PRODUCTIVITY

2nd Bishop Manning Lecture

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Introduction

It is a great honour to have been invited by the Catholic Commission for Employment Relations to present the second Bishop Manning Lecture this evening.

This Lecture honours the life and work of Bishop Kevin Manning, whose fifty years of service to God, the Catholic faith and the wider community culminated in his period as Bishop of Parramatta between 1997 and his official retirement in 2010, and whose mission has continued past that official retirement as Apostolic Administrator of Wilcannia-Forbes.

The sponsorship of this Lecture by the Catholic Commission for Employment specifically recognizes the contribution Bishop Manning made throughout his ministry to the furtherance of the Church's teachings about the dignity of work, and of the need for justice in the way that work is organized and remunerated.

And Bishop Manning's commitment to ecumenism, and to inter-faith dialogue, is also recognized in the fact that the Commission has reached outside the Catholic community in its invitations to deliver the first two of these Lectures – something which I acknowledge with humility.

In the first of these Lectures, former Prime Minister Bob Hawke referred at length to Pope Leo XIII's encyclical *Rerum Novarum* ('New Things'), which, as he explained, found expression in the famous 1907 'Harvester Judgement' of the Australian Conciliation and Arbitration Court under its inaugural President, Henry Bournes Higgins. That judgement established the principle that the minimum wage which could be regarded as 'fair and reasonable' is one which allowed a man, his wife and three children to afford 'a condition of frugal comfort estimated by current standards'.

The Harvester Judgement was of course handed down at a time when, for members of what was then (and for a long time afterwards) referred to as the 'working class', wages represented their sole source of income, and their only means of providing for themselves and their dependants. It was not then, nor until almost four decades afterwards, thought that there was any role for the State in providing any form of financial assistance to those with family responsibilities.

Today, of course, the State – and the community more broadly – take a very different view. According to the Budget Papers tabled in Parliament earlier this month, over the five years between 2011-12 and 2015-16, the Australian Government will provide over $100 billion in cash by way of 'Family Tax Benefits' to families with children. For the financial year 2011-12 (which is about to end), that works out to an average of just under $12,000 per eligible family – which is in turn equivalent to around 15% of the annual gross income of someone earning full-time adult male average weekly earnings. The Australian Government will also spend a further $78 billion on other payments to and services for families with children over the five years to 2015-16.

In my opinion, this extensive State support for people with family responsibilities means that it is neither necessary nor appropriate for the wage-fixing system to have substantial regard to employees' family responsibilities. If wages were to be set according to the principle laid down by Justice Higgins 105 years ago, there is a strong likelihood that they would be set at a level that would deprive at least some people – people without family responsibilities – of the opportunity to work, and in so doing, deprive them of the dignity of work which was at the heart of *Rerum Novarum*. As Pope John Paul II said in *Centesimus Annus* which was issued on the centenary of *Rerum Novarum*:

> "The obligation to earn one's bread by the sweat of one's brow also presumes the right to do so. A society in which this right is systemically denied, in which economic policies do not allow workers to reach satisfactory levels of employment, cannot be justified from an ethical point of view"[1].

One only has to look at Europe today – where in both Spain and Greece almost 50% of young people are without work, or Italy where unemployment among young people is not much lower than in Spain or Greece – to see evidence as to how labour market regulations designed to benefit one group of people – typically, those who have had jobs for a long period of time, through measures such as relatively high minimum wages, or onerous restrictions on retrenchments and lay-offs – can deprive others of the opportunity to work, and thereby concentrate the hardship caused by an economic downturn on those with the smallest voices.

Let me hasten to add that I am *not* arguing that the State should not set a minimum wage, or that the minimum wage which it does set should not be one which allows those who earn it to live at a decent standard; nor am I arguing that the present Australian minimum wage should be lowered, or frozen at its present level.

Rather, I am suggesting that circumstances have changed significantly (and for the better) since the era of *Rerum Novarum* and the Harvester Judgement, and that as a result, the view we take of the extent to which people's family responsibilities should be considered in determining what constitutes an acceptable minimum wage should also change.

Indeed, upon reading *Centesimus Annus* as I did in the course of preparing this lecture, I was struck by the wisdom and clarity of some of its prescriptions for what the role of the State should be in this context:

> "The principal task of the State is to guarantee … individual freedom and private property, as well as a stable currency and efficient public services … so that those who work and produce can enjoy the fruits of their labours and thus feel encouraged to work efficiently and honestly.
>
> … The State has a duty to sustain business activities by creating conditions which will ensure job opportunities, by stimulating those activities where they are lacking or by supporting them in moments of crisis"[2].

I would also add that, while I don't believe that employers should be required to have regard to their employees' family responsibilities in determining how they are remunerated, I do believe that employers should have at least some regard to those responsibilities when determining hours and conditions of employment – and that there may be some role for the State in ensuring that all employers do what the more enlightened employers will do of their own volition in that regard.

Productivity: why it matters

I've been asked to talk this evening about productivity, a topic to which I devoted a substantial proportion of the two-and-a-half years of what turned out to be, somewhat to my surprise, a 'sabbatical' between being employed as a chief economist by two different financial institutions.

Productivity is one of those words that have come to mean different and often contradictory things to different people.

To an economist, productivity is simply a measure of the efficiency with which what we call 'factors of production' – typically, labour and capital, although a broader view might also encompass land and even some of "God's gifts", such as finite natural resources, clean air and water – to produce goods and services that are of value to others, either when sold at a mutually agreed price to individual purchasers, or provided collectively to communities through the State and paid for indirectly through some form of taxation: although measuring productivity is in practice often much more difficult than this definition implies, (and in the case of some forms of economic activity next to impossible).

More colloquially, it is sometimes characterized simply as 'working smarter'. But is also often perceived, especially by employees, as 'working harder' – which to an economist is emphatically *not* the same thing as 'working smarter'.

But that perception is to at least some extent understandable in view of the ways in which employers often go about seeking improvements in productivity in practice, an issue to which I shall return later.

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'[3]. 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'[4]; 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'[5].

The Catholic Church recognizes this too. In *Centesimus Annus* Pope John Paul II wrote :

> "It is precisely the ability to foresee both the needs of others and the combinations of productive factors most adapted to satisfying those needs that constitutes another important source of wealth in modern society … Organizing such a productive effort, planning its duration in time, making sure that it corresponds in a positive way to the demands which it must satisfy, and taking the necessary risks – all this too is a source of wealth in today's society"[6].

In its submission to Fair Work Australia's latest annual wage review, the Australian Catholic Council for Employment Relations argues:

> "Productivity growth is vital for the continuing strength of the economy and the maintenance and improvement of living standards. Productivity growth enables increases in real wages"[7].

Australia's deteriorating productivity performance

If we are willing to accept these various authorities' conclusion that productivity, and productivity growth, are important – and (as *Centesimus Annus* reminds us) not just for economic reasons – then we must also be concerned by the steady deterioration in Australia's productivity performance over the past decade.

Here are the basic statistical facts about this performance:

- 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[*];

[*] Measured productivity growth is very sensitive to business cycle fluctuations: hence it is unwise to draw inferences about productivity growth from changes over periods shorter than three years (at a minimum).

- *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'[8].

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 11th out of 25 OECD countries in descending order of labour productivity growth in the 1990s, and 17th out of 34 countries in the 2000s.

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[9].

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.

I will return to that issue later on.

[*] 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.

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.

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[10].

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 the turn of the century.

And in work that I did whilst at the Grattan Institute[11], I showed that 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.

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 research12), 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 pursed 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'[13].

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

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). Annual surveys conducted since 2009 by Telstra have found that, while upwards of three-quarters of organizations with over 200 employees say that productivity is important, fewer than one-quarter of them are able to report that they've actually achieved measurable productivity gains over the past year[14].

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'[15].

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.

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.

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[*] For example, John Mueller and Mark Stewart (the latter a Professor of Civil Engineering at the University of Newcastle in NSW), in *Terror, Security and Money* (Oxford University Press, 2011) 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'

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'[16].

As an aside, the way in which this country treated Mohammed Haneef, a man completely innocent of the complicity in a terrorist plot on the other side of the world of which he was wrongly accused, and the indifference of the overwhelming majority of the Australian population to his treatment, is a stark illustration of the way in which 'these costs inevitably permeate society'.

To return to the main point, 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[17], 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 15th and 22nd[18].

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 possible to agree with Treasury Secretary Martin Parkinson that 'the root causes of Australia's present productivity performance are embedded in the decisions of the last decade'[19].

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 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.

The apparent contradiction between falling productivity growth rates and rising material living standards can be explained by noting that, during the 2000s, the consequences of Australia's declining productivity growth rate were offset (for most of the decade) by a rising population growth rate and (insofar as gross domestic income rather than gross domestic product is used as a measure of national income) by the surge in Australia's terms of trade (the ratio of export to import prices) to their highest sustained level in at least 140 years.

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.

Indeed, as Treasury Secretary Martin Parkinson points out, 'the rate of improvement in the living standards of Australians, at least that part measured by incomes, has already begun to deteriorate, even with the sustained and unprecedented rise in the terms of trade'[20].

So there is, I believe, a strong case for being concerned about the possible consequences of the deterioration in our productivity performance over the past decade, and for thinking about how it might be reversed.

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.

To the extent that this continues to be the case – as the on-going series of restructuring and lay-off announcements by major employers suggests – it will be important to ensure that the industrial relations system does not unduly inhibit the ability of firms to make productivity-enhancing organizational changes in the way that work is done. It is in this context that 'flexibility' is important – and that the conclusions of the Productivity Commission that 'some aspects of the 'Fair Work' system may be inhibiting the adoption of flexibility enhancing provisions' or that 'workplace flexibility provisions' in the 'Fair Work' system appear to have been used to place 'greater emphasis on strategies for developing family-friendly workplaces, rather than productivity'[21] are worth noting.

Again let me be clear that by 'flexibility' in this context I am *not* advocating that wages should be flexible downwards – as suggestions for greater flexibility in workplace relations regulation are sometimes portrayed as being (and as they are, I suspect, occasionally intended by some).

Nor am I suggesting that employees (and their representatives, where a meaningful proportion of them belong to unions) aren't entitled to be consulted in a meaningful and respectful way about prospective changes in the way that work is organized, or in the number of people employed to undertake particular tasks. They are: and being meaningfully and respectfully consulted is an integral part of being treated with dignity, as should be part of any employee's inherent rights as human beings.

To refer again to *Centesimus Annus,*

> "It is possible for the financial accounts to be in order, and yet for the people – who make up the firm's most valuable asset – to be humiliated and their dignity offended. Besides being morally inadmissible, this will eventually have negative repercussions on the firm's economic efficiency"[22].

But equally, and subject to respecting the rights of employees to dignified treatment, firms do need to be able to change the way in which work is done, and the number of people who do it, in response to changing business conditions, if improvements in productivity are to be attained.

That said, 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.

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).

But 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. It exacerbates trends in the distribution of income and wealth which, if taken too far, threaten to undermine public support for a market economy. And, to my mind at least, it's morally, and ethically, wrong. (John Paul II's words I cited a few moments ago are apposite here, too).

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).

One of the more thoughtful new entrants to Federal Parliament at the last election, Andrew Leigh, offers come compelling evidence of this in the context of our schools. (I should perhaps indicate that Andrew Leigh is a member of the Parliamentary Labor Party). Nonetheless, he writes:

> "Australian numeracy scores had failed to improve from 1964 to 2003. Since then, Australia's scores on the international PISA test have fallen. At the same time, the academic aptitude of new teachers – relative to their classmates – has declined. One possible reason for this is that Australia chose to focus on reducing class sizes rather than attracting the best teachers. Over the past quarter-century, class sizes have been cut by about 10 percent, while teacher salaries relative to other professional salaries have also been cut by about 10 percent.
>
> If we're learned anything from the economics of education over the past few decades, it's that the relationship between spending and outcomes is extremely weak. You can see this over time in Australia, where spending has risen but scores have flatlined"[23].

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'[24].

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).

There are also still examples where outright deregulation ought to be more actively considered. For example, the removal of restrictions governing entry into the Sydney taxi industry (for which there are 'few efficiency or social reasons') could produce benefits 'n the order of $250 million per annum', with even greater productivity and service benefits if accompanied by reform of the 'anti-competitive control of the taxi radio networks over all taxi operators'[25].

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'[26].

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

Early on in this lecture I quoted the Nobel Prize-winning economist Paul Krugman's widely-cited dictum that 'productivity isn't everything – but in the long run it's nearly everything'. Most of my subsequent remarks have been motivated by the second half of that quote.

But in concluding I want to acknowledge the truth of the first part of it as well. Productivity is *not* an end in itself: it is, at best, a *means* to an end. There are some highly desirable economic objectives which may, particularly in the short term, be inconsistent with the pursuit of the highest feasible levels of productivity, or rates of productivity growth. An example would be the objective of increasing the participation in employment of people who, through no fault of their own, are unable to be as 'productive' (in the strict economic sense of that term), at least initially, as others – for reasons of previous lack of access to educational opportunities, disabilities, difficulties in understanding or communicating in English, various forms of exclusion or marginalization from full participation in society. Yet such people are no less entitled to 'the dignity of work' than any other.

To quote one last time from *Centesimus Annus*,

> "It is not possible to understand the human person on the basis of economics alone … [but] the integral development of the human person through work … promotes the greater productivity and efficiency of work itself"[27].

As an economist, I have no difficulty in saying 'Amen' to that.

Footnotes

[1] John Paul II, Encyclical *Centesimus Annus* , 1 May 1991, para. 43.

[2] *Ibid*., para. 48..

[3] Paul Krugman, *The Age of Diminished Expectations: US Economic Policy in the 1980s*, MIT Press, Cambridge, 1992, p. 9.

[4] 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,

[5] 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.

[6] John Paul II, *op. cit.*, para. 32.

[7] Australian Catholic Council for Employment Relations, *Submission to the* Fair Work Australia *Annual Wage Review 2011-12*, March 2012, para. 200, p. 63.

[8] 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.

[9] The Conference Board, *Total Economy Database*, January 2012 (available at http://www.conference-board.org/data/economydatabase/).

[10] 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.

[11] 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); 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.

[12] 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.

[13] 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.

[14] Telstra, *The Telstra Productivity Indicator*, March 2012 (available at http://www.telstra.com.au/business-enterprise/resources-insights/telstra-productivity-indicator/index.htm).

[15] OECD, *Risk and Regulatory Reform: Improving the Governance of Risk*, Paris, 2010, p.119.

[16] Victorian Competition and Efficiency Commission, *Securing Victoria's Future Prosperity: A Reform Agenda*, November 2011, p. 90.

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

[18] See Saul Eslake, *op. cit.* (n. 11 above), p. 242.

[19] Martin Parkinson, *op. cit.* (n. 5 above), p. 22.

[20] *Ibid*., p. 15.

[21] Productivity Commission, *Economic Structure and Performance of the Australian Retail Industry, Draft Report* Canberra, July 2011, pp. 287, 307 and 319.

[22] John Paul II, *op. cit.* (n. 1), para. 35.

[23] Andrew Leigh MP, 'What Do We Eat After the Low-Hanging Fruit? A Brief Economic History of Australia, With Some Lessons for the Future', Talk at the McKell Institute, 18 May 2012 (available at http://www.andrewleigh.com/blog/?p=2617) , pp. 5-6.

[24] OECD, *Economic Surveys – Australia*, Volume 2010/21, Paris, November 2010, p.91-95

[25] Peter Abelson, 'The High Cost of Taxi Regulation, with Special Reference to Sydney', *Agenda*, Vol. 17, No. 2, 2010, pp. 41-72.

[26] Ken Henry (chair), *Australia's Future Tax System – Report to the Treasurer*, Commonwealth of Australia, December 2009, p. xviii.

[27] John Paul II, *op. cit*., paras. 24 and 43.