Productivity Priorities Post-Pandemic

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Economic growth has arguably become more important today than it has been for some time. It has become more important to our long-term fiscal sustainability and our ability to afford high quality services.

If we want to avoid the scarring effect of unemployment on young people, or the discouragement of our finite band of small business owners and risk takers, then growth is essential.

We start from a better position than most. Last week's national accounts data confirm that GDP has returned to its pre-pandemic levels.

Employment returned to pre-pandemic levels in roughly a quarter of the time it took to do so following the 1990s recession. The participation rate is at a record high.

The lockdown in Melbourne is a sobering check on triumphalism, but it is notable that twice now in the last 12 years, Australia has dealt with a global economic crisis better than almost any other economy in the developed world.

It is not hubris to objectively acknowledge that we went into those crises having gotten some big things right.

Those big things include strong fiscal buffers, a reasonably flexible labour market, openness to trade, well capitalised banks, independent monetary policy, credible public sector institutions and a targeted, but redistributive tax-transfer system.

Those are among the key planks of Australia's economic policy framework, much of which was developed and bedded down over the last forty years.

A key lesson from COVID and a message for today is that that framework is not broken.

The worst possible response to the pandemic and the recession would be to dismantle, or walk away from, the very policy architecture that has supported our relative success thus far.

That isn't to say that there isn't more to be done, or that the next wave of reform should look exactly like the reforms of the past.

Just as we should be objective about our successes, we need to start with an honest appraisal of the productivity growth challenge.

First, productivity growth has slowed across all developed economies in recent decades, leading to subdued growth in living standards.

In Australia, the decade since 2010 – even excluding last year – has seen our slowest growth in GDP per capita of any decade in at least 60 years.

France, Germany, the UK and the US have all seen labour productivity growth more than halve in the period 2006-17, compared with the ten years from 1996 to 2005.

Second, the causes of that slowdown are much debated, but without a clear consensus.

Economists have pointed to mismeasurement issues, a shift towards lower productivity industries, population ageing, a slowdown in the pace of technological discovery, a slowdown in the pace of technological diffusion, a plateauing of improvements in human capital, reduced rates of firm entry and exit, increased concentration and market power, lower capital investment, a shift to intangible capital and the slowing of growth in global trade.

Perhaps the closest we could get to consensus would be the view that there is no clear individual cause, which if addressed would singly reverse the trend.

Hence, productivity policy is not a mechanical process, where specific policy levers make known, quantifiable contributions to growth rates.

It is more a mindset than a recipe, and it involves having policy settings that at least stack the odds in your favour.

In broad terms, that comes through fostering flexibility so that labour and capital can move easily across industries and firms, by having even-handed policy settings that avoid locking in an inefficient or just a rigid allocation of resources, having strong credible public institutions to set the rules of the game and deliver public goods efficiently, creating the right incentives for innovation and risk taking and boosting the capability of the workforce through general education and targeted skill formation as well as physical and mental health.

But because the future path of innovation is unknown, we can't easily know which existing rigidities will hold us back.

Often it will be about detail.

This week I am talking with the nation's Treasurers (state and Federal) about:

- Innovations in health care which are already improving the management of chronic disease in cost effective and patient-centred ways.

- Our work on resources regulation identified good practices that individual regulators have adopted to deliver better and more timely decisions with more clarity for investors.

- Our work on planning has identified steps we could take to make zoning regulations more flexible and more agnostic about the location of economic activity.

- Our work on reg tech has focused on instances where digital technology can cut compliance costs for business, inform more targeted enforcement by regulators and generate data which can often then be a public good.

- Our work on skills has emphasised the importance of choice and efforts to lift quality, and to focus the system more on lifelong learning as well as the initial acquisition of formal qualifications.

One overarching observation about these efforts is that they all contribute to aggregate productivity growth, but to be enacted they have to make sense to people in their own right.

Reforms are usually best sold on their concrete particulars – how changes can improve everyday life for individuals, businesses and communities.

Productivity growth is ultimately about living standards, broadly conceived. In other words, better outcomes at lower overall cost to the community.

At the Productivity Commission, part of our job is to make specific recommendations to government for their consideration.

But governments have a lot on their plate, especially now. And they operate within constraints. One of which is the nature, direction and quality of the public debate.

We (all of us) have a role in influencing that debate.

Rather than exhorting government to do more, we could ask ourselves the question:

- Is our public debate on economic policy helping to foster a pro-productivity, pro-flexibility mindset?

- More modestly, is it even setting us up to avoid bad policy? To do no harm?

When I look at the current debate – with contributions from economists, policy commentators, business and community leaders – I see two dark clouds on the horizon.

The first is the renewed promotion of ideas of national self-sufficiency and sovereign capability coming out of the pandemic. This is not a new phenomenon, but it has found new voice.

The second is an overly sanguine view about ever-expanding debt and deficit as an ongoing approach to fiscal policy – effectively that government can and should go yet further with fiscal expansion in more normal economic times at no effective cost.

If you are in either of those camps, my advice is: be careful what you wish for.

On self-sufficiency, two high level points:

- Australia's experience with the protection of domestic manufacturing – roughly an 80-year experiment – was not an overly happy one.
- And in the last two economic crises, including today, trade has been a big part of Australia's recovery.

It is true that individual firms are taking their supply chains more seriously in light of COVID, as 'just in time' gives way to 'just in case' in some instances.

It is also true that global trade has flatlined since the GFC and support for multilateral trade liberalisation is at a low ebb, though this pre-dated the pandemic.

And it is arguable that trade and foreign investment policy for Australia are more complex than they were thirty years ago.

But it is also true that the death of free trade is much exaggerated, and the push to encourage domestic production as a policy priority is likely to undermine growth.

Our work on vulnerable supply chains shows that the proportion of our imports which come from a concentrated source, for which there are few substitutes and which flow into essential industries, is low. About 2 per cent of imported goods fit this description.

Even in many of those cases, domestic production would be a prohibitively costly option, compared with some stockpiling or measures to diversify sources of supply.

Similarly, whilst some might think we are highly dependent on a small number of export markets, in fact our levels of export concentration (by country and by product) are similar to those of our peers.

And in the height of the pandemic, while some shortages were met through domestic manufacturing (like gin makers shifting to hand sanitiser) mostly we dealt with emerging needs – like for PPE – through trade. And it worked.

As the OECD pointed out in February, global access to COVID vaccines relies critically on trade – as they require inputs from multiple different source countries.

Trade – rather than self-sufficiency – is the only feasible way to deal with these interdependencies.

That is not to say vulnerabilities will never arise, and that policy should not respond.

But as always it should be determined on the evidence and the particulars of the case, rather than a general claim that we can no longer rely on trade and have to make things here.

We can't make everything here, but we could certainly make ourselves poorer in the attempt.

Our first best policy is to keep up our international efforts to strengthen the global trading system – to update its rules and shore up the dispute resolution process.

My second dark cloud concerns the fiscal debate.

The right sort of fiscal debate is one that brings together insights from both macroeconomics and microeconomics (which I will term the 'supply side' view) because the fiscal response to date has had elements of both.

I have no argument with the current Federal fiscal stance. Active fiscal policy was necessary in the recession and it remains important in the early stages of recovery.

In the pandemic, the fiscal response was not really a conventional Keynesian stimulus, because it wasn't trying to boost activity in a period of weak demand.

Rather it provided income to those most affected by supply side restrictions, akin to a form of ex post collective insurance. It provided some protection against what amounted to uninsurable risks, the costs of which were concentrated on particular firms, households and sectors.

The fiscal response helped to smooth that cost across the community and through time – a more efficient form of insurance than would have been possible in private markets.

As restrictions have lifted and the economy recovers, the fiscal response has looked more conventionally Keynesian – boosting aggregate demand to stimulate confidence and activity. At the same time, there has been a focus on removing the rigidities associated with policies like Jobkeeper, to allow some reallocation of resources across the economy.

The duration of that stimulus is a matter for macroeconomic judgment.

Ultimately, the Government's policy is to return to a stable debt to GDP ratio once the recession is behind us and we are closer to full employment.

The prudence of that approach is supported by the likelihood that bond yields will remain below nominal growth rates.

This means that the debt to GDP ratio will gradually decline. Alternatively, we can afford to run small deficits in the future, and still maintain a steady debt to GDP ratio.

The risk in the public debate is that this insight – that GDP growth tends to exceed interest rates – is taken to imply something altogether different and much bigger: that debt and deficit no longer matter at all…

…that we can afford the next and the next 'one-off' rise in debt on the grounds that growth rates will continue to outpace bond yields – noting that in other developed economies, the very same observation is being used to justify debt to GDP ratios more than twice as high as ours.

In the economists' language, the view that growth rates will outpace interest rates provides some comfort about the sustainability of existing steady state debt levels, but it gives no guidance as to *which steady state debt level* we should choose.

In choosing a debt level, there is both a macroeconomic and a microeconomic case for caution.

The macro case is, first, that we need to rebuild fiscal buffers for the next emergency.

Second, that if inflation did re-emerge, or if bond yields exceeded nominal growth for a period (not impossible for a resource exporter like Australia) then, by implication, we would need a fiscal consolidation.

Successful fiscal consolidations in history are rare. They are not often popular. And they would likely be even less popular in a period of rising inflation or falling terms of trade or slow real growth or rising interest rates: but those are the very circumstances in which our currently favourable debt dynamics would reverse.

The reason fiscal consolidation is hard in practice comes down to incentives:

- spending proposals tend to look attractive individually but add up to an unattractive and unaffordable total; and
- future taxpayers are under-represented by today's voters.

Then there is a microeconomic case for caution.

This is based on the observation that fiscal choices come back to the use of real resources in the economy. And there are some limits on the extent to which real resources can actually be borrowed from the future. One way this happens in practice is through a decrease in capital accumulation.

The real cost of government spending is measured in the labour, capital and materials used that would otherwise be employed elsewhere, such as in pursuit of some private entrepreneurial aim —innovation or investment.

That sense of scarcity can seem less evident during a conventional demand-side recession, or when inflation is low.

But as we move along the path of recovery – even in an economy operating at less than its potential – it is a mistake to think that government spending has no opportunity cost.

Resources have an alternative use, with an alternative value to society – a value which might even be higher than that which a government program produces. Obviously, this is particularly true if government spending is not universally of high quality.

An infrastructure project that doesn't pass a cost benefit analysis, or a funding model that rigidly locks in an existing business model, or an industry program that diverts resources into a favoured sector, can all act to reduce growth and wellbeing.

In other words, in addition to observing aggregate fiscal rules, governments have to ensure that their interventions (backed by coercive powers like taxation) are consistent with allocating scarce resources to their highest value.

Often as microeconomists we look at prices and observed behaviours ('revealed preference') to provide clues as to where that value lies.

For example, in the Commission's recent Mental Health report, we tried to calculate the cost-effectiveness of various policies and programs by looking at the improvement in 'quality adjusted life years' which they bring about – to try and compare alternative programs and prioritise them according to their 'bang for buck'.

For the same reason, it is important to undertake cost benefit analysis of infrastructure projects, and rigorous evaluations for social programs.

And also to try and include a clear sense of the efficiency loss from taxation where new spending is involved.

It is important to apply similar rigour to choices about consumption through time (i.e. today vs. the future).

The simple story of debt dynamics (growth rates greater than bond yields) is incomplete if not grounded in some sense of well-being through time (or utility as economists refer to it) – that is, the trade-offs between consumption today and consumption in future years or by future generations.

Some might see a long-term reduction in interest rates as indicating a good time to borrow – and this logic fits well for a household or a business.

But a government, trying to manage the scarce resources of the economy as a whole, might want to understand *why* real interest rates are actually lower and what that means for its resource allocation decisions.

Could it be, for example, that lower real interest rates reflect some shift in societal preferences *in favour of the future?*

If so, then when it comes to project assessment, this might boost the case for capital investment: at a lower 'discount rate' we might find it more attractive to sacrifice consumption today, to invest for a future pay-off.

It does not necessarily follow that at the same time we should (or can) *bring forward* significant consumption by borrowing heavily *from* the future, even if bond markets make that look feasible and attractive.

These are complex considerations, so the approach to inter-temporal choice and inter-generational equity needs to be thought through carefully. In the face of uncertainty about future growth the case for a precautionary principle is even stronger.

The imposition of fiscal limits, as per current stated policy and the budget's medium-term projections, fits with such an approach. The view that debt and deficit no longer matter does not.

To return to my earlier theme, luckily for Australia, our fiscal frameworks and adherence to budgetary rules has served us well.

They have been backed by a public consensus around fiscal restraint. That consensus has been a significant intangible asset for Australia over the last few decades.

If that public consensus fragments, or is undermined by 'expert' opinion, then gross debt is unlikely to stabilise at 51 per cent of GDP.

So the public debate is important in shaping future policy for good or ill.

We should have an open debate about our productivity challenge; but it should include an honest appraisal of the things we had right before the pandemic and from which any departure would come at great cost to current and future generations.