Productivity policies: the 'to do' list*

> *The Productivity Commission has a long list of things to do. My answer to what we can do about productivity is: go get the list and do them.* (Glenn Stevens, June 2012)

Introduction

In the decade and a half since the Productivity Commission was formally established, it has completed 110 inquiries and other commissioned studies and made some 1500 policy recommendations to governments. All of these recommendations were made because the Commission judged that their implementation would enhance Australians' living standards and quality of life. In many cases, they would do so by raising the capacity of Australia's economy to produce valued goods and services — in other words, by raising its 'productivity'.

On a rough reckoning, around two-thirds of the Commission's recommendations over the years have been accepted and (more or less) implemented by governments. That is not a bad strike rate, given that our reports typically deal with complex and politically contentious areas of public policy, where benefits to the majority can necessitate withdrawing advantages from (vocal) minorities. It nevertheless leaves a sizeable residual, to which Reserve Bank Governor Glenn Stevens was no doubt alluding in his much-reported remarks. Many in the media took him literally though, and were disappointed that the Commission did not in fact have a 'list' at the ready.

Many of the unimplemented recommendations from past reports remain directly applicable today, but others do not. A fair number have been overtaken by subsequent changes to the policy in question or in related areas, changing the 'context' from what it was when the recommendations were framed. The more detailed or distant the recommendation, the more likely that this will be an issue.

The upshot is that devising a list of those recommendations that remain valid — passing the dual tests of delivering net benefits and being superior to alternative policy options — would generally require at least some reconsideration of the broader settings. While that may not always be straight forward, it can of course be

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done. The reasons why the Commission has not actively maintained a list of this kind have more to do with what might be called institutional propriety. Having sought the Commission's independent advice on significant (and frequently contentious) areas of public policy, once an elected government decides for whatever reason not to accept that advice, it would be considered poor form for the Commission effectively to continue treating these as 'live' issues.

Lists from the past

That is not to say that constructing lists that include previously neglected, but still relevant, reform opportunities is never appropriate or worthwhile. Indeed, at times, the Commission has been asked to do just that. The first instance occurred while the Productivity Commission's enabling legislation was still before the Parliament, with the interim organisation directed to produce a *Stocktake of Microeconomic Reforms* (PC 1996). This contained over 120 recommendations across such diverse policy areas as labour markets, economic infrastructure, competition policy, social services, taxation and industry assistance. These set the scene for a range of reforms and more detailed follow-up reviews. The Commission's next major agenda-setting report was its 2005 *Review of National Competition Policy* (PC 2005a), which charted reform directions for Australia extending well beyond the competition domain, and was the precursor to COAG's (ongoing) National Reform Agenda.

On the issue of regulatory 'red tape', the Commission has put forward wide-ranging lists of reforms in its series of *Stocktakes of Regulatory Burdens* and its *Regulatory Benchmarking* studies for COAG. And currently the Productivity Commission is engaged in a joint scoping study with its New Zealand namesake to develop a comprehensive agenda for further trans-Tasman integration, much of which involves previously traversed reform areas (APC and NZPC 2012).

Also, as the Commission's Chairman, part of my role over the years has been to make speeches at national forums such as this, highlighting reform themes and policy agendas emanating from our work (Banks 2010a, 2011a, 2012). That includes proposals from past reports with enduring policy relevance. In view of the evident interest in such lists, and the ongoing debate about what really matters for productivity growth, I propose doing so again today — the last such opportunity in my current job.

Why productivity is important (once again)

Back in 1996 when the incoming government amalgamated the Industry Commission, EPAC and BIE to form the present organisation, some expressed

puzzlement at the name chosen for it. 'Good idea, but why call it the *Productivity* Commission?' more than one person asked me. None of the doubters were business people, however, who would have appreciated the role that productivity played in their own enterprises.

Community groups have had more difficulty seeing why productivity matters, and labour unions have traditionally been suspicious of it as providing cover for job cuts or reductions in wages and conditions. A breakthrough occurred in the Accord years, when national wage increases were directly linked to productivity gains. And this new attitude was sustained through the move to enterprise bargaining and the advent of National Competition Policy. But some ambivalence appears to have re-emerged.

Productivity's real contribution

One possible explanation is that much of the rhetoric around productivity today treats it as if it were a policy objective in its own right. That is wrong and can lead to perverse results. Productivity, like production, matters not for its own sake, but because growth in it can generate the higher incomes and government revenues needed to raise living standards and rectify disadvantage. Policies to promote productivity need to have these larger ends in view.

Since tariff liberalisation and other microeconomic reforms in the mid-1980s first began to transform Australia's industrial landscape, wages in this country have increased by one-third in real (inflation adjusted) terms. Until recently this was primarily underpinned by productivity growth. The drivers of the gains in labour productivity were capital investment, more efficient production methods within firms and better allocation of resources across industries; not greater work 'intensity' or harsher working conditions. In this same period, the number of jobs in the economy increased from 6.9 million to 11.5 million — at a rate exceeding population growth — with participation rates rising significantly and unemployment rates falling.

Conceptually, productivity is simply a measure of the relationship between outputs and inputs, expressed in volume terms. At a national level, labour productivity can be computed as national output divided by the number of hours worked across the economy. This abstracts from what labour happens to have been paid. Rather, it depends on labour's skills and, more importantly, where and how well these are being put to use (and combined with capital) in enterprises and industries throughout the country.

There are essentially only two ways of increasing the per capita income of a society over time — by producing more per person or by getting higher world prices for what is produced. Over the past decade, Australia's failure to do the former has been more than made up for by the latter. Indeed, the decline in our productivity performance and the rise in our terms of trade have been almost equally unprecedented. But no country (not even a Lucky Country) can expect its terms of trade to rise forever. Their recent decline puts the spotlight back on productivity growth as the main conduit for higher incomes into the future. While the labour force participation rate is important, it is to productivity growth that we must primarily look if we are to meet the ongoing challenges of an ageing society (PC 2005). And it is to productivity growth that we must look if we are to succeed in making necessary fiscal repairs in the wake of the Global Financial Crisis, while addressing important social needs. As has been said, a government cannot redistribute what its economy does not produce. Productivity growth is fundamental to this.

Will it recover?

The end of the mining boom will in itself bring about part of the productivity improvement we need. As the Commission has shown in several detailed studies, Australia's productivity slide has had much to do with cyclical and structural forces that are temporary or reversible. Drought is perhaps the clearest example, by curtailing the output and thus productivity of the agricultural sector. It also affected the measured productivity of public utilities for which water is an 'output'. The mining boom has been a much stronger influence, with historically high export prices prompting the biggest investment surge in Australia's history. For reasons that are now well known, this simultaneously dragged down the productivity of capital and subtracted significantly from measured multifactor productivity growth.

Thus, as my colleague Dean Parham put it recently, the pronounced decline in productivity has had more to do with 'adjustment' than 'crisis' (Parham 2012). And a return to more 'normal' productivity growth is to be expected as the forces responsible abate. Meanwhile, during the terms of trade boom, Australia experienced almost the fastest growth in per capita incomes on record, notwithstanding the Global Financial Crisis.

The ability of productivity growth to stage a comeback has been illustrated by the sharp rebound for agriculture following the end of the drought. The end of the minerals export price bonanza should see productivity recover somewhat in that sector too, as new investment subsides and higher output associated with previously 'unrequited' input growth comes on stream. (A jump in economy-wide labour

productivity in the most recent quarterly data has been seized on by some, but the proverb 'one swallow does not a summer make' is apt when assessing productivity trends.)

While there is no cause for panic about Australia's productivity outlook, there is also little reason for complacency. Indeed, there are a number of grounds for caution or even concern:

- For a start, while we can attribute about one-half to two-thirds of the productivity decline in the last cycle to the 'usual suspects', it is less clear what is behind the rest — particularly for the manufacturing sector, which was the single biggest contributor to the overall decline.
- Secondly, while the surge in capital inputs in mining is likely eventually to generate output broadly commensurate with the massive outlays, this is much less certain for public sector investments in the utilities sector, particularly those directed at security or 'quality' objectives in electricity and water.
- Thirdly, with the transmission of the mining boom to other parts of the economy and, most directly, to those industries supporting mining activities, some firms are likely to have tolerated cost increases and inefficiencies in the rush to capture higher prices (and profits). Their legacy may not easily be reversed as the boom subsides.
- Finally, there is as yet no firm basis for assessing the causes of the further marked deterioration in productivity performance since the end of the last cycle in 2007–08. Moreover, this period has seen a number of significant policy initiatives in areas such as infrastructure, labour markets and environmental regulation for which the productivity impacts are uncertain, but unlikely to be all positive.

A little improvement can make a big difference

So the jury is out on how much of a recovery in productivity we can look forward to. If the Inter-Generational Report's projections are indicative, however, we are living in a time of diminished expectations when it comes to productivity (as opposed to public spending). Between the first IGR in 2002 and the third a decade later, the projected rate of economy-wide labour productivity growth was lowered from 1.75 to 1.6 per cent (Treasury, 2010).

This is a projection, not a forecast, and merely reflects the fall in the preceding long term average. But its effects illustrate that small differences in productivity performance make for large cumulative differences in future prosperity. The 0.15 percentage point difference between the two projections translates to a reduction in

per capita GDP of nearly $7000 (in today's dollars) by 2050. If in practice we only managed to achieve the pre-1990s average rate of growth of 1.4 per cent, GDP per capita would be reduced by a further $8000. By contrast, if we could recapture and sustain the exceptional 2 per cent average growth of the 1990s — a target set by Prime Minister Rudd in 2010 — we would on average gain $18 000 per capita, with GDP nearly 20 per cent greater than otherwise. That would clearly be a stretch, but the closer we can get to it the better off we stand to be, both economically and socially.

The policy framework

While there is widespread agreement that a return to higher productivity growth is desirable, opinions differ considerably as to how governments can best facilitate this. Different interests and parties have focused on different things and been dismissive of others' prescriptions, sometimes with good cause. Almost any policy proposal having an economic dimension has tended to be portrayed as 'pro-productivity', whether that is the case or not. As a consequence, the public has become confused or bemused, making it difficult to build support for policies and reforms that really would make a difference.

In various studies and reports over the years, and notably in its submission to a parliamentary inquiry in 2009, the Commission has set out a framework that explains how policies can foster or hinder productivity growth, and provides a basis for assessing areas of priority (PC 2009a).

The essential insight underlying this policy framework is that productivity begins in workplaces. The 'headline' productivity numbers for our economy, or key sectors within it, represent nothing more than the accumulated productivity results achieved by individual enterprises and organisations. It follows that what matters for the productivity performance of individual organisations — whether in the private or public sectors, and whether operating for profit or not — is also what matters in formulating a 'productivity policy' agenda.

The two contributors to productivity

There are two crucial determinants of how much firms contribute to a country's productivity performance: one is 'innovation', the other is what economists call 'creative destruction'.

An organisation cannot raise its productivity without change — whether through doing new things or doing old things better. In this sense, productivity is virtually

synonymous with innovation. However, the innovation that counts is a much richer concept than the exogenous technological advances espoused in economics textbooks. While genuinely new technologies are important in extending the 'production possibility frontier' — particularly 'enabling' technologies like electricity or ICT that have multiple applications — whether and how well organisations apply technologies in practice is more important to a country's productivity (PC 2004a, 2007a). New or different management practices, work arrangements and supply–chain structures also contribute, as can improved delivery systems and customer relationships. Unfortunately, firm-level data on innovation leave much to be desired in seeking to trace this multi-faceted process.

The productivity of an industry or economy depends not just on the productivity levels of constituent firms or organisations but also on their respective market shares. Not all firms in an industry are equally productive. Productivity can be raised in aggregate simply by better performers displacing poorer performers. The decline and exit of the weakest performers is thus an important mechanism for delivering aggregate productivity growth. Indeed, international studies attribute between one-fifth and one-half of (labour) productivity growth to such changes in industry composition (Dolman and Gruen 2012). The process has been called 'creative destruction' because the demise of less successful firms enables the more 'creative' (innovative and productive) use of the released labour and capital in other firms or industries.

The three channels of government influence

Decisions that shape the productivity performance (and profitability) of enterprises are ultimately the responsibility of their managers. The quality of management is therefore clearly very important — not just in private enterprise (where market disciplines play a useful role) but also within the not-for-profit and government sectors. That said, managements' decisions, and the consequences of those decisions, are conditioned by governments — both through the myriad of 'rules' within which organisations must operate, and by governments' taxing and spending behaviours. Policies that encourage organisations to be cost-conscious and innovative, while not inhibiting better performers from prevailing over weaker ones, can legitimately be called 'pro-productivity'; those having the opposite effects are 'anti-productivity'.

Governments influence the productivity of firms and organisations through three main channels:

- *incentives* — the external pressures and disciplines on them to perform well

- *capabilities* — the human resources and knowledge systems, the institutions and infrastructure, needed to devise productivity-enhancing changes and support them effectively
- *flexibility* — the scope to make the necessary changes.

The Commission has characterised the 'incentives' channel as a 'driver' of productivity improvements, and the other two as 'enablers'. All three are strongly interactive. Together, they influence the motivation and the ability of organisations to make the changes needed to enhance productivity. The contribution of information technology to productivity growth illustrates this well. Both theory and evidence demonstrate that competition provides a powerful incentive for the development and uptake of IT. But new business models at the firm level, including changed work arrangements and skill sets, are needed to fully exploit the new technologies (PC 2004a).

Key implications of this framework are that policy needs and priorities could be expected to vary over time and there is unlikely ever to be a 'silver bullet'. A related implication is that productivity is unlikely to improve if policy advances in one channel are countermanded by backsliding in others. A 'pro-productivity' agenda needs to proceed on all three fronts. Policy consistency is also needed to convey the right signals for the managers and owners of enterprises to single-mindedly pursue productivity improvements and undertake the necessary (risky) innovations and investments. In more recent years, the signals have become blurred again, prompting a resurgence of rent-seeking behaviour from firms and industries under market pressure.

The Lists

All three channels of policy influence have been a focus for government initiatives over the years, commencing with the progressive liberalisation of international trade and capital flows from the 1980s.

But while governments have hardly been idle on the productivity front, there have also been important omissions and 'blind spots'. A number of these have been identified by the Commission as requiring action, and should continue to be on the list of things for governments to do.

1. Incentive policies

As emphasised, productivity improvements generally necessitate changes within organisations and across industries. But change is never easy: it requires effort; it

can be disruptive, and is often resisted. There need to be good reasons for going to the trouble.

Competition provides such a reason, at least for firms operating in the private sector. In competitive markets, enterprises with relatively low productivity will generally be less profitable than others and will eventually face market sanctions. As Samuel Johnson famously put it in another context, the prospect of a hanging 'concentrates the mind'. Competition accordingly drives both innovation and 'creative destruction', the dual determinants of a country's overall productivity performance.

Actions that foster competitive markets — including for corporate control — must therefore be fundamental to a government's policy agenda to enhance productivity. Exposure to international competition is perhaps the most important area of all, as it obliges local enterprises to strive for world's best practice.

As noted, Australia has undergone successive rounds of reform directed at opening up industries to both domestic and foreign competition. These culminated in the National Competition Policy, which remains embedded in policy-making frameworks today. The benefits to the community have been substantial (PC 2005a). It is therefore of concern that progress has stalled or even reversed in some policy areas. The 'to do list' among Commission recommendations is still a fairly long one.

- *Abolish remaining tariffs (PC 2000, 2008a, 2010a)*. Most industries now receive relatively low levels of tariff assistance, the result of incremental reforms over the past 25 or so years. But remaining tariffs still impose unnecessary costs on the community. They detract from Australia's productivity primarily by helping to prop up an industry's least productive firms. They also confuse the signals for all industries as to whether their futures lie in the pursuit of productivity or preferment.
- *Limit provisions for anti-'dumping' action (PC 2009b)*. Selling goods abroad at prices below those at home is normal business practice in various circumstances and one adopted by many Australian firms. Imposing (often sizeable) penalty duties on such imports protects less competitive firms at the expense not only of consumers, but also other local user industries (as the auto assemblers are finding right now in relation to their steel inputs). The rules allowing such 'administered protection' should be tightened in the true spirit of the WTO accord, not made more permissive.
- *Terminate selective industry subsidies that cannot deliver demonstrable net social benefits (PC 2008a, 2009c).* Unless they rectify a (legitimate) market failure, industry subsidies merely serve to sustain the market performance of less

productive and competitive firms or activities, lowering Australia's productivity in the process. Such programs, totalling nearly $9 billion annually from Australian taxpayers (PC 2012e), should be terminated if they cannot be demonstrated to yield a net payoff to the community. (Taxpayer support for private sector businesses cannot even loosely be characterised as 'co-investment' unless this test is satisfied.) In particular:

  - subsidies to support 'innovation', including 'green technologies', in specific industries (such as the assistance programs for the Automotive and Renewable Energy industries) which currently amount to over $3 billion, need to be able to deliver socially valuable spillovers over and above those attainable through generic support (such as the R & D Tax Concession);
  - adjustment assistance should facilitate change and be directed primarily at enhancing the skills and mobility of workers, rather than supporting firms under competitive pressure (PC 2001, 2012e).

- *Extend reforms to drought support (PC 2009d)* so as to move from open-ended assistance for farmers facing hardship, to arrangements with common criteria and duration provisions.
- *Phase out public sector procurement preferences (PC 2008a).* Favouring local suppliers on grounds other than price and quality inflates budgetary costs, detracts from government service performance (including Australia's defence capability) and, once again, undermines productivity by enabling less productive firms to retain market share and hold onto scarce resources.
- *Conduct a second, more focussed round of NCP reviews (PC 2005a, 2011i)* Reviews need to target the more significant restrictions on competition that avoided, or were not adequately subjected to, rigorous and independent scrutiny in the first round of NCP legislative reviews, or where the economic environment has significantly changed. Priorities include:
  - *pharmacy ownership restrictions*, which add to healthcare costs for little apparent benefit
  - *taxi licence quotas*, which raise transport costs and make it harder to reduce urban congestion, without demonstrably enhancing either safety or quality
  - *coastal shipping protection,* which has recently been strengthened — raising costs to user industries and weakening inter-modal competition — without being subjected to a public interest test
  - *the ban on parallel book imports,* which, although recently retained, would benefit from a further review in light of ongoing market and technological developments

– *unduly restrictive licensing and self-regulation of certain professional services,* including within the medical and legal fraternities.

2. Capability policies

How well organisations respond to challenges and opportunities in their operating environments comes down to the capability of their people and the systems that support them. Organisations need managers who can effectively seek out and develop better ways of doing things, and employees with the skills necessary to adapt. Investment in human capital development is thus fundamental to innovation and the related productivity improvements within enterprises. But complementary investments in the systems that support firm-level innovation are also important, as are the infrastructure services on which most firms depend.

A 'human capital' list

Much human capital is inherent in the aptitudes and life experiences of people. But the demands of the 'information age' increasingly require higher level skills that are best acquired through formal education and training. Such skills are of two kinds: specific and generic. Both are important, but the innovation and adaptation that underpin productivity growth are placing increasing demands on the more general analytical, discovery and communication skills. These are grounded in the literacy and numeracy acquired progressively at school and developed through higher education.

The related policy challenges are many, and they vary across the different components of the education system. Ensuring quality teaching is fundamental in all areas, but has been a neglected area of education policy. Indeed certain policies have undermined it. Recent attempts under COAG to rectify the situation, and enhance the performance of education and training systems generally, have resulted in a proliferation of programs, not all of which have been evidence-based.

- *Re-focus early education programs on disadvantaged children (PC 2011b).* It is these children who most need institutional support and for whom empirical studies show the biggest gains from participation in pre-school.
- *Make greater use of salary differentials* to attract and retain quality teachers in disciplines where there are persistent shortages (maths, science, IT) and in disadvantaged and remote areas (PC 2012a).
- *Devolve and enhance performance appraisal* for teachers, with principals having the authority to hire the best teachers and fire the worst ones (PC 2012a).

- *Modify industrial relations arrangements* for schools and VET colleges to allow greater variation in remuneration and conditions, more flexibility in hiring to meet skill needs and more effective management of under-performance (PC 2011e, 2012a).
- *Raise required 'threshold scores'* for school teachers and qualifications required for VET practitioners (PC 2012a).
- *Strengthen independent validation and auditing of* service *providers* to ensure they deliver to the standards needed for proper skill acquisition and advancement (PC 2011b, c).

A list to enhance the 'Innovation System'

The innovations that shape the productivity potential of organisations can stem from 'internal learnings' specific to a firm, but commonly involve the absorption and application of knowledge generated externally. The institutions and forces responsible for creating and transmitting knowledge are therefore important for a country's productivity performance. These include the regulatory regimes for trade and foreign investment as conduits for access to the much larger stock of knowledge generated overseas.

Because knowledge is hard to contain within an organisation, 'the market' will tend to under-provide it, leaving space for government to play a potentially valuable role. Over the years, governments have provided extensive and diverse support for the various components of Australia's 'innovation system' — academic and public research institutions, intellectual property laws, financial assistance for private R&D, promotion of linkages between firms and research bodies, etc. Indeed, innovation policy has seen considerable innovation itself, which has yielded some useful lessons to enhance policy effectiveness.

The ongoing challenge is to allocate support in ways that are likely to yield a net payoff to the community. It has proven particularly hard to design business support so as to generate additional R&D and associated spillovers that are worth more to society than a program's full costs. The way the tax concession has evolved has generally been consistent with this need. However, it and other programs face incessant pressure for design changes that will make them more 'generous', reinforcing the need for evidence-based policy.

- *Conduct rigorous evaluations* of all government innovation programs to verify that they are achieving 'additionality' and are cost effective (PC 2007a).

- *Focus government support on basic and strategic research*, where market failures are potentially greatest, rather than commercialisation activities, which are more likely to be privately profitable (IC 1995, PC 2003, 2007a).
- *Facilitate greater cooperative research* between businesses and public/academic institutions, but adopt more 'nimble' mechanisms (PC 2007a).
- *Lower the rate of public funding for Rural Research and Development Corporations*, as the above-average component yields little additional benefit. The savings should be reallocated to a new body that can sponsor more broadly relevant research for the sector (PC 2011d).

An infrastructure list

The timely and efficient provision of infrastructure services is crucial to firm performance. Transport and communications provide platforms for production and innovation in both the private and public sectors. The costs and quality of these infrastructural services, as well as of energy and water, bear strongly on many firms' international competitiveness. For this reason, the reductions in import barriers from the mid-1980s soon prompted a focus on infrastructure reforms, particularly for inefficient public utility monopolies.

The infrastructure reform task has involved a range of initiatives to enhance the performance of public enterprises and improve regulatory frameworks. These are still evolving today. Among Commission recommendations that remain crucial to future productivity improvements are the following:

- *Further reform the governance of public utilities* to clarify the primacy of efficiency objectives, and avoid political interference in managerial decisions (PC 2005a, 2008e). While the corporatisation of public utilities brought initial productivity gains, the evidence is increasingly clear that public ownership of infrastructure can undermine the potential for ongoing improvements, including in the vital electricity sector (PC 2012b).
- *Undertake transparent cost-benefit analysis of all options* prior to any major public infrastructure investment (PC 2008e, f) and when determining quality or environmental standards (PC 2012b). Public investments are otherwise prone to 'optimism bias' and a confusion between political and economic ends. Poor infrastructure decisions have a high opportunity cost and can be a long-term drag on the economy's productivity.
- *Extend the use of cost-reflective pricing*, including to manage peak demands (electricity) or supply disruptions (water) (PC 2011e, 2012b). Political aversion

to price rises, even where needed to balance supply and demand, can suppress or distort investment and may result in higher prices in the long term.

- *Ensure that price-regulation regimes do not inhibit efficient investment* and that they enable price differentiation where this can recover costs with less impact on demand (PC 2012b).
- Specifically for *land transport* (PC 2007b), introduce institutional reforms for roads to connect revenue with spending decisions, while progressively moving to location-based road pricing, particularly for freight.
- Specifically for *water utilities* (PC 2011e), align procurement, pricing and regulatory arrangements with an overarching efficiency objective.
- Specifically for *electricity* (PC 2012b), phase out retail price regulation, introduce smart meters, bolster the regulator and modify the regulatory regime to increase consumer orientation and to avoid inefficient investment.

A government services list

As for public utilities, the efficiency of government administrative and human services can have direct (within the public sector) and indirect impacts on Australia's productivity. Government spending on human services amounts to some $170 billion a year, equivalent to nearly 13 per cent of GDP. Health services alone account for nearly 40 per cent of this and are growing rapidly in response to the demands of an older and more affluent population (PC 2005b).

Even small productivity improvements in the government sector would have a substantial cumulative impact. For example, a 5 per cent gain in the health sector would free up some $4 billion (PC 2006a). That scope clearly exists for gains is illustrated by differences in the performance of human services across states and territories, as revealed in benchmarking data (SCRGSP 2012).

- *All major human service programs should be periodically reviewed* to ensure that they are well-targeted and cost-effectively delivered, including identifying scope for design changes that would enhance consumer choice and contestability in provision (PC 2006a).
- In the case of aged care, after the current suite of reforms is implemented, *move progressively to lift caps on place numbers for care and direct funding through individuals* rather than providers, and revise asset tests (PC 2011f).
- In the case of the systemic reforms needed to *support people suffering significant disability*, progress the trials and resolve crucial funding issues to ensure a system that is fair and sustainable (PC 2011g).

- For the *health workforce,* enable services to be provided by those professionals who can most cost-effectively do so to required standards (PC 2005c).

3. Flexibility policies

How well organisations respond to incentives to raise productivity depends not only on the capability of their people and support systems but also on the scope for them to make the changes needed to realise an organisation's productive potential. The key policy issues in this area are regulatory, with a myriad of regulations shaping the behaviour of firms and other organisations in all parts of the economy.

While most of these regulations have worthy objectives — whether economic, social or environmental — many are formulated without sufficient regard for collateral damage on productivity and whether objectives could be met in more cost-effective ways.

Regulations that affect flexibility are essentially of three kinds: those that define what enterprises can (or can't) do; those that prescribe how they must go about their business, and those that otherwise raise the costs of making changes. They can have effects on productivity by constraining and conditioning adjustments not only within firms but also across industries and regions. While there have been reforms in numerous areas, including under COAG's Seamless National Economy work streams, many impediments remain. Reflecting this, of the nearly 1000 enterprises responding to an ACCI national survey earlier this year, one-half indicated that regulatory provisions had 'prevented them making changes needed to expand their businesses' (ACCI 2012).

This underlines the ongoing challenge of embedding a proper accounting of costs and benefits into regulation-making practices, including consideration of alternative options. The Commission's current review of Regulatory Impact Assessment processes has confirmed deficiencies at Commonwealth and State levels. Some 20 broad 'leading practices' have been identified which, in themselves, constitute an important 'to do list' for all jurisdictions (PC 2012g). It is also important to monitor and review existing regulations that affect businesses to ensure that these remain 'fit for purpose' and avoid unintended consequences.

- Requirements for review of regulations should be specified when they are being made and embedded in legislation in cases where there are significant uncertainties about the impacts (PC 2011a).
- Review processes for key regulations should be conducted at arms-length from policy departments and include a public draft report (PC 2011a).

Workplace regulation

Industrial relations regulations are among the most pervasive of all in their coverage of organisations and their influence on work arrangements. Whether they are also among the most important to get right from a productivity perspective is hotly contested.

It was more widely accepted in the 1980s when the opening of Australia's economy to international competition (and, thus, best practice productivity levels) exposed the true cost of rigidities embedded in labour laws and work practices that had evolved through the era of so-called 'protection all round'. Since the move to enterprise bargaining under the Hawke-Keating Governments, the industrial landscape has become more accommodating of diversity and change among firms and across regions. This not only contributed to the 1990s productivity surge, but also to the comparative resilience of employment in subsequent downturns (notably the GFC) and the avoidance of a generalised 'wage breakout' during the mining boom (PC 2012h, Lowe 2012).

It has to be said, however, that most of the labour market reforms from the 1980s to the early 2000s were essentially 'no brainers' — redressing obvious anti-productivity features of a highly centralised, prescriptive and adversarial system. While the changes faced political obstacles, there was widespread recognition of the need for reform. This changed with the reforms under 'Work Choices', the justifications for which were neither adequately explained nor widely understood by the public. Industrial relations policy has been a 'war zone' ever since, with reasoned public discussion about fairness/productivity trade-offs the biggest casualty. It would therefore be astonishing if those trade-offs had been properly accounted for.

The Productivity Commission has not been required to provide advice about this, so there is no formal list of recommendations from which I can confidently draw. However, the Commission's reviews into the 'education work force' (PC 2011b, c, 2012a), the retail industry (PC 2011h) and electricity (PC 2012b) have brought to light several features of current arrangements that appear problematic at a sectoral level.

Recently, I found myself being condemned by union leaders for suggesting that such regulations should be treated no differently to other areas of social regulation that have potentially adverse economic impacts; namely that their proponents should be required to demonstrate that there are public interest benefits that exceed the economic costs, and that such benefits to society could not be achieved in more cost-effective ways (Banks 2012). This is not saying that regulation should never

favour fairness over productivity in the workplace, only that the justification for this needs to be transparently tested. The very hostility provoked by what should be an unexceptionable proposal may be confirmation of the desirability of adding it to the list.

Other regulatory restraints on the list

Various other areas of regulation may also inhibit the flexibility that firms and workers need to raise productivity and respond to market pressures. There are regulations that are excessively prescriptive or costly to comply with, as well as some that are simply not justified in policy terms. Many have been addressed in Commission reports over the years, but there is still some way to go in implementing identified remedies. Among the more significant ones that remain relevant are the following:

- *Native vegetation regulation*s are costly and can have perverse impacts. While improvements have been made in some jurisdictions, responsibility needs to be devolved, with landholders addressing local impacts and the wider community subsidising the extra costs of landholders providing public goods (PC 2004b).
- *Heritage regulations* can impose undue costs on certain people and stymie socially valuable developments. They should be restructured to enable up front accounting for the costs as well as benefits of controls (PC 2006b).
- *Renewable energy targets* are costly and can be counterproductive in seeking to reduce carbon emissions. They should be phased out under carbon pricing or other market-based policies (PC 2008b).
- *Development approval processes* are complex, duplicative and cause unwarranted delays with high opportunity costs for major projects (PC 2011i).
- *Planning and zoning controls* should meet amenity and other objectives without unduly restricting retail competition (PC 2008b, 2011i).
- *Stamp duties* on conveyancing inhibit housing turnover, contributing to reduced affordability and lower labour mobility (PC 2004c).
- *Occupational licencing* can inhibit workforce mobility, create barriers to entry and raise business costs. There are potential gains from extending the coverage of reforms (PC 2012c).
- *Rural water*, where ongoing state-based restrictions on trading in the Murray Darling Basin mean that water is still not flowing to its most highly valued uses (PC 2010c).

- *Waste management* programs often have costly targets and collection methods. Policy needs to be refocussed on achieving net social benefits, underpinned by cost-benefit analysis (PC 2006c).
- *Chemicals regulations* are unduly fragmented, lack effectiveness in key areas and impose excessive costs on industry. Governance failures need to be addressed at four levels (PC 2008d).
- *Mutual recognition* is not realising its potential to lower costs for inter-jurisdictional activities and transactions. The regime needs to be strengthened and exemptions removed (PC 2009e).

A cross-cutting issue: taxation

Taxation has a ubiquitous influence on productivity through all three channels of incentives, capabilities and flexibility. It affects the allocation and efficiency of resource use. It also affects the incentives for work and entrepreneurship (PC 1995, 2005b).

Notwithstanding various reforms over the years, it is generally accepted that the tax systems of the Commonwealth and States still comprise too many taxes and rely too heavily on the more distortionary ones. Taxes also differ across jurisdictions in ways that needlessly complicate and raise the costs of doing business. Better tax systems — fewer, less distorting taxes with broader bases and lower rates — would enhance labour force participation as well as industry productivity. It was estimated that the 'Henry Review's' list of tax reforms could raise Australia's GDP by 2-3 per cent (Henry et. al. 2010). Making better use of the GST, by broadening its coverage and raising its rate as in a number of other OECD countries (including New Zealand), would likely deliver additional gains.

What are the priorities?

It would seem that there is indeed a 'long list of things to do' — even based just on those areas where the Commission has been asked to report. (A comprehensive list would be longer.) The range of recommendations can be summarised as governments needing to (a) spend better and (b) regulate better. Expressed like this, the task at hand sounds pretty straightforward. The evidence has been assembled. The gains are waiting to be tapped. Why have these productivity-enhancing reforms not been done?

When making the remarks cited at the start of this paper, Governor Stevens went on to observe that the things on the Commission's list were not 'popular' and had

proven difficult for governments. Most of them involve arrangements that currently provide significant advantages to particular groups, who naturally take more interest in resisting reform than the wider electorate takes in supporting it. The fact that the Commission was directed to such policy areas in the first place reflects this political difficulty, and a perceived need not only to have an independent assessment of what to do, but also to alert the community to the gains and thereby help to generate more support for necessary reforms.

The items that remain on the Commission's 'to do list' are generally those for which this has proven most difficult — the hardest political nuts to crack. Achieving enduring reform in such areas to date has required the concerted support and skilful advocacy of political leaders at both Commonwealth and State levels, and across the political divide (Banks 2010b). But the political capital and bureaucratic resources needed to advance 'unpopular' reforms are not in unlimited supply. They must be harnessed to focus on priorities and sequencing that are manageable and can yield the highest payoffs over time (PC 2011a, 2012f).

So, where should today's priorities lie? How can governments best advance Australia's productivity performance by spending and regulating 'better'?

For a start, spending *more* no longer represents the line of least resistance in promoting productivity. Indeed, the importance of making room for increased expenditure on key human service reforms, and notably disability support (PC 2011g), increases the need to spend *less* in other areas. The list under the 'incentives' heading provides several 'win-win' options (reforms that would lower budgetary outlays while lifting productivity).

In the regulatory area, the structural pressures of the 'multi-speed' economy have lent particular importance to the need to enhance flexibility and adaptability within enterprises and across industries and regions. This will remain the case as our economy changes gears again during the post-boom phase. It suggests that items on the 'flexibility' list should for the present generally take precedence over those on the 'capability' list, reversing recent emphasis.

As noted, taxation reform would simultaneously address both spending and regulatory dimensions. However, taxation involves complex interactions and there is scope for unintended consequences if reforms are not handled in an integrated way, as envisaged in the Henry Report.

The bottom line

I am conscious that this list of priorities may look too encompassing or complicated for those seeking quick fixes or simple solutions — or those who sometimes ask at events such as this 'What is the single most important reform to improve Australia's productivity performance?'. My usual response to that question, and the burden of my presentation today, is that there *is* no single thing that can do the job. Indeed, a policy approach based on such a presumption would be destined for failure.

Rather, what is needed is an approach to 'productivity policy' that embraces both the drivers and enablers of firm performance, and is consistently applied. That in turn requires policy-making processes that can achieve clarity about problems, reach agreed objectives and ensure the proper testing of proposed solutions (including on the 'detail' and with those most affected). The beneficial and enduring structural reforms of the 1980s and 1990s are testimony to the value of these policy-making fundamentals. Good process in policy formulation is accordingly the most important thing of all on the 'to do list', if we are serious about securing Australia's future productivity and the prosperity that depends on it.

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