

Whatever happened to the productivity revolution?

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Parents, teachers and coaches often tell their charges that 'you only get out of something in proportion to what you put into it', or words to that effect.

Economists are interested in this idea too. They spend a lot of time thinking about what they call *productivity* – how much goods and services are produced for each unit of labour and capital (and sometimes other 'factors of production' such as technology as well) which is applied to producing them. That's because, as the Harvard competitiveness guru Michael Porter puts it, 'productivity is the prime determinant in the long run of a nation's standard of living'¹.

And lest readers think that Porter was only concerned about material things, he went on to emphasize that 'high productivity not only supports high levels of income but also allows citizens the option of choosing more leisure instead of working longer hours' and 'allows a nation's firms to meet stringent social standards which improve the standard of living, such as in health and safety, equal opportunity and environmental impact'.

Productivity isn't easy to measure. In some sectors of the economy (especially those such as education, health or defence, where consumers don't pay directly for what they use), it's difficult to measure the output of goods and services. And while it is usually fairly easy to measure labour inputs (the most common measure is hours worked), calibrating the input of other factors of production such as capital or technology can be more problematic.

For these reasons, economists often simplify the discussion by focussing on *labour* productivity (output of goods and services per hour worked), and sometimes to the *market* or *non-farm business* sector of the economy.

As many observers have noted, Australia's vastly improved economic performance during the 1990s owes a great deal to the dramatic pick-up in the growth rate of Australian labour productivity not only by comparison with previous decades, but also with other economies during the 1990s.

According to the marvellously comprehensive global data-base maintained by the Growth and Development Centre at the University of Groningen in the Netherlands (with financial support from the Conference Board in the US)², Australian output per hour worked increased at an average annual rate of 2.3% per annum during the 1990s, compared with 1.9% per annum during the 1970s and 1.1% per annum during the 1980s.

Moreover, unlike the 1950s and 1960s, when productivity growth was higher than it was in the 1990s but much lower than in other industrialized countries, Australian productivity growth during the 1990s was higher than the average for our peer group.

¹ Michael E. Porter, *The Competitive Advantage of Nations* (The Free Press, New York, 1990), p. 6.

² Available at <http://www.ggdc.net/>.

Thus, whereas Australia's productivity fell from almost 180% of the OECD average in 1950 to less than 88% of the OECD average in 1990 – with the inevitable result that our standard of living (as measured by per capita GDP) slipped from 6th among OECD countries to 19th over the same period – between 1990 and 1999 our productivity rose to almost 95% of the OECD average, which in turn helped to lift our standard of living back to 10th among our OECD peer group.

All of the research which has been done, both in Australia and overseas, on the improvement in Australia's productivity performance during the 1990s finds that the major reason for it was the series of reforms undertaken by governments of both political persuasions and at both levels, beginning in the 1980s, which consciously and deliberately sought to expose privately- and publicly-owned businesses and agencies to greater competition domestically and from abroad, with a view to encouraging and enabling the managers of those organizations to make and implement decisions which would allow them to combine labour, capital and technology to produce goods and services more efficiently – that is, to lift productivity. And, as the evidence unambiguously shows, it worked.

We are of course now more than half-way through another decade, and it is becoming increasingly apparent that the improvement in productivity growth sustained through the 1990s has slipped away during this one.

According to the University of Groningen database, Australian productivity growth between 2000 and 2005 averaged just 1.5% per annum, below the OECD average of 1.8%. As a proportion of the OECD average, the level of Australian productivity has slipped back to 90.6%. As a percentage of the level of productivity in the US (often regarded as 'best practice'), Australia's productivity has fallen from a peak of 86% in 1998 to 79% in 2005, the lowest since 1990. The only reason Australia's standard of living has continued to improve relative to our OECD peers this decade – to 8th in 2005 – has been the improvement in our 'terms of trade' driven by the effect China is having on the prices of our mineral and energy commodity exports.

There are some sound reasons why Australia may never be able to attain the level of productivity observed in the United States³. But it is surely a matter of profound disappointment that all of the improvement which Australia made in terms of productivity performance relative to the United States during the 1990s has been eroded in the space of just six years.

To some degree, the slowdown in productivity growth during the current decade may be a consequence of approaching the peak of the business cycle, with those now finding employment being less 'productive' than those who gained jobs during the 1990s, or the result of businesses being less focussed on striving for 'efficiency gains' now that profits are at such high levels by historical standards and as a share of national income.

However, two other possibilities suggest themselves based on the results of research into the reasons for the improvement in Australia's productivity performance during the 1990s.

³ See, for example, Bryn Battersby, 'Does Australia's geography affect labour productivity', *Economic Roundup* (Spring 2006), pp 67-76, Australian Treasury, Canberra, http://www.treasury.gov.au/documents/1190/PDF/06_distance.pdf.

The first is that the productivity-enhancing benefits of the 1980s and 1990s reforms have begun to wear off⁴, while the political appetite for further reforms of this nature has waned. Thus, although the Howard Government maintained the pro-competition reforms of its predecessor, it has balked at extending them to areas such as pharmacies, newsagents, international aviation, health insurance, agricultural marketing and the traditional professions. Similarly, State Governments have been reluctant to enhance the role of competition in areas of their primary responsibility such as education and health.

Although the Howard Government's 2006 labour market reforms may improve productivity over the longer term (by increasing the flexibility with which employers can 'manage' their work forces), to the extent that they achieve the objective of inducing greater participation in the labour market by persons of relatively low productivity then at least initially average productivity will be *lower* (as it was in New Zealand).

The second possibility is suggested by the torrent of productivity-stifling legislation and regulation imposed during the current decade with the supposed objective of improving 'national security' and standards of corporate governance.

I'm not in the best position to judge whether those objectives actually have been (or could have been) achieved through the measures adopted by our governments, although to be honest I'm somewhat skeptical on both counts.

For what it's worth, I suspect that a good deal of the legislation and regulation that has been imposed in the name of 'national security' since September 11 2001 is intended more to shelter governments from blame in the event of another major terrorist attack, or (as Tony Blair's 'third way' guru Anthony Giddens has explicitly advocated⁵), to scare people into accepting erosions of civil liberties and other measures which they would otherwise regard as repugnant, than it is to reduce the actual likelihood of another terrorist attack⁶.

Similarly, since those who have been jailed or heavily fined in recent years in the United States and Australia for various acts of corporate malfeasance, have been convicted and punished for acts that violated laws already in existence, it is far from clear what has been achieved by Sarbanes-Oxley and its Australian equivalents in terms of actually reducing the likelihood that shareholders in publicly listed companies might be defrauded by greedy executives – as distinct from creating the impression that governments have been doing something to reduce that possibility.

⁴ As suggested, for example, by the OECD in its most recent survey of the Australian economy - OECD, *Australia* (Paris, 2006), p. 55.

⁵ Anthony Giddens, *New Statesman*, 10 January 2005 (<http://www.newstatesman.com/200501100020>).

⁶ In his most recent novel *The Unknown Terrorist* (Picador, 2006), Tasmanian author Richard Flanagan has an ASIO agent telling a NSW policeman, 'People out there don't understand all the threats, all the issues ... We need to give them lessons as to what's important and what isn't ... Unless they're terrified, they won't agree with what we do and why we have to do it' (pp. 271-2). This is, of course, fiction: but it's not at all far removed from Giddens' views. Moreover legislation and security measures introduced by the Blair Government in Britain have often been cited as a precedent and rationale for similar measures in Australia.

But there can be little doubt that the legislation and regulation enacted in the names of 'national security' and 'corporate governance' has required the employment of tens of thousands of people who do little of any obvious value themselves, yet whose activities clearly do detract from the productivity of those who are doing something useful – as anyone who uses our airports, or who has cause occasionally to seek entry to public or private buildings in our major cities, or who is responsible for the preparation of financial statements for a publicly listed company, can readily attest.

In the United States, which has had a similar experience (and where productivity growth has similarly slowed this decade), employment of persons as 'security guards' and in 'airport operations' has risen at more than double the rate of the work force as a whole since September 2001.

Although the Australian Bureau of Statistics doesn't provide the same richness of detail on employment by occupation as the US Bureau of Labor Statistics, it would be surprising if something similar hasn't occurred here.

Sadly, the Government appears to have 'given up' on the objective of regaining the productivity growth rate achieved during the 1990s. In the *Mid-Year Economic and Fiscal Outlook* released in the week before Christmas, the Treasury's projections for economic growth in 2008-09 and beyond were quietly revised down by one-quarter of a percentage point to 3% per annum, just six months after the 2008-09 projection was revised down from 3½% to 3¼% in the May Budget Papers on account of the expected impact of population ageing on labour force participation.

The most recent downward revision was explained in the MYEFO papers as being to 'reflect Australia's long-run average productivity growth rate of 1¾%', without further elaboration.

So there you have it – the 'productivity revolution' is officially over. And so too, inevitably, is the recovery in Australia's standard of living relative to that of other industrialized economies, even though for the time being that is being disguised by the strength in mineral and energy commodity prices.

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