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Fix productivity slump before the crunch comes

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*We face a painful reckoning if measures aren't taken now to address productivity growth, writes **John Daley.***

Living standards of people and countries are primarily determined by how much individuals, businesses and governments produce for each unit of labour and capital they use.

In the long run, "productivity growth" – producing more with the same inputs – is the only sustainable way for children to enjoy higher living standards than their parents.

As American economist Paul Krugman said in 1991 (before he became more widely known for writing in *The New York Times* and winning a Nobel Prize): "Productivity isn't everything, but in the long run, it's almost everything."

Australia emerged during the 1990s as a "miracle economy" (another one of Krugman's phrases) when our productivity improved dramatically. From a rather dismal long-run average of slightly more than 1½ per cent a year, Australian labour productivity grew by more than 3 per cent a year in the second half of the '90s.

An Australian worker in 2000 produced almost 20 per cent more for every hour worked than in 1995 – and living standards were correspondingly higher. This achievement largely resulted from wide-ranging reforms designed to press firms and government agencies to become more productive by exposing them to more competition from home and abroad.

Over the past decade, however, Australia's productivity performance has deteriorated dramatically. Labour productivity growth slowed to about 1 per cent a year during the second half of the 2000s. Worse still, "multifactor" productivity (the efficiency with which labour and capital are combined to produce goods and services) actually started to decline.

Measured relative to the United States (as a rough proxy for "best practice"), Australia's labour productivity fell from a peak of nearly 92 per cent in the late '90s to slightly more than 84 per cent last year – the lowest since the early 1970s.

All of the improvement in our relative productivity due to the reforms of the late 1980s and '90s disappeared.

Australians haven't yet felt the consequences of this decline. Slowing productivity growth has been more than offset by a rapid increase in our terms of trade (the ratio of export prices to import prices).

The dollars in an Australian's pocket today buy more goods from overseas than they did 10 years ago. Australians feel wealthier because China and India have industrialised and urbanised and increased the prices we get for our commodity exports. At the same time, we succeeded in weathering the global financial crisis.

There's an echo of the "lucky country" era of the 1950s, 1960s and early '70s, when Australia rode the post-war population boom and the industrialisation of Japan. We sought to insulate ourselves from the consequences of deteriorating productivity performance behind ever-rising trade barriers.

This was not a sustainable strategy, and the consequences became starkly apparent when the post-war baby boom faded and Japan's industrialisation was complete.

No one can say with any real confidence when the current resources boom will end. All we know is that, one day, it will. And when it does, if we haven't reversed the decline in productivity performance, the consequences will be painfully obvious, just as they were in the second half of the '70s.

There's a dangerous complacency in some government circles that our deteriorating productivity performance over the past decade can be attributed largely to one-off distortions in the mining and utilities sector.

No question, measured productivity in those two sectors has fallen sharply. In mining, there is a long lag between investment in new projects and reaching full production; and high prices for minerals have made it profitable to extract lower-grade ores.

In utilities, we have invested in lower productivity but less carbon-intensive energy and expensive desalination plants to ensure longer-term security of urban water supplies.

But according to calculations published in a report from the Grattan Institute, *Australia's Productivity Challenge* by Saul Eslake and Marcus Walsh, these developments account for less than one-10th of the decline in Australia's labour productivity growth rate over the past decade. Productivity growth has slowed across most sectors in the Australian economy in the past decade, suggesting that the problem is systemic.

The report argues that the real culprits are the absence of any meaningful productivity enhancing reforms over the past decade; a wave of productivity stifling regulation, often in the name of security or corporate governance; relatively buoyant corporate profits muting the imperatives for business to seek productivity gains; shortages of skilled labour and infrastructure bottlenecks increasingly encountered as the Australian economy moved closer to full employment; and a decline (at least relative to other countries) in Australia's take-up of productivity enhancing new technologies.

In response, Australia needs a reinvigorated approach to economic reform; a change in the mindset that looks to government to regulate the risk out of every form of human activity; a determined focus on improving the quality and reach of our education and training systems; a better system of governance for our infrastructure investments; and a substantially improved national innovation effort.

Making the hard decisions will be a political challenge when, in the short term, there is no obvious crisis. But unless we are happy for the current resources boom to end as uncomfortably as all our previous booms, we need a concerted effort to improve Australian productivity so that all of us can enjoy the higher living standards this brings.

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