capture the dividend of new ideas.
3. Creating a more dynamic economy through fostering competition, efficiency and contestability in markets.
4. Lifting productivity in the non-market sector to deliver high quality services at the lowest cost.
5. Securing net-zero at least cost to limit the productivity impact caused by climate change.

Our report also sets out a detailed prioritisation framework and implementation roadmap for meeting and overcoming our productivity predicament.

Many of recommendations are directly or indirectly related to competition and market dynamism, particularly given the changing structure of Australia's economy towards services. For example in a service-based economy, fit for purpose labour market regulation is key, particularly in relation to the gig economy, which can be an important source of market entry, innovation and dynamism.

For the most part, real wages and productivity move together. Finding productivity improvements leads to increases in real wages. So labour market settings need to facilitate and indeed maximise cooperation between parties and encourage innovation, reward aspiration and effort, and preserve fairness.

[11] PC (1991).
[12] PC (2021).
[13] PC (2023c).

Shoehorning platform work into other employment categories would put at risk its productivity impacts and its benefits for gig workers. But gig workers have genuine concerns that need to be taken very seriously. Improved safety protection and access to dispute resolution are warranted.

Our migration policy settings should be viewed through a productivity lens and focus on the composition of the intake at least as much as the aggregate quantum. In this regard, we think there is great merit in moving towards a system that places a greater emphasis on employer nomination, and less of a reliance on skill lists.

Reforms to occupational licensing arrangements would also assist with the better allocation and matching of scarce labour resources across the economy.

On digital infrastructure, we think there needs to be better regional internet connectivity, as well as policies in place to ensure that there is more transparency around digital infrastructure funding decisions and evaluation of previous investments.

And the market for internet connectivity may now be sufficiently developed to allow for a more competitive method of allocating funds.

Openness to trade, investment and international migration are key drivers of market dynamism and prosperity more generally. We recommend getting rid of our remaining tariffs, and progressively removing Australia's anti-dumping and countervailing measures, and subjecting any new measures to an economywide cost benefit test.

We should increasingly accept product standards adopted in other leading economies as 'deemed to comply' with Australian standards. And we could bring application fees for proposed FDI into agricultural land assets closer into line with other forms of investment.

On taxation, we recommend a suite of reforms. In addition to abolishing Australia's remaining tariffs, we also recommend abolishing stamp duty on insurance premiums, moving towards a more system of efficient road user pricing, and moving away from taxes that discourage encourage efficient asset transfers and capital allocation, such as stamp duty on property transactions.

Related to this, our systems of business and industrial planning and zoning could be improved, with an eye towards encouraging greater geographic competition between businesses. And there is scope for state and territory governments to improve public transport pricing arrangements.

Finally, on merger policy: we conclude that overall, there does not appear to be a strong case for the implementation of a new formal authorisation regime, of the kind proposed by the former chair of the ACCC. Instead, we think there may be more value in the ACCC further considering its internal merger review processes; and for government to consider how best to avoid perverse incentives across merger clearance procedures.

Competitive Neutrality Policy

To conclude, I would like to mention one aspect of the Commission's responsibilities that we believe warrants a close look, and which could benefit from reform: the area of Competitive Neutrality.

It has been 30 years since the Hilmer Report on National Competition Policy – which was introduced by Prime Minister Keating as an "important contribution towards furthering competition policy in Australia".[14]

A key part of the Hilmer report dealt with the principle of competitive neutrality – the proposition that state-owned enterprises and private businesses should compete on a level playing field. Competitive neutrality (CN) policy is also concerned with government businesses that may compete with each other.

It has long been recognised that favourable conditions for government enterprises in relation to their private sector counterparts can distort all kinds of economic decisions – particularly around innovation, investment and hiring, ultimately leading to suboptimal outcomes for consumers and workers.

Those artificial cost advantages can also lead to resources (capital and labour) flowing to government businesses simply because of their government ownership rather than them being the most efficient (productive) users of resources. Where these resource allocation distortions occur, the nation's productivity suffers.

The principle of competitive neutrality is likely to become increasingly important, particularly given the growth of the non-market sector (for example, in the care economy) and the re-entry of governments into some of the economy's "commanding heights", such as energy and telecommunications.

The Government's approach to operationalising CN principles is set out in the 1996 Competitive Neutrality Policy Statement[15] and the Competitive Neutrality Guidelines for Managers.[16] Unfortunately, Australian Government businesses sometimes fail to comply with these obligations and guidelines.

An integral part of competitive neutrality policy and its implementation is a competitive neutrality complaints handling mechanism, which is intended to bring some discipline to the implementation of competitive neutrality and provide ongoing accountability.

The Australian Government Competitive Neutrality Complaints Office – the AGCNCO, a separate unit within the Commission – is that mechanism. It deals with any complaints and provides independent advice to Government following its investigations.

Any individual, organisation or government body with an interest in the application of competitive neutrality may lodge a complaint. While governments are not obliged to accept the AGCNCO's advice, we think there needs to be a strong cop on the beat in relation to competitive neutrality.

However, although our competitive neutrality policy has served Australia well over the last three decades, it is deficient in several areas. To name just a few:

1. Australia's competitive neutrality policy lacks a credible enforcement regime.
2. There is a lack of guidance on what a public interest test should embody and what it should look like.
3. There are poor processes to ensure compliance with the policy by start-up government businesses.

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[14] Statement by the Prime Minister the Hon PJ Keating MP, 25 August 1993. https://pmtranscripts.pmc.gov.au/sites/default/files/original/00008945.pdf

[15] https://www.pc.gov.au/about/core-functions/competitive-neutrality/commonwealth-competitive-neutrality-policy-statement-1996.pdf

[16] https://www.pc.gov.au/about/core-functions/competitive-neutrality/2004-competitive-neutrality-guidelines-for-managers.pdf

4. There is little guidance or principles on what constitutes ‘government’ in significant government business activities.
5. There is little guidance on what policy or complaints process should apply for business activities with multiple government owners.
6. There is no mention of the full range of possible material competitive advantages (other than those relating to tax, debt and regulatory neutrality and earning a commercial rate of return), and poor guidance on methodologies for estimating the value of some advantages.
7. There is an absence of guidance on whether any identified cost advantages should be addressed by the imposition of a CN adjustment payment, or by directly addressing the source of the advantage.
8. There is a need to reformulate the commerciality test in CN policy.

Australia recently signed up to the OECD’s Recommendation on Competitive Neutrality.[17] In light of this renewed commitment, and given this Committee’s – and the Government’s – focus on competition and dynamism, it may be an appropriate time to look more closely Australia’s competitive neutrality regime, with an eye to reform.

In this respect we support the earlier findings of the Competition Policy Review[18] (the Harper report), which recommended all Australian governments should review their competitive neutrality policies and complaint handling mechanisms to ensure they remain fit for purpose in the 21st century.

The Government’s recently announced two-year Competition Policy Review may provide a further opportunity to examine competitive neutrality policy.

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[17] The Recommendation was formally adopted on 31st May 2021 at the Ministerial Council Meeting. All OECD members have adhered. https://legalinstruments.oecd.org/en/instruments/OECD-LEGAL-0462#adherents.

[18] See Commonwealth of Australia (2015). https://treasury.gov.au/sites/default/files/2019-03/Competition-policy-review-report_online.pdf. The Commonwealth undertook a review in 2017. https://consult.treasury.gov.au/competitive-neutrality-review.