OECD Global Forum on Productivity:
Conference Dinner Speech, Sydney, 20 June 2019

The politics of productivity: successes and failures 'Down Under'

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Introduction

It is a great pleasure to be attending this OECD Forum once again and I am honoured to have been invited to address the Conference dinner.

At a time when the OECD has (rightly) been advocating that economic growth be more 'inclusive', the creation of this Forum has provided a welcome signal that productivity growth nevertheless remains fundamental to raising living standards for all members of society.

Over the years, OECD research has made an important contribution to understanding trends in productivity, as well as the policies and reforms that can promote better outcomes -- and *how to get them*.

It has become increasingly apparent that the last mentioned -- what an OECD study back in 2010 labeled 'Making Reform Happen' -- is the most challenging issue of all. Knowing what reforms or policies would do most good is obviously important, but so too is knowing how to get them implemented (and making them stick). That kind of capability is exercised more in the realm of politics than economics, and has proven the hardest to achieve.

So to complement an excellent conference program devoted to key questions concerning productivity trends and drivers, the focus for my remarks tonight will be on the policy-making task itself – specifically, what can be gleaned from Australia's experience on how to go about it, and how *not* to go about it.

The OECD has long regarded Australia as something of a 'poster child' for structural reform and taken a keen interest in what has been achieved and how it might be emulated elsewhere. In 2005 I was invited to give a presentation in Paris with the (somewhat boastful) title '*Structural reform Australian-style: Lessons for Others*?'. While unaware of it at the time, that year seems to have been the high water mark for productivity-enhancing reform 'down under'. Since then, telling the story of our past successes has been increasingly hard to reconcile with what has actually been happening (or not happening) on the ground.

However the more recent experience continues to provide some important lessons. The difference is that I now feel that these apply at least as much to Australia as to 'others'.

The era of 'Fortress Australia'

As many here will know, early last century, abundant primary resources and commodities fetching high prices on world markets saw incomes in Australia soar to among the highest in the world. This was the 'lucky country' described in Donald Horne's classic, but often misinterpreted, treatise on Australia. Horne's real message concerned whether our society was deserving of such bounty, and what the future might hold for us. For as countries like Singapore and Taiwan have shown, over time countries can make their own luck; or, as in Australia's case, they can forfeit it.

An implicit compact among what Europeans call the 'social partners' saw our newly federated country pursue a policy course for much of the twentieth century that was profoundly (and unashamably) protectionist, anti-competitive and redistributive, with resource industries effectively taxed to support the rest of the economy. Australia, in a phrase made famous by Horne's book, was complacently 'riding on the sheep's back'.

By the second half of the century, the legacy of our 'Fortress Australia' approach, was an economy with low trade participation, inefficient public utility, financial and other services, and a fragmented, high-cost manufacturing sector characterized by weak management, strong unions, outdated technologies and inflexible and indulgent work arrangements. In short, in terms of the themes of this conference, we had managed to create an economy lacking in both capability and dynamism.

I'm sure it won't come as a surprise that this resulted in Australia becoming a productivity laggard by OECD standards. In the 1970s and 80s our productivity growth averaged only a little over one-half that for the OECD as a whole. Australia's international ranking in terms of GDP per person fell from 5th in 1950 to 8th in 1970 and 15th by the end of the 80s. And the advent of a secular decline in our terms of trade in the post war years meant the comparative living standards of Australians declined too.

The 'Reform Era'

Australia seemed destined to sink lower, in company with certain other resource-rich countries like Argentina and Uruguay that shared our policy approach. (Singapore's redoubtable Lee Kuan Yew cheekily pronounced that we were destined to become the 'white trash of Asia'.)

Instead, this country embarked on a wide-ranging program of structural reforms that opened the economy to international and domestic competition, improved the efficiency of key public utilities and other government enterprises, and reduced rigidities in labour markets (among the most rigid in the OECD).

An indication of the extent of the reforms over the 1980s and 90s can be gleaned from that essentially Australian measure of net trade restrictiveness, the Effective Rate of Assistance, which for manufacturing fell from 25 to 5 per cent. With the liberalization of imports the implicit tax on exports also fell and Australia's trade-to-GDP ratio increased from around 20 to 40 per cent.

These policy changes prompted the exit of internationally uncompetitive firms and industries and transformed many that remained, including in their production methods and pursuit of innovation, as well as facilitating new market entry.

As a result, industry productivity surged, with MFP growth rates roughly doubling in energy, water, transport and communications. Australia went from productivity laggard to become a leader among OECD countries within the space of a decade, with our per capita GDP ranking rebounding from 15th to 8th by 2005.

During this period, real wages increased by some 40 per cent, with real household incomes growing on average by 2.5 per cent annually in the 1990s, well above historical experience and above that for the OECD as a whole. Moreover, gains were fairly evenly spread across the income distribution. Unemployment initially rose, but within a few years had declined to historically low levels.

The outcome was not only a more productive economy, but also (assisted by a freely floating currency) one that was more flexible and resilient. This enabled us to withstand the major external shocks of the Asian Crisis in the late 1980s and the Global Financial Crisis, as well as benefit from the mining boom and an unprecedented rise in our terms of trade without the downsides of earlier episodes.

Explaining Australia's reform success

I think you'll agree that this was a pretty good story to be able to tell, not least because it confirmed what the OECD itself had advocated about the role of open markets and competition in promoting growth. That major transition costs were avoided along the way may have been less expected, but this vindicated the close attention paid to adjustment in the design of the reform program (including phasing arrangements and assistance for displaced workers and impacted regions).

What was perhaps most surprising was not that pro-market microeconomic reforms worked, but that such a wide-ranging structural reform program actually happened. The IMF described our reform-induced economic transformation as 'miraculous'.

After all, it needed to overcome all the political obstacles and asymmetries of influence that militate against any reform benefitting the (relatively passive) majority at the cost of an active (and vocal) sectional minority. It had to proceed against the current of decades of successful rent-seeking that had conditioned policy expectations and entrenched a sense of entitlement. And some key reforms needed to secure coordinated action within our federation by jurisdictions that had hitherto shown little inclination to cooperate.

So how did Australia manage to pull this off? What was, as they say, the 'secret sauce'?

'Making reform happen'

The answer is that there were multiple ingredients, most of which were not in themselves special to Australia. Indeed they align closely with the OECD's list of 'common traits' of successful reforms drawn from its 2010 survey of member countries.

First on that OECD list is the importance of an *electoral mandate*. Reforms that would disturb the existing order and require adjustment will typically be resisted and need broad acceptance of their overall benefits to prevail. In Australia's case it would be fair to say such a mandate was generally present, but not always in the conventional sense of being tested at an election. The first term of the reforming Hawke Government in 1983 was notable for the lack of an explicit reformist mandate. But this was achieved in office by actions that, in Hawke's words, 'brought the people along'.

This is no less legitimate and can be more effective, given the heightened challenges of selling policies with distributional consequences in an election contest (as Opposition leader Hewson found with his *Fightback!* Agenda in the 90s and Bill Shorten has just rediscovered with his radical taxation proposals at the recent election.) In any case, if the margin is close, an election win may not be accepted by Opposition parties as electoral endorsement of specific policies. Ultimately the key to ongoing community support for reform comes from acceptance that past reforms have actually delivered. In Australia that proved to be the case.

Secondly, the OECD notes that *effective communication* is 'essential'. Clearly no real mandate could be achieved without it. Australian governments in this period placed considerable emphasis on selling the gains from reform to the general public, as well as building coalitions of support and countering the arguments of those resisting it. As a consequence, for example, the mining and farming sectors ended up playing a key role in the successful campaign to reduce manufacturing protection.

Thirdly, successful reforms were found to have benefitted from *solid research and analysis* to support them, with the OECD noting the role that trusted *institutions* have sometimes played in this. No doubt Australia's experience weighed heavily on this particular finding. Almost all of our major reforms were preceded by in-depth independent public reviews that established a solid case for change. They also served to educate the public about the costs of the status quo and the benefits of proposed reforms, and provided support for government in prosecuting reform and in countering the claims of vested interests.

Australian governments also created institutions to benchmark performance and monitor and report on reform implementation, among which the most notable was the National Competition Council. In all of this it was supported by a highly effective public administration, both in informing decisions and translating these into coordinated action.

The OECD review also noted the importance of allowing *adequate time* for the development of reform proposals and their effective implementation, and that in many cases more than one attempt was needed. Again, this accords with the Australian experience. For example, the National Competition Policy had its origins in jurisdictions agreeing in 1991 to an inquiry (the Hilmer Review) that commenced a year later and took a year to complete, with nearly another year before an agreement to proceed.

As a second example, the GST could be said to have had a gestation period of some 15 years, being first raised unsuccessfully as 'Option C' at Labor's Tax Summit of 1984 and then again by the Coalition in Opposition in the early 1990s before finally being carried at the end of the decade. And the general tariff reductions introduced in the 1980s took over a decade to achieve, and were preceded by a 25 per cent tariff cut in 1973.

The OECD further cites the role that a '*burning platform'* has played in a number of reform initiatives. An economic crisis can 'concentrate minds' about the need for change and lessen political resistance. But in Australia this was achieved through what was arguably more the perception of crisis than the real thing. For example, in 1986 Labor Treasurer Keating, citing a further deterioration in the balance of payments, raised the spectre publicly of Australia descending to 'banana republic' ranks unless key reforms were made. His successor in a Liberal Coalition Government, Peter Costello, initiated a series of Intergenerational Reports that revealed the threat demographic ageing posed in the absence of timely action on the fiscal and structural fronts.

Lastly, the OECD's review concluded that *leadership* had been 'critical' to the success of all reforms, both politically and institutionally. Arguably Australia's own reform program would not have got off the ground without leaders who were committed to it, who understood the importance of making the case, who were skillful in taking it to the public and resilient in dealing with critics. Individual reforms were framed by a consistent narrative about the need for a more productive and competitive economy to underpin higher living standards. A key feature of this period was the cooperative relationship forged among political leaders of different political persuasions and from different jurisdictions, and between government and the senior representatives of the private and community sectors.

All of these factors played a role in building consensus about the need for reform and achieving broad agreement on its directions. This helped ensure that there were few setbacks in advancing key reforms once agreed, or reversals once they were implemented.

Other countries have of course also had reform successes, as the OECD's report documents, but Australia has stood out for the breadth, quality and duration of its reform program. And for the ability of reforming governments to achieve electoral success. (This stands in contrast to former EC President Juncker's famous comment about knowing what to do, but not how to get re-elected afterwards).

Things fall apart

Australians today refer to this period as the 'reform era'. This is not just because of what was achieved, but also because the approaches to reform and the high success rate are seen as things of the past.

That is not to suggest that governments since then have lacked reform ambition or not attempted further major reforms.

Indeed, a new program of important national reforms was developed shortly after the NCP, in line with an agenda first laid out in a wide-ranging stocktake of reform in 2005 by the Productivity Commission and later advocacy by the Victorian Government. It sought to complete unfinished business in the competition domain, but mainly to extend reform into the 'human capital' areas of education and training, health and other human services. While there was some progress on this National Reform Agenda, as it was called, momentum could not be maintained and it all gradually subsided.

There have also been multiple reform attempts over the past decade or so by different federal governments. They have covered such key areas as taxation, workplace regulation, federal-state relations, carbon abatement, population policy, education, health and much else. Indeed, to use a sporting analogy, the reform arena has at times been a crowded one. But most of the contestants dropped out or are yet to reach the finishing line (as shown rather starkly in a timeline appended to a recent Treasury working paper).

Not only has there been a failure to advance reform in key areas bearing on our productivity performance, some of these have seen new policy initiatives likely to set things back. A case in point is Industrial Relations, where there has been an accretion of regulations and arbitral rulings that have weakened enterprise flexibility in many ways that cannot be justified by appeals to 'fairness'.

A failure of process

The struggle to make progress on reform in more recent times is often attributed to tougher politics. A good case can indeed be made that trends in media and society (and associated voting habits) have made reforms harder to implement, particularly those with distributional as well as efficiency impacts. However the reform era was no cakewalk either, with trenchant resistance from sectional interests facing exposure to greater competition. And the challenges in securing nationally coordinated reforms across multiple jurisdictions and different governments should not be underestimated.

While the political difficulties confronting structural reform may well have increased, it is also the case that past successful strategies for overcoming political obstacles have often been missing in action. If we could characterize the reform era on the whole as 'good process securing good outcomes', the latter period has been more a case of 'poor process securing poor outcomes'.

Features too commonly observed over the past decade or so include:

- Policies appearing 'out of the blue', often without a clear rationale as to why they would be beneficial to the community
- Policies being formulated without consulting key stakeholders, particularly on the detail, or with consultations narrowly confined to particular interests
- Policies dependent on inter-governmental cooperation being announced before agreement is obtained
- Policy decisions being made without the benefit of information on their costs
- Abrupt reversals to previously announced policy positions without adequate explanation or justification
- Policy ideas being floated prematurely and withdrawn at the first hint of opposition.

(I could give several examples under most of these headings but will spare our international audience such specifics, which I have detailed elsewhere.)

Unlike the reform era, even in those cases where public inquiries have been employed, they have often not been well handled and things have typically not ended well. In key areas, Governments have failed to respond to recommendations, or they have 'cherry picked' among them, or made arbitrary design changes that compromised their effectiveness. (Again there is no shortage of specific examples.)

In short, underprepared policies have been foisted on an unprepared public. It should not be surprising therefore that these would have failed to secure support within electorates and thus also within parliaments.

Deteriorating economic performance

The legacy of this dismal decade is a policy landscape that has become less conducive to productivity growth and the higher living standards that depend on it. That we have yet to see productivity growth rise again following the mining boom, as the PC had anticipated, is perhaps unsurprising. The Commission's most recent update shows labour productivity and

MFP alike still running at historically low rates. It also finds that while other countries have also had sluggish productivity growth, Australia has fallen further below the 'global productivity frontier'.

As in the Lucky Country years, the impact of this poor productivity performance on incomes was initially offset by surging terms of trade. But as the terms of trade descended again from their historic highs, income growth suffered and only picked up more recently when the terms of trade partly recovered. While there has been a tendency to focus on Australia's long unbroken record of growth in aggregate GDP, in per capita or household terms the story is less attractive, with a new term, '*per capita recession*', entering the policy lexicon.

I don't believe the current malaise is something that can be fixed by macroeconomic policies that merely seek to stimulate aggregate demand. Nor can it be fixed by expanding our economy through high rates of immigration. It is a deeply *microeconomic* phenomenon requiring policies to enhance the performance of the economy's supply side.

Back to the future for reform?

The good news is that there are plenty of policy ideas around that could achieve just that. For example, the list of unimplemented Productivity Commission recommendations that I compiled on leaving the organization back in 2012 remains largely intact. Moreover it has since been embellished and expanded in further reports by the Commission and other sources.

The main issue is what to focus on and in what order; for if there's another lesson from our more recent experience, pursuing reform on too many fronts merely dilutes attention from each and courts failure in all.

Reform proposals involving new spending in areas like infrastructure (especially roads and rail), education, training and health, seem to be the most popular these days, despite limited fiscal room. But we have already seen government spending in such areas rise dramatically over recent years without much to show for it.

Productivity gains are more likely to come from removing or refining regulations that distort decisions, raise risks, stifle innovation or impose undue transaction costs on firms, particularly where these have pervasive effects across the economy. From this perspective, I'd attach highest priority right now to Industrial Relations, Taxation and Energy/Carbon policy. If the past is any guide, the fact that reform in these areas has become so contentious can be seen as a measure of the gains on offer.

Accepting that the main challenge is not technical or economic but political, I'd suggest that the key to that is simply for governments to do what has worked in the past -- and stop doing what has *not* worked. If there is an overarching lesson from Australia's reform experience that would have to be it.

I find it hard to believe, even in today's political settings, that a policy proposal that is based on credible evidence of a problem, that can be demonstrated to yield significant overall benefits, that has involved effective engagement with the public at key points along the way, and that is pursued by government with conviction and consistency – I cannot believe that such a policy could not succeed, whether in this country or in others.