Future productivity

Tax and Transfer Policy Institute / Business Council of Australia workshop on 22 September 2021

Michael Brennan, Chair

Thank you for having me here today as part of this important session.

I have benefited a lot from the previous two sessions – it's been a dauntingly high-quality discussion. And thank you to Alison for her observations about our productivity challenge.

I would like to make two observations – one about capital deepening and then a perspective on the link between productivity growth and fiscal pressures.

What has resonated with me in all contributions so far is the importance for Australia of maintaining openness to the world. We are the archetypal small open economy and have benefited enormously from trade, foreign investment and the flow of people. Not just for a more efficient allocation of resources, but because these things have facilitated the flow of ideas.

In light of COVID, border closures, supply chain interruptions, and our strategic realities, all of these policy settings are rightly being scrutinised and, in some cases, adjusted – which is appropriate, but we should remain mindful of the overarching importance of openness to our economic future.

Both Alison and Ken have rightly raised the link between capital deepening and labour productivity growth.

Capital deepening

At its simplest, investment leads to more capital; and a higher capital to labour ratio tends to mean more output per worker (or value added per hour worked) – which is the very definition of labour productivity.

At a high level, we often think of it as though the investment and the capital deepening directly cause the increased productivity. Which can be taken to imply that we need to 'just add capital' to generate labour productivity.

It's a stylised version of reality and it has its uses. It is the underpinning of the Solow Growth Model and it's the way CGE models generate increased output from some

external change that boosts capital investment – like a tax change or a rise in FDI (foreign direct investment).

Perhaps it's a reasonable approximation of reality when you think of a firm using new equipment to replace some labour and make production more efficient. But in most cases, capital deepening and productivity growth are correlated because they are caused by the same thing – namely people coming up with and executing new ideas.

Firms invest because they have an idea – for a new product or process – a new way to satisfy a consumer demand out there. The investment might actually turn out to be technically inefficient because the idea doesn't work out, the business fails, or the investment gets written off. But we still want that, because in a modern economy we rely on that process of experimentation. It is the feedstock of productivity growth and economic progress.

So, it is important to reduce barriers to investment – whether in the tax system or in foreign investment policy – as part of the broader policy settings that help us generate, adopt and diffuse new ideas and turn them into action.

My point is that it is as much (maybe more so) about the ideas as it is about the capital stock per se.

Which points to the role of a range of other policy areas, such as regulation, skills and labour mobility. In fairness, governments have been tackling these things, through the deregulation taskforce, the progress on automatic mutual recognition of occupational licenses, insolvency reforms, responsible lending changes, and also things like the Commonwealth's digital economy strategy and the work of the services roundtable on global trade in services.

Hence business has a role to play, in terms of being outward looking, taking risk, embracing new technology and skilling its workforce. A high growth economy is one where boards, institutional investors, bank lenders and SMEs are all embracing that vision of turning ideas into new (and often disruptive) business models and products.

Productivity growth and fiscal pressures

My second observation concerns productivity growth and fiscal pressures as set out in the IGR (Intergenerational Report).

Alison pointed out that the IGR shows the effect of a lower growth scenario – if productivity growth was to average 1.2 per cent instead of 1.5 per cent, then projected deficits are out to 2060 are materially higher than the baseline. Which underscores the need for strong productivity growth in the market sector in order for us to pay for the spending pressures on government.

The IGR also describes a subtle shift in the composition of government spending out to 2060. There are spending pressures in areas like:

- Health (rising from 4.6 per cent of GDP today to 6.2 per cent in 2060)
- Aged care (1.2 per cent to 2.1 per cent)
- NDIS (1.2 per cent to 1.4 per cent)
- Defence (2.1 per cent to 2.3 per cent).

These are partly offset by Education which is projected to fall from 1.9 per cent to 1.2 per cent of GDP.

Overall, these functions – where government directly funds a service – are projected to rise from 11 per cent of GDP to 13.2 per cent.

By contrast, pensions and payments to individuals will fall as a share of GDP – from 6.4 per cent to 4.8 per cent.

In other words, there is a general trend of Commonwealth spending will be shifting away from transfers to individuals and towards the funding of services.

The NSW IGR tells a similar story, with health spending rising from 29 per cent of total recurrent spending to 38 per cent.

If these areas are increasing as a share of government spending, it suggests these sectors will increase as a share of the economy – taking up a larger slice of capital and labour resources.

While we talk about the need for economy wide productivity growth to pay for this, we do not talk enough about the need for productivity growth within these areas.

To return to my earlier point about new ideas and business models, it is notable how little the basic business model of hospitals, primary health, school education, courts, prisons and many regulators has actually changed.

And to return to my earlier point about capital deepening, although there is plenty of investment in these areas it doesn't generally economise on labour.

Looking through the PC's *Report on Government Services*, it is notable how many areas of state service delivery have increased employment by more than population growth over the last decade.

In some of these areas of service delivery we appear to use what economists refer to as Leontieff production function – where capital and labour are applied in fixed proportions, hence we build the sort of capital assets that also require new labour as well – like a new hospital, or police station or school building.

These are often important expansions of service delivery, but it is important in all these areas for us to also keep finding technology and investment that can do things differently and free up labour. This is akin to exploring new business models for the delivery of public services.

Technology – including the rise of digital technology – is a big opportunity here.

I have talked elsewhere about the tendency for the health sector to embrace cutting edge medical technology but neglect general purpose technologies that could reduce reliance on the one-on-one, real-time consultation as the overwhelmingly dominant business model.

Our work on mental health and our work on innovations in chronic health care delivery show that adroit use of digital technology can cut costs and raise convenience and quality of service.

The broad point is, in thinking about the role of productivity growth in addressing future fiscal pressures, we will increasingly need to think about productivity in the delivery of these services – to reduce their real cost over time – as well as the productivity growth in the rest of the economy that helps us pay for it.