

'Productivity' has re-appeared in conversations about Australia's economic performance and prospects in the past couple of years, after a rather extended absence. In these conversations, as in earlier ones, productivity appears to mean different (and often contradictory) things to different people.

To economists, 'productivity' is simply the efficiency with which 'factors of production' (typically labour and capital, although the list could be broadened to include land, energy or finite natural resources such as water and air) are combined, in workplaces, firms, regions or the nation as a whole, to produce goods and services which are in turn valued, in some way, by those who consumer or use them.

This concept of productivity is often expressed colloquially as 'working smarter'. But productivity has come to be widely seen by employees (and by the public at large) as instead meaning 'working harder' (and with fewer co-workers) – a perspective which is to at least some degree understandable given the way in which many business leaders portray what they think needs to be done in order to increase productivity, either in their own businesses or across the economy as a whole. And that perspective, combined with a widespread (but again, to at least some degree understandable) cynicism about who benefits most from increases in productivity, arguably makes increases in *genuine* productivity harder to accomplish.

One of the arguments of this chapter is that, for improvements in Australians' average material living standards to be sustained (economically) over the coming decade and beyond, Australia's overall productivity performance will need to improve considerably from that which has characterized the 21<sup>st</sup> century thus far. But another argument of this chapter is that it will prove very difficult to achieve any sustainable improvements in the productivity performance of individual workplaces – and hence, in the productivity performance of the Australian economy as a whole – if the costs and benefits of achieving those improvements in productivity performance are not seen to be more 'fairly' shared than those associated with past episodes of stronger productivity growth.

In that sense, the issue of productivity fits readily into this book's theme of 'inclusive growth'.

### **Why does productivity matter?**

Productivity matters because – as the Nobel Laureate Paul Krugman memorably put it in 1992, 'productivity isn't everything – but in the long run, it is almost everything', because, as he went on to explain, 'a country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker'<sup>1</sup>.

This view has been more recently echoed by Australia's two most senior economic policy officials – RBA Governor Glenn Stevens, who three years ago identified productivity as 'the only real basis' for 'optimism about future income'<sup>2</sup>; and Treasury Secretary Martin Parkinson, who last year pointed out that 'in the long run, productivity growth – producing more from the same inputs – is the only sustainable way for future generations to enjoy higher living standards'<sup>3</sup>.

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<sup>1</sup> Paul Krugman, *the Age of Diminished Expectations: US Economic Policy in the 1980s*, MIT Press, Cambridge, 1992, p. 9.

<sup>2</sup> Glenn Stevens, 'Challenges For Economic Policy', Address to the Anika Foundation, 28 July 2009 (available at <http://www.rba.gov.au/publications/bulletin/2009/aug/pdf/bu-0809-3.pdf>), p. 13,

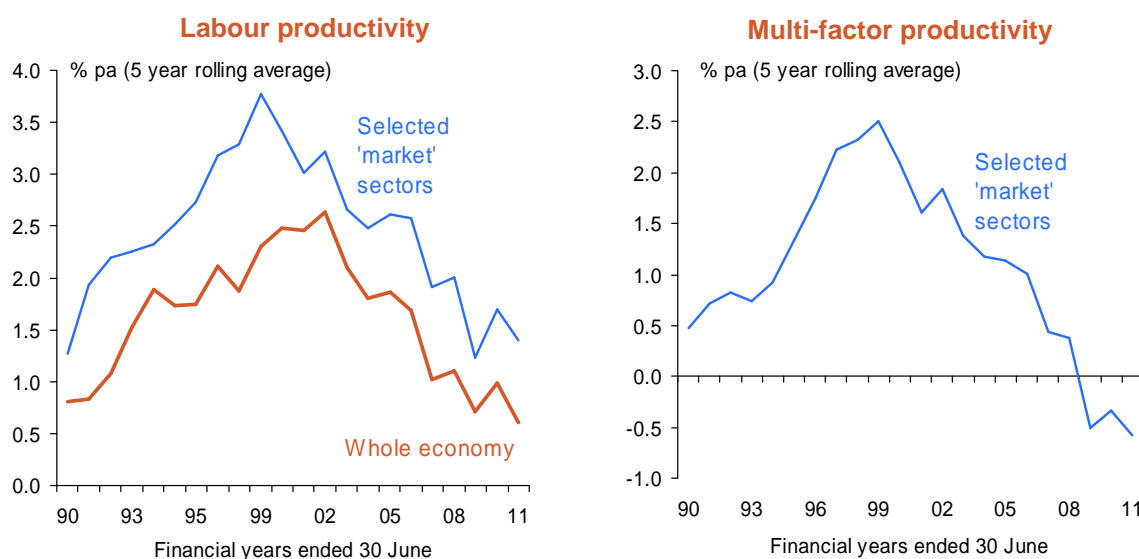
<sup>3</sup> Martin Parkinson PSM, 'Sustaining Growth in Living Standards in the Asian Century', Address to the Seventh Economic and Social Outlook Conference, Melbourne, 30 June 2011 (available at <http://www.treasury.gov.au/PublicationsAndMedia/Speeches/2011/Sustaining-growth-in-living-standards-in-the-Asian-Century>), pp. 11-12.

For the past decade, it has seemed as if Australia has been able to defy these propositions: productivity growth has slowed substantially (more on that below), but material living standards have continued to improve, even in the face of the severe world recession induced by the global financial crisis. However that has been almost entirely attributable to the upswing in Australia's terms of trade (export prices relative to import prices) driven, for the most part, by the rapid increase in China's demand for many of the commodities with which the Australian continent is so richly endowed. With the terms of trade having peaked in the September quarter of 2011, and China's growth rate seemingly moving to a new, slower, pace, Krugman's dictum will re-assert itself; and as Martin Parkinson has said more recently, 'growth in Australian living standards will also slow unless productivity picks up'<sup>4</sup>.

### Australia's deteriorating productivity performance

No matter how it is defined or measured, Australia's productivity performance has deteriorated sharply since the turn of the century:

Chart 1: Alternative measures of productivity growth



Note: 'Selected market sectors' are agriculture, forestry and fishing; mining; manufacturing; electricity, gas, water and waste services; construction; wholesale trade; retail trade; accommodation and food services; transport, postal and warehousing; information, media and telecommunications; financial and insurance services; and arts and recreation services.

Source: ABS, *Experimental Estimates of Industry Multi-factor Productivity, 2010-11* (5260.0.55.002).

- since 2005-06, *labour productivity* (real gross value added per hour worked) across the Australian economy as a whole has grown at an average annual rate of just 0.6%, compared with 1.9% per annum over the first half of the 2000s, 2.5% per annum over the second half of the 1990s, and 1.7% per annum during the first half of the 1990s. Indeed going back to the 1960s, there is no period of five years or more during which labour productivity growth has been slower than that since the mid-2000s;

<sup>4</sup> Martin Parkinson, 'Introductory Remarks', Australia-Israel Chamber of Commerce, Sydney, 7 March 2012 (available at <http://www.treasury.gov.au/PublicationsAndMedia/Speeches/2012/Introductory-Remarks-to-the-Australia-Israel-Chamber-of-Commerce>), p. 7.

- *labour productivity* in what the ABS calls the ‘market sector’ (ie excluding the public administration and safety, education and training, and health care and social assistance sectors where productivity is particularly difficult to measure) has grown at an average rate of just 1.1% per annum over the past six years, compared with 2.4% per annum over the first half of the 2000s and 2.9% per annum over the second half of the 1990s;
- ‘*multi-factor productivity* (which takes account of the contribution of capital as well as labour) in the ‘market sector’ actually *declined* over the six years to 2010-11, at an average annual rate of 0.7%, after growing by 0.9% per annum, on average, over the first half of the 2000s and at an average annual rate of 1.7% during the second half of the 1990s.

To quote Glenn Stevens again, ‘it is now just about impossible to avoid the conclusion that productivity growth performance has been quite poor since at least the mid 2000s<sup>5</sup>.

All of this has come, of course, after a decade (the 1990s) in which Australia’s productivity growth rate was substantially above that which we had experienced in previous decades, and was also high by contemporary international standards.

Australia has been by no means unique in experiencing a slow-down in productivity growth since the turn of the century. However, whereas Australian labour productivity growth was in line with the (unweighted) OECD average in the 1990s, during the 2000s it was 0.2 percentage points below the weighted OECD annual average growth rate. Australia ranked 11<sup>th</sup> out of 25 OECD countries in descending order of labour productivity growth in the 1990s, and 17<sup>th</sup> out of 34 countries in the 2000s (Chart 2).

Chart 2: Labour productivity growth in OECD countries

### Labour productivity growth (% pa)

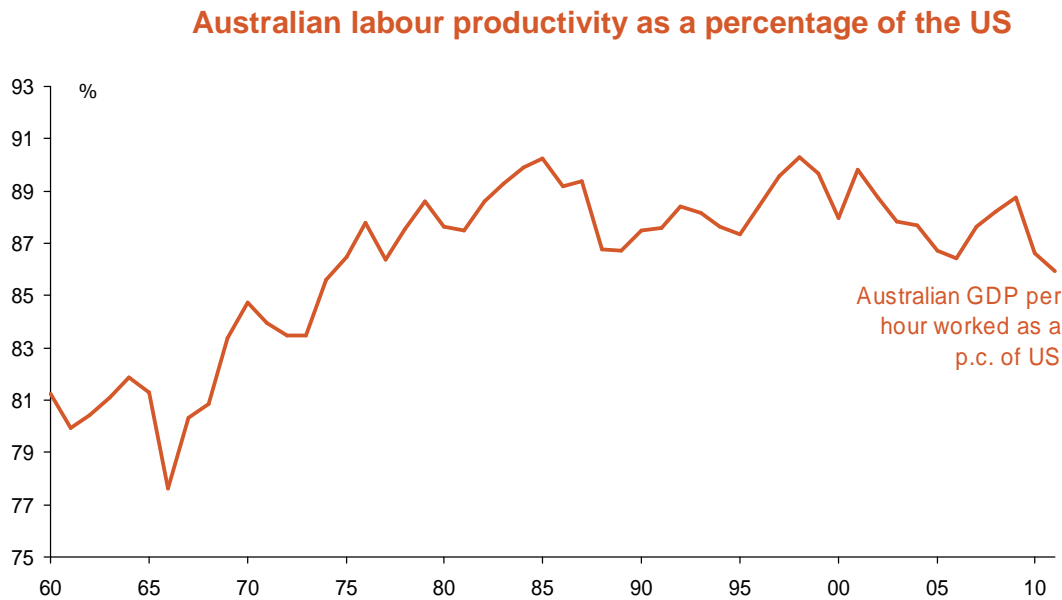
	1990s	2000s	Change		1990s	2000s	Change
Australia	2.1	1.3	-0.8	Italy	1.5	0.0	-1.5
Austria	..	1.2	..	Japan	2.1	1.6	-0.6
Belgium	2.3	0.5	-1.8	Korea	5.6	4.3	-1.2
Canada	1.8	0.9	-1.0	Mexico	..	0.3	..
Chile	..	2.6	..	Netherlands	2.1	0.7	-1.4
Czech Republic	1.9	3.5	..	NZ	1.3	1.1	-0.2
Denmark	..	0.6	-1.3	Norway	2.8	0.7	-2.1
Estonia	3.0	4.8	..	Poland	..	3.2	..
Finland	2.0	1.5	-1.5	Portugal	3.7	1.1	-2.5
France	2.3	0.8	-1.2	Slovakia	..	4.5	..
Germany	1.7	0.9	-1.4	Slovenia	..	2.6	..
Greece	..	1.5	-0.2	Spain	1.4	1.1	-0.3
Hungary	1.0	2.9	..	Sweden	2.4	1.6	-0.7
Iceland	4.7	2.6	1.7	Switzerland	0.3	0.8	0.5
Ireland	0.5	2.0	-2.8	Turkey	1.8	3.7	2.0
Israel	..	1.2	0.7	UK	2.7	1.2	-1.5
				USA	1.8	2.2	0.4

Source: OECD Statistics Portal – Productivity (2011).

<sup>5</sup> Glenn Stevens, ‘The Cautious Consumer’, Address to the Anika Foundation, 26 July 2011 (available at <http://www.rba.gov.au/publications/bulletin/2011/sep/pdf/bu-0911-10.pdf>), p. 82.

Using the United States as a crude proxy for 'best practice' in terms of labour productivity\*, the level of Australian labour productivity has declined from a peak of 90.3% of the US level in 1998, to just 85.9% of the US level in 2011 – the lowest such percentage since 1974, according to figures compiled by the Conference Board in the United States<sup>6</sup> (Chart 3).

Chart 3: Australian labour productivity as a proportion of US levels



Note: Labour productivity here is real GDP (in 2011 US dollars) per hour worked.  
Source: The Conference Board, *Total Economy Database* (2012).

Since there has been a growing tendency in parts of the business community to attribute this deterioration in Australia's productivity performance wholly or in part to recent changes in Australia's industrial relations system, it is perhaps worth emphasizing at this point that Australia's productivity growth rate has steadily declined under three different industrial relations systems – the one introduced by Peter Reith as Employment Minister in the first term of the Howard Government, the 'Workchoices' system introduced by the Howard Government in its last term of office, and the present Government's 'Fair Work' Act.

It is also worth emphasizing that there is too much 'noise' in data on productivity (since it is the ratio of output to a measure of labour input, and hence subject to the volatility of and any errors in the measurement of either) to allow anyone to draw any reliable inferences or conclusions from data for periods of less than three (or preferably five) years.

That is not to say that there may not be aspects of the current industrial relations system that are detracting from efforts that firms may now be making to improve productivity in individual workplaces – but simply that the case is as yet far from proven, at least by statistical evidence.

\* On the grounds that the United States has higher GDP per hour worked than any other OECD country except for Luxembourg and Norway, two small economies an unusually large proportion of each of which is accounted for by a sector with intrinsically high levels of labour productivity, namely financial services and oil extraction, respectively.

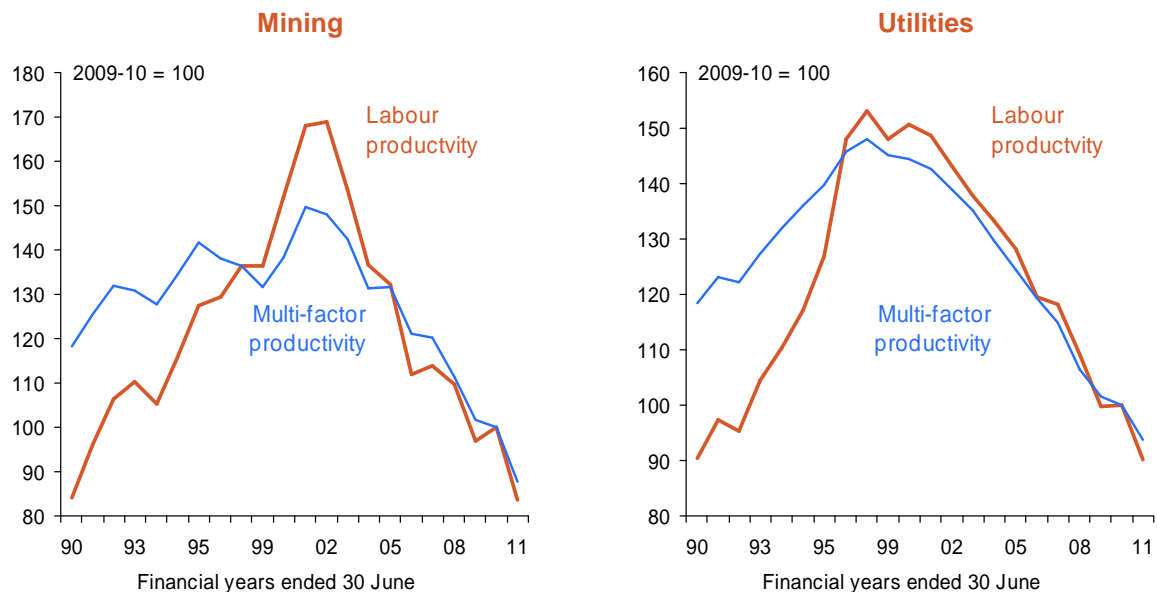
<sup>6</sup> The Conference Board, *Total Economy Database*, January 2012 (available at <http://www.conference-board.org/data/economydatabase/>).

## Why has Australia's productivity performance deteriorated?

Until quite recently it was widely accepted, at least in 'official circles', that the deterioration in Australia's productivity performance was largely attributable to sharp declines in productivity in the mining and utilities sectors, which reflected circumstances peculiar and particular to those industries, and that there was as a result little genuine cause for concern about figures such as those which I cited a moment ago.

There's no denying that productivity has fallen sharply in these two industries (Chart 4).

Chart 4: Productivity growth in the mining and utilities sectors



Source: ABS.

The mining sector has been gearing up for a huge expansion in response to the demand for energy and minerals (particularly those associated with steel-making) from China and India. Since 2001-02, hours worked in mining have risen by more than 150%, while the real value of the mining industry's capital stock has risen by 115% - yet the volume of mining output has risen by only 26% over the same period. As a result, labour productivity in the mining sector has fallen by 50% over this period, and multi-factor productivity by 41%.

Once these projects reach full production, measured labour and multi-factor productivity should rebound strongly, potentially reversing much of their decline over the past decade – although to the extent that high prices for various mineral commodities have made it commercially logical for companies to exploit low-grade ores (which require larger amounts of labour and capital to produce a given volume of output, thus also detracting from measured productivity) the mining industry's apparently poor productivity performance could continue for a prolonged period.

The utilities sector recorded substantial productivity gains in the 1990s, largely as a result of reforms engineered by State Governments. During the past decade, however, electricity and gas businesses have had to invest heavily in response to continued growth in demand (especially for peak load, which inevitably entails a large degree of 'redundancy' at non-peak times), to replace ageing transmission infrastructure, and to meet government-mandated renewable energy targets. Likewise governments have undertaken significant investments in water infrastructure (including desalination plants in five States), with a view to guaranteeing security of supply in drought conditions, whilst

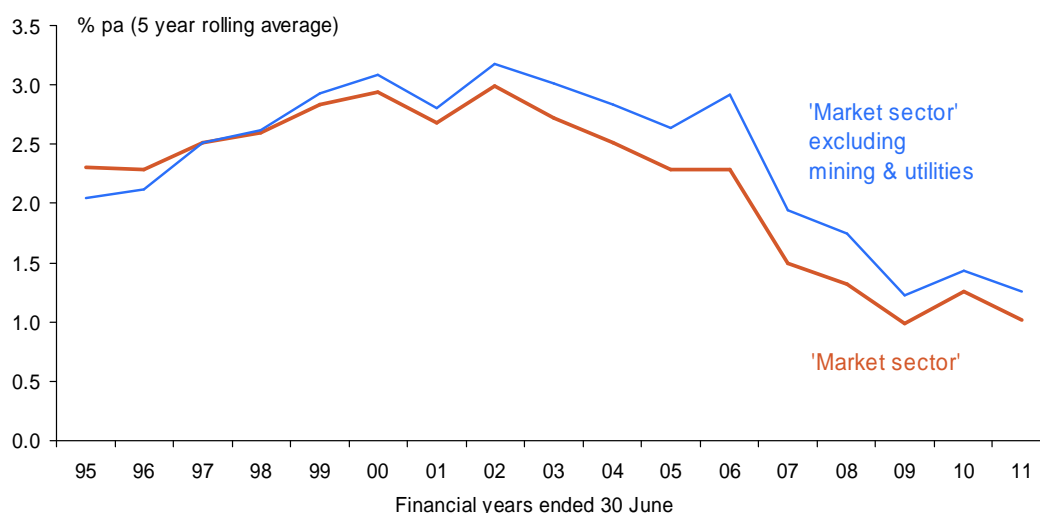
simultaneously imposing restrictions on the use of water throughout much of the decade, which detracted from the output of water businesses without commensurate reductions in factor inputs.

Thus, in this sector, hours worked have increased by 80% since 2002-03, and the real value of the productive capital stock by almost 90%, whereas output has risen by only 13%: correspondingly, labour productivity has fallen by 37% and multi-factor productivity by 33% in the utilities sector over this period.

If these developments truly did explain most of the deterioration in Australia's productivity growth rate over the past decade then perhaps there would be little reason for concern about it<sup>7</sup>. However, given that the mining and utilities sectors together have over the past decade employed about 19% of Australia's non-housing capital stock and a little over 2% of Australia's workforce, to produce about 11% of Australia's overall output, it seems *prima facie* implausible that these two sectors could have accounted for nearly all of the decline in Australia's productivity since 2000y.

And if these two sectors were excluded from consideration, labour productivity growth in the rest of the 'market sector' has still slowed from 3.1% per annum over the five years to 1999-2000 to 1.3% per annum over the five years to 2010-11, only 0.1 of a percentage point per annum less than the decline in the equivalent measure of labour productivity growth including the mining and utilities sectors<sup>8</sup> (Chart 5).

Chart 5: Labour productivity growth including and excluding the mining and utilities sectors



Note: 'Market sector' includes agriculture, forestry and fishing; mining; manufacturing; electricity, gas, water and waste services; construction; wholesale trade; retail trade; accommodation and food services; transport, postal and warehousing; information, media and telecommunications; financial and insurance services; rental, hiring and real estate services; professional, scientific and technical services; administration and support services; arts and recreation services; and other services. 'Selected sectors' excludes the rental etc, professional etc, administration and support and other services sectors.

Sources: ABS; Saul Eslake & Marcus Walsh *Australia's Productivity Challenge* (Grattan Institute February 2011), updated.

<sup>7</sup> As indeed some are still arguing: see, for example, Dean Parham, *Australia's Productivity Growth Slump: Signs of Crisis, Adjustment or Both?*, Productivity Commission Visiting Researcher Paper, April 2012.

<sup>8</sup> See Saul Eslake and Marcus Walsh, *Australia's Productivity Challenge*, Grattan Institute, February 2011 (available at [http://www.grattan.edu.au/pub\\_page/069\\_report\\_productivity\\_challenge.html](http://www.grattan.edu.au/pub_page/069_report_productivity_challenge.html)); and Saul Eslake, 'Productivity: The Lost Decade', in Hugo Gerard and Jonathan Kearns (eds.), *The Australian Economy in the 2000s*, Proceedings of a Conference at the Reserve Bank of Australia, 15-16 August 2011 (available at <http://www.rba.gov.au/publications/confs/2011/eslake.pdf>), pp. 223-254.

If that conclusion is accepted, then what other reasons might there be for the slowdown in Australia's productivity growth rate?

One widely-proffered explanation is that, in market contrast to the period between the mid-1980s and the late 1990s, when wide-ranging economic reforms implemented by governments of both political persuasions evidently did contribute to the improvement in productivity growth that was recorded during the 1990s (a conclusion supported by a considerable body of research<sup>9</sup>), the past decade has seen very little by way of productivity-enhancing reforms.

This is part attributable to changes in the political environment, including a diminution in the enthusiasm of both major political parties for continuing reforms of the type pursued in the 1980s and early 1990s once the politically 'easiest' reforms (what management consultants typically call the 'low-hanging fruit') had been accomplished, and once what remained was seen as more politically 'challenging', including to important elements of the 'core constituencies' of both sides of Australian politics. Changes in voting behaviour – particularly in rural and regional areas, but also in areas such as western Sydney – made both major political parties more sensitive to the views of those who perceived themselves (not always inaccurately) as 'losers' from the reforms of the 1980s and 1990s.

The lack of enthusiasm for productivity-enhancing reforms since about 2000, on the part of both political leaders and the public at large, also seems in part attributable, paradoxically, to the generally more prosperous economic circumstances of the last decade.

The willingness of political leaders to undertake (and the public at large to accept, if only tacitly) the reforms of the 1980s and 1990s were to a significant degree prompted by the economic vulnerabilities exposed by the persistence of high inflation and unemployment since the mid-1970s, the decline in Australia's terms of trade during the 1970s and 1980s, and two severe recessions occurring within less than a decade.

By contrast, the past decade has been one of almost uninterrupted growth in economic activity, employment and household disposable income, lower unemployment than at any time since the mid-1970s, sound public finances (especially by comparison with other 'advanced' economies'), relatively low and stable inflation, relatively low and stable interest rates, a generally rising exchange rate (something widely seen among the broader population as a short-hand summary of international investors' views of Australia's economic performance) and (perhaps most importantly in this context) a dramatic reversal of the downward trend in Australia's terms of trade which had prevailed throughout most of the twentieth century.

Professor Ross Garnaut has described this as 'a Great Complacency that descended upon the country after a decade of exceptional economic growth ... as a community we accepted the excellent economic performance as evidence that we had changed enough'<sup>10</sup>.

To the extent that this is the case, this 'complacency' has not been confined to the public policy arena.

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<sup>9</sup> See, for example, Charles Bean, 'The Australian Economic 'Miracle': A View from the North' and Peter Forsyth, 'Microeconomic Policies and Structural Change', both in David Gruen and Shona Sretha, *The Australian Economy in the 1990s* (Reserve Bank of Australia, Sydney, 2000), pp. 74-114 and 235-267; Productivity Commission, *Annual Report 2009-10* (Canberra, 2010), p.62; and OECD, *Towards a Seamless National Economy, OECD Reviews of Regulatory Reform: Australia 2010* (OECD, Paris, 2010), p. 14.

<sup>10</sup> Ross Garnaut, 'Breaking the Australian Great Complacency of the Early Twenty First Century', Paper presented at the 2005 Economic and Social Outlook Conference, Melbourne Institute and The Australian, 31 March; downloadable at <http://www.rossgarnaut.com.au/AustralianEconomy.html>.

As the profit share of Australia's national income increased to unprecedented levels during the years immediately before the onset of the global financial crisis, businesses themselves attached less importance to the pursuit of productivity gains at the enterprise or workplace level (which is, after all, where the decisions that actually lead to higher levels of productivity are formulated and executed, if at all).

As with the diminished enthusiasm for productivity-enhancing reforms at the political level, this low emphasis on achieving productivity gains at the enterprise level is to at least some extent understandable. Productivity-enhancing change in individual work-places is often disruptive and unpleasant, both for those on the 'receiving end' of that change and those (typically 'middle managers') who have to communicate it to those affected and implement it. When making such changes is no longer a matter of survival – as it was for many businesses in the 1990s – it is not surprising that there is the appetite for making them has diminished.

It is also to some extent inevitable, and consistent with both historical experience and the contemporary experience of other countries, that as the Australian economy moved closer to 'full capacity' in the second half of the 2000s, a situation characterized by (among other things) increasing shortages of skilled labour and the emergence of 'bottlenecks' in key areas of infrastructure provision, measured productivity would deteriorate – irrespective of whether political and business leaders had maintained their earlier enthusiasm for productivity-enhancing change in either the public policy-making or business decision-making spheres.

A different perspective on the impact of reform (or the lack thereof) and regulation on Australia's productivity performance that is far less frequently heard coming from business leaders (or anyone else, for that matter) but which I personally believe is important has been the increasing volume of legislation and regulation in reaction to various actual or perceived threats to 'security', instances of misbehaviour in the corporate sector, and other more quotidian aspects of life.

A common belief underpinning this legislation and regulation appears to be that it is both possible and desirable to eliminate various kinds of risk (to life, to property, to public order and safety, to people's savings, to standards of corporate or private behaviour, and so on) through additional legislative or regulatory action, irrespective of the probabilities attaching to those risks, irrespective of the adequacy of already existing legislation or regulation to that end, and irrespective of the costs of seeking to eliminate those risks relative to the benefits of doing so.

As the OECD has noted, 'the public discussion of risk focuses unduly on consequence, with inadequate regard to the likelihood of those consequences. To the extent this occurs, risk reduction activity is likely to be skewed toward risks with high consequences but low probability'<sup>11</sup>.

The legislation and regulation which have been imposed by governments in the aftermath of the terrorist attacks of September 11 2001 and subsequently, and numerous but uniformly unsuccessful attempts to repeat them, are (in my opinion) very much a case in point. John Mueller and Mark Stewart (the latter a Professor of Civil Engineering at the University of Newcastle in NSW) report that the myriad 'security' measures enacted after the terrorist attacks of the early 2000s have never been subjected to any kind of probability assessment or cost-benefit analysis. Their own cost-benefit analyses find that of these measures, only the decision to harden cockpit doors in aircraft has been 'cost effective'; while programs under which gun-toting officers travel on selected flights, and the implementation of 'full body scanners' at airports, fail such tests 'miserably and 'comprehensively'<sup>12</sup>.

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<sup>11</sup> OECD, *Risk and Regulatory Reform: Improving the Governance of Risk*, Paris, 2010, p.119.

<sup>12</sup> John Mueller and Mark Stewart, *Terror, Security and Risks: Balancing the Risks, Benefits and Costs of Homeland Security*, Oxford University Press, 2011.



Much of this legislation and regulation has required the employment of additional staff, the acquisition of additional capital equipment or the costly modification of existing buildings and infrastructure, without resulting in the production of any additional (measured) goods or services, and often with the incidental effect of diverting the time and attention of other people from activities that would have otherwise resulted in the production of additional goods and services.

In other words, whatever public or private benefits that have been procured through legislation and regulation of this type have inevitably come at some cost in terms of productivity.

Nor has Australia's experience in this regard been unique, although when one looks beyond the realm of aviation 'security' to other aspects of business and personal life, the quantum and reach of 'risk-averting' legislation and regulation may well have been more pervasive in Australia than in many other 'advanced' economies.

The Victorian Competition and Efficiency Commission summed it up rather well, in my opinion, when it last year called for 'greater public understanding of risk issues, including the omni-present nature of risk in every day life and the constant trade-offs between risk and return that characterise daily decision-making' and an 'appreciation of the size of the costs that can be involved and the fact that these costs inevitably permeate society, rather than affecting only regulated businesses'<sup>13</sup>.

A society which is increasingly unwilling to tolerate risk of any kind, and seeks through a growing body of legislation and regulation to prevent risks from being taken, is unlikely to be one in which businesses will be willing to accept the risks inherent in the sorts of innovation that is one of the key drivers of productivity growth.

Thus, consistent with the fact that Australia has slipped from 5th on the World Bank's annual ranking of economies by 'ease of doing business' in 2005 to 15th last year<sup>14</sup>. Australia's position in various surveys of innovation performance has fallen from being typically ranked behind only the Nordic countries and the United States in the second half of the 1990s to now ranking typically somewhere between 15<sup>th</sup> and 22<sup>nd</sup><sup>15</sup>.

It's neither possible nor meaningful to apportion the blame for Australia's poor productivity performance over the past decade among these various hypotheses. But I think it is hard to disagree with Treasury Secretary Martin Parkinson that 'the root causes of Australia's present productivity performance are embedded in the decisions of the last decade'<sup>16</sup>.

### **What – if anything – should be done about Australia's productivity performance?**

Although Australia's productivity growth performance has been deteriorating for more than a decade, it is only in the last couple of years that it has attracted any degree of public concern.

That's been partly because (as noted earlier), it had for a long time been assumed that the deterioration in our productivity performance was attributable largely to peculiar developments in a couple of industries that would eventually pass or right themselves. And it's been partly because the deterioration in our productivity performance would seem thus far to have had few if any adverse consequences for the living standards of Australian citizens. For example, since the turn of the

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<sup>13</sup> Victorian Competition and Efficiency Commission, *Securing Victoria's Future Prosperity: A Reform Agenda*, November 2011, p. 90.

<sup>14</sup> World Bank and International Finance Corporation, *Doing Business 2012*, Washington DC 2011 (available at <http://www.doingbusiness.org/reports/global-reports/doing-business-2012>).

<sup>15</sup> Saul Eslake, *op. cit.* (footnote 8 above), p. 242.

<sup>16</sup> Martin Parkinson, *op. cit.* (footnote 3 above), p. 22.

century real household disposable income has grown at an average annual rate of 4.1%, compared with 2.7% in the 1990s, 2.4% in the 1980s and 3.3% in the 1970s; and the unemployment rate has been pretty close to the commonly-accepted definition of 'full employment' since about 2005.

This has been possible largely because of the surge in Australia's terms of trade since about 2002, and by a faster rate of population growth compared with the 1990s.

There is a very strong echo here of Australia's experience during the 1950s, 1960s and early 1970s. Then, as during the past decade, the consequences of a rather ordinary (by international standards) productivity performance were obscured by the combination of rapid population growth (the result, in turn, of the post-war 'baby boom' common throughout the world, and Australia's own post-war immigration program) and the benefits to Australia (both through terms of trade gains and increases in production capacity) arising from the urbanization and industrialization of what during this period became our largest export market (namely, Japan).

But when the post-war population boom came to an end (in the early 1970s), and shortly afterwards Japan more or less 'caught up' with US and Western European levels of per capita GDP and the commodity intensity of its economy subsequently began to decline, the consequences of Australia's poor productivity performance for Australians' living standards became more readily apparent, in the form of weaker average economic growth rates, and persistently high inflation and unemployment.

The same fate could await Australia in the decade ahead now that population growth has begun to slow, as demographic change erodes labour force participation rates and average hours worked and if, as both Treasury and Reserve Bank forecasts presume, Australia's terms of trade have reached their peak.

Consistent with my earlier observation that one of the reasons for Australia's poor productivity performance over the past decade was the lack of any real incentives for firms to pursue productivity gains (since acceptable rates of profit growth were being obtained without the need for them, there are now some indications that the difficulties being encountered by sectors of the economy which have been adversely affected by some of the side-effects of the mining boom, in particular the persistently strong exchange rate, or by the heightened propensity to save on the part of households (compared with the two decades prior to the onset of the global financial crisis), are prompting businesses in those sectors, of their own volition, to place a much higher priority on productivity-enhancing organizational and other changes at the enterprise or workplace level, as a matter of survival, without any need for public policy changes.

However, some employers could be a lot more thoughtful than they have been about the way in which they seek to make productivity-enhancing changes in their workplaces, if they wish to foster an environment in which such changes can be made more readily.

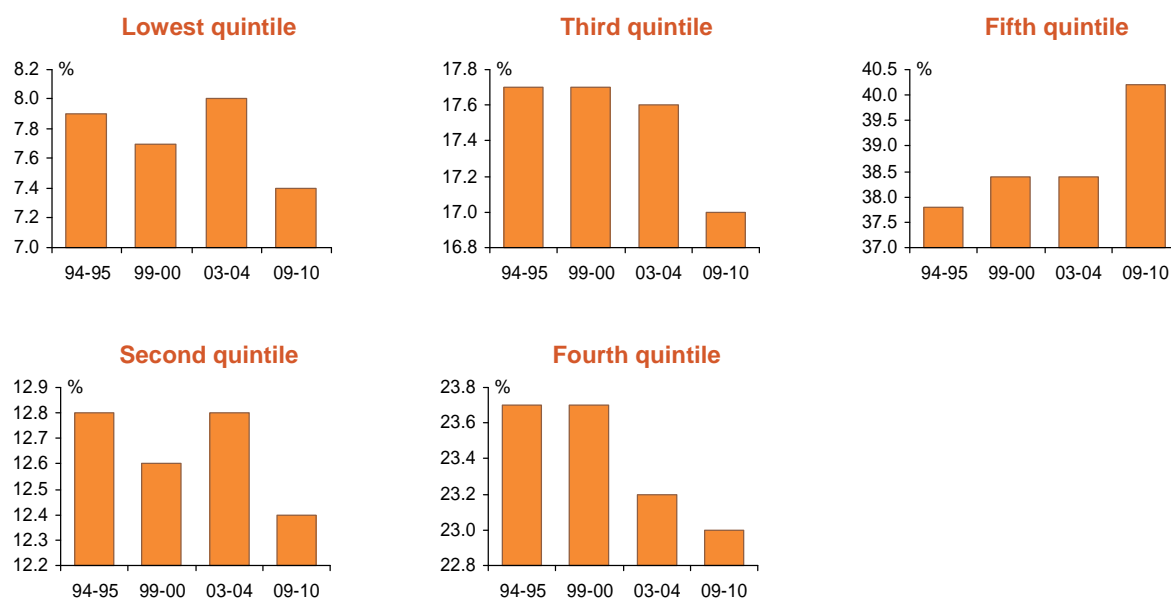
In particular, business leaders, and business organizations, need to give more thought to the distributional consequences both of their own decisions and of the policy changes which they advocate.

The distribution of income and wealth has become more unequal over the past two decades, albeit not to the same extent as in the United States (or, perhaps surprisingly, in China). ABS data suggest that the share of total 'equivalized' household disposable income accruing to households in the top quintile of the income distribution increased by 2.4 pc points, to 40.2%, between 1994-95 and 2009-10 – with most of that increase occurring between 2003-04 and 2009-10 – while the share accruing to all other quintiles declined<sup>17</sup>(Chart 6).

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<sup>17</sup> ABS, *Household Income and Income Distribution* (catalogue no. 6523.0), 2009-10.

Chart 6: Shares of 'equalized' household disposable income by quintiles



Note: Disposable income is income after tax & Medicare levy, 'equalized' for differences in the number of people per household  
 Source: ABS Household Income and Income Distribution 2009-10 (6523.0).

Data compiled by Andrew Leigh, formerly a Professor of Economics at ANU and now a Labor Member of Parliament, shows that the share of taxable income accruing to the top 1% of taxpayers rose from less than 6.5% in the early 1990s to a peak of 10.1% in 2005-06, before falling back (as a result of the impact of the global financial crisis on share and top-end property prices) to 8.9% in 2008-09; while the share accruing to the top 0.1% rose from less than 2% in the early 1990s to a peak of 3.7% in 2005-06, before falling back to (a still high) 2.9% in 2008-09<sup>18</sup> (Chart 7). These figures are a lot lower than the corresponding ones for the United States (where the shares of taxable income accruing to the top 1% and top 0.1% of households peaked at 18.3% and 8.2%, respectively, in 2007), but they are still high by historical standards.

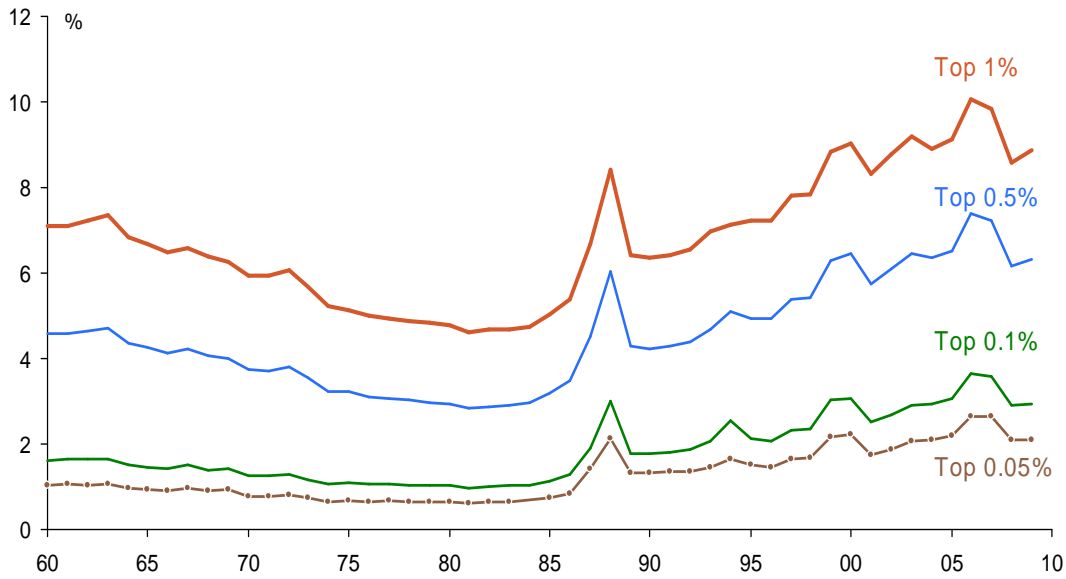
The distribution of wealth has always been much less equal than that of income, and has become more so over the past two decades. The share of 'equalized' household net worth has risen from 58.6% in 1993-94 to 62.2% in 2009-10<sup>19</sup> (Chart 8).

The purpose of quoting these statistics here is not to make an argument for greater redistribution of income and wealth, but rather to emphasize that it will be increasingly difficult for business leaders to pursue organizational changes in workplaces that are perceived by employees as resulting in fewer people working longer hours, or to pursue changes in legislation, regulation or other public policies which give business leaders greater freedom to make such changes, if the rewards from such changes are seen to accrue disproportionately to those at the upper end of the income scale, either in individual enterprises, or across society as a whole.

<sup>18</sup> AB Atkinson and A Leigh, *The Distribution of Top Incomes in Australia*, ANU Centre for Economic Policy Research, Research Discussion Paper No 516 (March 2006); updates on [www.andrewleigh.org](http://www.andrewleigh.org).

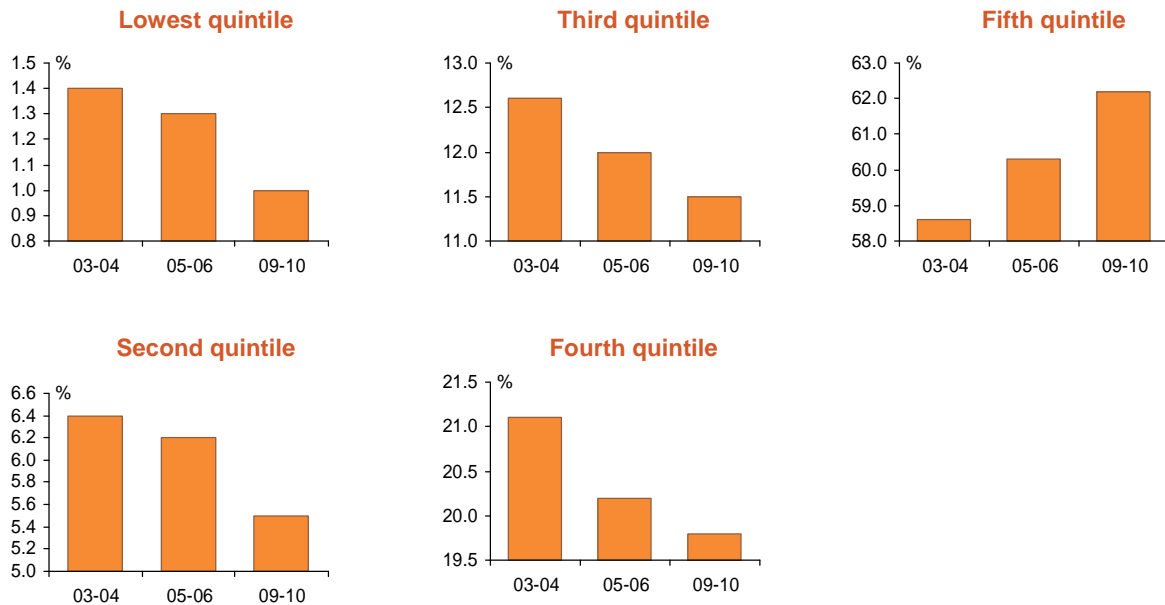
<sup>19</sup> ABS, *Household Wealth and Wealth Distribution* (catalogue no. 6554.0), 2009-10. '

Chart 7: Shares of taxable income accruing to the highest income groups



Source: Andrew Leigh, update of data originally published in AB Atkinson & A Leigh, *The Distribution of Top Incomes in Australia*, ANU Centre for Economic Policy Research Discussion Paper No. 514 (March 2006) (based on taxation statistics).

Chart 8: Distribution of 'equalized' household net worth by quintiles



Note: Wealth is 'equalized' for differences in the number of people per household  
 Source: ABS Household Wealth and Wealth Distribution 2009-10 (6554.0).

Thus, while it may not be illegal for executives of companies to award themselves large salary increases or bonuses, or to put their hands up for large options packages with undemanding performance hurdles, whilst simultaneously sacking large numbers of their employees (or arguing for greater freedom to do so), the 'optics' of it are dreadful. That kind of behaviour does nothing to enhance public understanding or acceptance of the occasional need for painful and unpleasant changes in the way work is organized, or the number of people who do it, in individual workplaces. It

does terrible things to the loyalty and morale of the staff who remain after ‘restructurings’ have been undertaken. And it exacerbates trends in the distribution of income and wealth which, if taken too far, threaten to undermine public support for a market economy.

In this context it is also worth noting evidence which suggests that inadequacies in management may be at least as significant a reason for Australia’s poor productivity performance as inflexible employee work practices. For example, research by the McKinsey Global Institute indicates that ‘Australia has a larger tail of low-performing firms than other advanced economies’ in terms of operations, performance management and talent management<sup>20</sup>; while other research suggests that lifting management practices in Australian manufacturing firms to the average level in the US would raise the level of productivity in Australian manufacturing by around 8 per cent<sup>21</sup>.

There are of course other areas of regulation which could also be examined with a view to reducing their adverse impact on productivity. In particular, a re-thinking of the increasing trend, identified earlier, of seeking to reduce perceived risks through legislation and regulation without any assessment of probabilities or opportunity costs would almost certainly be beneficial from the standpoint of improving productivity performance. Much of the legislation and regulation enacted over the past decade in the name of ‘security’ and improved standards of corporate governance comes into that category, in my opinion.

There remain many areas of the Australian economy that have, largely for political reasons, remained largely insulated from competitive pressures of the sort that, in other sectors, have acted as strong incentives for the pursuit of productivity-enhancing structural and organizational change – including international aviation, agricultural marketing (other than grains), pharmacies, newsagents, private service professions (such as law, medicine, and architecture), and services sectors dominated by public sector agencies (such as health care, education, public transport and law enforcement).

Some of these are, admittedly, relatively small as a share of output or employment; others (in particular the service delivery sectors mentioned above) are both large themselves, and important ‘enablers’ for other sectors of the economy.

One of the key obstacles to the pursuit of productivity-enhancing reforms in these areas is the near-universal belief that there is a linear correlation between the number of people employed in delivering these services and the quality of them, notwithstanding the absence of any empirical evidence in support of that belief (for example, between staff-student ratios in schools and student outcomes).

Similarly, it is widely accepted that Australia’s infrastructure, particularly in transport, is inadequate for many of the requirements of Australia’s growing economic, personal and social needs, and that this is in part due to ‘under-investment’ in infrastructure in the 1980s and 1990s.

However, as the OECD notes, it also reflects ‘weak co-ordination between public infrastructure and development and fiscal management’ and a ‘lack of co-ordination between the various levels of government, and between jurisdictions at the same level’, so that ‘infrastructure decisions are frequently taken with no regard for national priorities’<sup>22</sup>.

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<sup>20</sup> McKinsey Global Institute, *Beyond the Boom: Australia’s Productivity Imperative*, August 2012, p. 33.

<sup>21</sup> Nicholas Bloom, Christos Genakos, Raffaella Sadun and John Van Reenen, ‘Management practices across firms and countries’, National Bureau of Economic Research Working Papers, no 17850, 2012; David Gruen & Ben Dolman, ‘Productivity and Structural Change’, Paper presented to 41st Australasian Conference of Economists, July 2012.

<sup>22</sup> OECD, *Economic Surveys – Australia*, Volume 2010/21, Paris, November 2010, p.91-95.

The solution to these weaknesses is not simply ‘more spending on infrastructure’, especially if that spending is as unco-ordinated and with as little regard for national priorities as in the past – although at least the creation of Infrastructure Australia makes it a little harder for infrastructure spending decisions at the federal level to be dictated largely by political considerations.

It is of no less importance to the objectives of higher levels of productivity or faster productivity growth that better use is made of existing infrastructure, including through rational pricing regimes, and through avoiding ill-conceived regulation that detracts from the efficiency with which existing infrastructure is used (for example, by arbitrary and ‘knee-jerk’ reductions in speed limits on roads, or ‘security’ procedures entailing excessive or unnecessary delays in the movement of goods and passengers through airports).

Finally, tax reform could play an important role in improving Australia’s productivity performance. The Henry Review of Australia’s tax system urged that ‘Australia should configure its tax and transfer architecture to promote stronger economic growth through participation and productivity’<sup>23</sup>.

Australia’s personal and business income tax systems (and State land and payroll tax systems) are littered with exemptions and concessions which confer favourable treatment on particular groups of taxpayers, particular forms of business organization, or particular types of economic activity at the expense of others, leading to household and business investment decisions often being excessively influenced by tax considerations rather than their intrinsic merit (which must be to the detriment of productivity, among other things).

Unfortunately, many of the Review’s recommendations to that end were promptly ruled out – by both sides of politics – for transparently political reasons.

## Conclusion

As the famous quote from Paul Krugman cited at the beginning of this chapter says, productivity ‘isn’t everything’. More specifically, it is the *means* to an end – higher material standards of living – rather than an end in itself. And indeed ‘higher material standards of living’ is not necessarily an end in itself either, but a means to other ends, ends which most people agree are worth pursuing. As Michael Porter wrote,

‘High productivity not only supports high levels of income but allows citizens the option of choosing more leisure instead of longer working hours. It also creates the national income that is taxed to pay for public services which again boosts the standard of living. The capacity to be highly productive also 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’<sup>24</sup>.

Australia has been able to ‘get away with’ ignoring a declining trend in productivity over the past decade because of a fortuitous reversal in what had previously been a long-term downward trend in our terms of trade. More recently, that long-term downward trend seems to have resumed, albeit from a much higher level than at the end of the 20<sup>th</sup> century. As such, further gains in material living standards – and in other aspects of life which gains in material living standards make possible – will be much harder to come by, unless the downward trend in productivity growth can itself be reversed.

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<sup>23</sup> Ken Henry (chair), *Australia’s Future Tax System – Report to the Treasurer, Commonwealth of Australia*, December 2009, p. xviii.

<sup>24</sup> Michael E Porter, *The Competitive Advantage of Nations*, The Free Press, New York, 1991, p. 5.

Reversing the downward trend in productivity growth will not be easy. It will require changes in public policy, legislation and regulation, in the composition of economic activity and employment, and in management and work practices and habits.

Those changes will, in turn, require something more than grudging acceptance. They will need the active consent and co-operation of citizens, voters and employees. That consent and co-operation will not be forthcoming if the benefits of higher levels of productivity or faster rates of productivity growth accrue predominantly to those who already enjoy the highest material standards of living.

In other words, any sustainable, successful productivity agenda has to include a distributional dimension.