GRATTAN Institute

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(by Saul Eslake, Program Director, Grattan Institute; originally published in the Melbourne Age *'Business Day' section, 28th January 2010)*

Economic growth – in the sense of growth in the income derived from the production of goods and services – comes from four sources: from population growth; from growth in the proportion of the population employed in producing goods and services; from increases in the hours worked by those who are employed in producing goods and services; and from increases in the value of the goods and services produced by those in employment for each hour that they work.

Population growth, by itself, does not result in higher levels of per capita income, except to the extent that it allows businesses and governments to spread fixed costs over a larger base and exploit economies of scale. There may also be negative consequences of faster population growth, not all of which are captured by conventional economic statistics.

Increasing participation in employment has traditionally been an important source of economic growth, and remains an important objective when there are people who would like to work but are unable to find jobs, or where lack of affordable child care, perverse incentives arising from the taxation and social security systems, racial and other forms of discrimination or other barriers prevent people from working. However, as a nation's population ages, the proportion of people who are willing and able to work will tend to decline, even if obstacles to the continued employment of older workers are removed. Similarly, population ageing is likely to be associated with a decline in average hours worked. And although there are clearly some who would like to work longer hours than they presently do, on average Australians already work longer hours than their counterparts in most other advanced economies. For most Australians, longer hours of work would not necessarily be perceived as resulting in improved standards of living, even if they were matched by higher incomes.

Hence, if only by a process of elimination, a higher rate of productivity growth – that is, more rapid growth in the value of goods and services produced for each hour of work done – provides the best means of offsetting the impact of population ageing on the Australian economy, and thus for minimizing the extent to which taxes will otherwise need to increase in order to provide the increased health care and other services which an ageing population is likely to require, as well as for meeting the ongoing aspirations which most Australians have for rising standards of living for themselves and their children.

It was thus heartening to see Prime Minister Kevin Rudd, in the first of a series of speeches looking at longer-term challenges facing Australia, advocating the adoption of a 2 per cent per annum target for Australian productivity growth over the next four decades, as opposed to a 'business as usual' figure of 1.6 per cent per annum. Although a difference of 0.4 percentage points per annum might not sound like much, compounded over 40 years it amounts, according to the forthcoming Intergenerational Report from which the Prime Minister was quoting, a difference of $570 billion to Australia's annual economic output by 2050, equivalent to an additional $16,000 for every man, woman and child on average.

As the Prime Minister rightly noted, achieving this target for productivity growth will require a 'concerted effort'. Unnoticed by most, Australia's labour productivity growth performance has slipped markedly, from over 2 per cent per annum during the 1990s (and over 3 per cent per annum during the second half of the 1990s) to a little over 1½ per cent per annum during the decade just ended. Relative to US levels, Australia's overall labour productivity has slipped from a peak of 88% in 1999 to 80% in 2008 – in effect reversing all of the productivity gains Australia made on this score in the 1990s.

The effects of this slowdown in productivity growth have been masked by the enormous increase in the prices Australia receives for its resources exports over the past decade. However, while the China-driven resources boom almost certainly has further to run, it seems highly implausible that it will

continue for another 40 years, and it would be imprudent for policy-makers to assume that it will. Eventually, Australia's 'terms of trade' will return to the downward path which they travelled for most of the twentieth century.

Some of the slowdown in Australia's rate of productivity growth over the past decade is attributable to temporary factors affecting specific sectors of the economy, in particular mining, where the enormous increase in employment required during that industry's expansion phase has yet to be reflected in increased output, and in the utilities sector, where water restrictions have cut output by much more than employment has fallen. In both of these industries, productivity growth has actually been negative over the past decade, and should rebound significantly in coming years. But labour productivity growth has also slowed, in some cases quite substantially, over the past decade in ten of the seventeen other sectors of the Australian economy.

Improving Australia's overall productivity growth will, as the Prime Minister asserted in his speech earlier this month, require sustained investments in the fundamental drivers of productivity growth, including economic infrastructure (especially transport and energy), education and innovation. And, increasingly, these investments are in train. However productivity improvements will not come simply from spending more money, public or private. That money has to be spent wisely and well, in ways that address identifiable shortfalls in infrastructure, skills, technologies and organizational processes, rather than simply in order to claim that more money has been spent in these areas. New infrastructure needs to be capable of moving people and goods around more quickly and efficiently; additional spending on education needs to result in the more widespread acquisition of usable skills; innovation needs to be directed towards saleable products.

Sustaining higher rates of productivity growth also requires labour and capital to be allowed, indeed encouraged, to migrate from lower-productivity activities to higher-productivity ones in response to changing technologies and market conditions. Competition, both domestically and from overseas, can speed up this process; industry policies, as they have traditionally been conceived, are often explicitly designed to prevent it. Competition also encourages and facilitates the search for productivity improvements within individual enterprises and industry sectors. Thus, while achieving higher rates of productivity growth requires more than simply 'more micro-economic reform', and in particular more than the micro-economic reforms which were the hallmark of the 1990s, it does necessitate an ongoing commitment to structural change, and that's more than simply a matter of 'cutting red tape', however desirable that might be in itself.

If the Prime Minister's highly laudable vision of sustaining a 2 per cent per annum rate of productivity growth over the next four decades is to be realized, governments will need to focus on the quality of the investments they make as well as on their quantity, and to embrace competition as a driver of structural change, as well as strengthening the capacity of individuals and businesses to cope with it.