Back to the Future: Restoring Australia's Productivity Growth*

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The theme of this Outlook conference, 'Restoring Prosperity after the Crisis', has a similar policy message to the previous one, some eighteen months ago, but in rather different circumstances. That such a turnaround — from boom to bust to incipient recovery — could have occurred in such a short space of time is remarkable, if not unprecedented. But we have witnessed much else that has been unprecedented in this period, including the degree of commonality internationally in governments' fiscal and monetary responses to the crisis and in their pro-active interventions in financial markets.

Australia's own policy response has itself been unprecedented, involving a reversal of our budget surplus on a scale and speed never experienced before, with a fiscal stimulus amounting to 5½ per cent of GDP, the third largest in the OECD. And we have been in new territory in the extent and nature of the stimulus spending, involving two rounds of lump-sum cash payments to households, targeted additional subsidies for first home purchases and home insulation, and two rounds of infrastructure spending.

Together with historically low interest rates and still buoyant demand for mineral exports from China (itself a consequence of fiscal pump-priming) Australia's economy has weathered the storm very well thus far and many Australians are already contemplating recovery. Whether it is realised remains to be seen, as our economic fortunes do not depend on us alone. It will be important, for example, that China's demand remains strong and (not unrelated) that the US economy regains strength in the months ahead.

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* Presentation to the Melbourne Institute/Australian *Economic and Social Outlook Conference*, 'The Road to Recovery', 5 November 2009.

Just as ‘moving ahead of the curve’ was seen as important to the success of our demand stabilisation policies, timely policy interventions to enhance the performance of the economy’s supply-side will also be needed to underpin a sustainable recovery and growth in the longer term.

The recent unprecedented fiscal expansion and associated debt add to the pre-existing imperatives for higher productivity growth arising from demographic ageing, increasing globalisation and the costs of achieving greenhouse gas abatement and other sustainability goals. Productivity growth can help service the debt now accumulating from fiscal deficits, as well as offset the effects on incomes of withdrawal of stimulus spending.

Causes of the productivity slump

Australia’s recent productivity growth record does not, at face value, look encouraging. Following the dizzy heights attained in the 1990s, the MFP growth rate dropped back to its historical average of 1.1 per cent in the next cycle to 2003-04 — which was not surprising — but has averaged small *negative* growth in the current incomplete cycle, which has been a surprise.

Given the importance of productivity growth to living standards, it has also been of widespread concern, prompting calls for policy actions to remedy it. This is fine, indeed important, but any such policy actions need to be informed by a close analysis of the causes of the decline.

Commission research to this end suggests that in fact much of the decline resulted from specific developments in three industries (PC 2009d). The most significant has been the impact on measured productivity in the mining sector of a lagged production response to the major capital investments needed to satisfy booming export demand, as well as some depletion in deposits. At the same time, agricultural productivity has suffered from drought, and the utilities sector has seen major capital investments coinciding with reduced output growth, reflecting in part demand management initiatives.

Once the influence of these events is removed from the estimates, MFP growth actually rises above trend in the last complete cycle and changes from -0.2 per cent to 0.7 per cent in the current period. Some 70 per cent of the decline since 2003-04 is accordingly accounted for by the unusual developments in these sectors.

That still leaves 30 per cent unaccounted for. However, it seems plausible that general capacity constraints throughout the economy over that period may have played a key role here. With buoyant demand and tight labour markets, efforts are likely to have been made to satisfy demand even at the expense of increased input costs, as long as additional profits could be made.

The lesson from a comparison of the 1990s and 2000s is that while productivity is obviously important to our economic future, it was not a driver of the high income growth in the most recent period. Indeed, it was partly a casualty of Australia's economic success.

With current policy discussions in mind, what should also be noted is that Australia's productivity slump was not caused by any lack of spending on education and training, R&D or even infrastructure — important though these may be in the long term. Indeed, infrastructure spending had increased significantly and, when adjusted for differences in industry structure, Australia's expenditure on R&D has remained near the top of the OECD.

In seeking policy guidance from our productivity history, the story of the 1990s boom is more instructive (PC 1999, Banks 2003). This new 'golden era' of productivity was preceded by a series of microeconomic reforms which, on the one hand, increased the incentives for enterprises to perform well by removing barriers to competition, while on the other, enhancing their capacity to respond to these market pressures through more flexible, enterprise-based work arrangements and lower prices for existing infrastructure services.

Post-crisis priorities

COAG's current Reform Agenda encompasses some unfinished business in these areas, as well as a new focus on reforms to enhance human capital development — thereby increasing the participation and productivity of labour in the years ahead. Taken together, COAG's agenda and that of the Australian Government, cover a lot of territory. In the current economic setting, there would seem to be particular merit in prioritisation. The 'sweet spot' for policy effort in the next few years is likely to be those reform areas which (a) can bring productivity gains in the short term, underpinning economic recovery, while (b) achieving this at little or no cost to the budget.

From this perspective, there are three policy areas that deserve particular attention: industry assistance; regulatory reform and infrastructure. All three have regulatory dimensions and all present reform opportunities that could be implemented quickly (to borrow the metaphor, all are 'shovel ready').

It could also be said that these reform areas contain few surprises. Reforms have been stymied in the past through political resistance. However, one would hope that such resistance may be more easily overcome under crisis (or even post-crisis) conditions, as the old saying about 'not wasting a crisis' would have it.

Remove or reform 'unproductive' industry assistance

The policy response in most countries to an economic crisis has traditionally involved some government assistance to selected industries. This is perhaps politically inevitable. Its form and duration, however, are crucial to its impacts, both in the short term (on the market) and longer term (on productivity).

As is well known, escalation of assistance to trade-exposed industries in the 1930s was a contributor to the length and ultimate severity of the Great Depression. Empirical studies suggest that protectionism explains over 40 per cent of the drop in world trade in that period. This is one lesson which hopefully has been well learnt. The OECD warned in late 2008 that 'keeping markets open will … be an essential condition for recovery and long-term growth' (OECD 2008). And the G20 communiqué from November 2008 stated: ' … within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services' (G-20 2009).

Nevertheless, in the past year the WTO has reported a rise in trade-restricting measures, outnumbering trade liberalising initiatives by at least two to one (WTO 2009). Unlike the 1930s, however, the scope for a broad protectionist break-out today is contained by a web of WTO rules and reciprocal agreements. Accordingly, most of the trade-related assistance actions have been temporary measures that are 'within the rules', or in areas where rules are either not present or not binding.

The net impact to date on global protection levels is not known, but the apparent early bottoming of the hitherto vertiginous drop in world trade volumes — in contrast to the pattern in the 1930s — suggests that the increase has been modest overall.

That is just as well, because Commission modelling suggests that even if countries chose to exploit only the 'head room' available to them within WTO tariff bindings, world trade would fall by around 8 per cent, with world output (and incomes) declining overall by some A$1 trillion (PC 2009a).

With unemployment levels continuing to rise in many countries, domestic political pressures to provide such assistance can be expected to increase. Keeping the potential costs in the public's mind will be an important political responsibility if we are to build on the incipient recovery. History tells us that the discipline of individual G20 countries will be crucial to their collective ability to hold the line.

One area where such discipline — in the absence of effective WTO coverage — has been lacking, is government procurement policies which discriminate against foreign supplies. At least 15 countries have imposed such measures over the past year. Regrettably, Australia is among them. The New South Wales Government recently introduced a price preference of up to 25 per cent for locally-supplied goods and services. Other states have previously implemented similar, though less protectionist, measures. As the Commission observed in its Annual Report:

> Such policies not only risk reducing the value of government spending for taxpayers, but also provide a poor demonstration effect internationally, and are a liability when seeking to encourage other countries to reduce protection (p13).

A second focus for industry assistance initiatives worldwide in the past year has been that long-standing beneficiary, the automotive industry. Consistent with WTO rules, governments have generally not increased tariffs — indeed some, including Australia, have maintained planned reductions. Instead, many have provided subsidies in various guises. As all economists know, however, a given tariff can be replaced by a subsidy with equivalent protective effect. The impact on production, trade and global welfare is much the same.

The assistance to the automotive sector announced by the Australian Government in November 2008 as part of its stimulus package, was reportedly the second largest among OECD countries, in per capita terms. While much of the $6.2 billion for producers leveraged off recommendations made by the Bracks Review, which pre-dated the Global Financial Crisis (GFC), top-ups to the Automotive Competitiveness Investment Scheme and the Green Car Innovation Fund were provided to help the industry cope with expected additional market difficulties. Removing these top-ups in what are now less threatening market circumstances, would yield a budgetary saving of at least $1.7 billion.

Government assistance to selected industries generally makes for poor ‘crisis policy’, because it comes at the cost of penalising unassisted activities. The net impact on jobs is hard to discern even in the short term. Recessionary forces are typically economy-wide and generally cannot be neutralised by industry-specific measures.

The main exception to this general rule, especially in the short-term, is the finance sector, given the contagion risks any major failures pose for the whole of the ‘real’ economy — as the unfolding of the GFC itself has demonstrated. Support for financial markets and institutions has been a strong feature of most governments’ responses to the crisis. This has included guarantees of liabilities, the purchasing of illiquid assets (or accepting them as loan security) and equity contributions to troubled institutions. This support appears to have played an effective stabilisation role, and may have foreshortened the drawn-out recovery phase that typically characterises recessions originating in financial markets (IMF 2009).

That said, if maintained, some measures could inhibit desirable competition and innovation, and encourage undue risk-taking through moral hazard. For this reason, the Australian Government has designed its mechanisms of support to be temporary. However, withdrawing industry support — which is always difficult — could prove particularly challenging for the finance sector.

As the Commission has noted in various reports, there is also considerable scope to rationalise industry assistance that predates the crisis. The Commission's most recent estimate of total industry assistance at the Commonwealth level alone amounts to over $17 billion in gross terms, of which some $8.3 billion comprises budget expenditures. Much of this has not been reviewed regularly to determine whether it is generating net benefits to the community. On the basis of those reviews that the Commission itself has conducted, however, it seems likely that a substantial proportion could be withdrawn to positive effect both on the budget and on the economy (PC 2008c, 2009e).

In addition, Australian governments intend to spend some $23 billion to 2011-12 on programs to reduce carbon emissions, much of which takes the form of assistance to selected industries and technologies. The potential environmental payoff from such assistance is unclear, and the costs of achieving abatement benefits appear excessive in some cases. With the advent of the economy-wide pricing of carbon through the Carbon Pollution Reduction Scheme (CPRS), it will be important to rationalise this assistance. However, by then a sense of entitlement may have taken hold, and investments undertaken, which could make withdrawal difficult.

Remove regulatory burdens and avoid adding new ones

Regulatory reform is a key strand of the National Reform Agenda. In the current circumstances, it has the added attraction that it can enhance productivity — by reducing business costs and constraints, and improving production incentives — while involving little fiscal cost. Indeed, in many cases it will yield fiscal dividends.

Two dimensions of regulatory reform assume importance currently: one is removing existing burdens and distortions; the other is avoiding adding to these unduly through new regulations. The latter also raises more fundamental issues to do with the regulation-making process itself.

The first two waves of structural reform in Australia focussed on regulatory impediments to competition, both in the private and public sectors of the economy, which contributed to the surge in productivity growth in the 1990s. However notwithstanding two decades of effort, various anti-competitive regulations remain. These are all well known (PC 2005). They remain in place not because they have been found to be justified in the public interest — on the contrary, most studies have found their efficiency costs to be unwarranted — but rather because of the political clout of their beneficiaries over the years.

A second category of identified regulatory reforms that could be expedited to assist with economic recovery is ‘redtape’ — business compliance burdens that exceed what is necessary to meet legitimate regulatory objectives. They were a ‘sleeper’ for many years, accumulating even as major advances were being made on the competition front. The Regulation Taskforce (2006) estimated that they could be adding $8 billion to the costs of doing business, the removal of which, the Commission estimated subsequently, could boost GDP by nearly $12 billion (PC 2006).

Repositories of ‘reforms-in-waiting’ at the Commonwealth level, include those in the Productivity Commission’s series of reports surveying redtape burdens, including most recently, in important areas of social and economic infrastructure (PC 2009a). The Regulation Taskforce’s initial wide-ranging stocktake, which preceded these, also still contains some recommendations waiting to be implemented.

Equally, while there is now a commendable focus on advancing reforms to some 27 regulatory ‘hot spots’ that add to the costs of doing business across jurisdictions, no reforms (other than wine labelling!) have yet been implemented. Less than half are on track for completion within the original timeframes. Nevertheless, it should be noted that these include such important areas as trade licencing, health workforce registration/accreditation, consumer policy, standard business reporting, and upstream petroleum regulation. Given the long history of resistance to reform in those areas, the progress that is being made is to be applauded. The challenge is to use the common imperative now facing all governments, to progress all the reforms within a time frame that can assist economic recovery.

Minimising new burdens

Under the heading of ‘avoiding unnecessary new regulatory burdens’, that could compromise economic recovery and inhibit productivity growth in the long term, are three contentious areas of regulation that will need close attention: industrial relations, carbon emissions reduction and financial markets. All three have pervasive effects throughout the economy and all inevitably require tradeoffs to be made between competing objectives, of which economic efficiency and productivity impacts are only one. Getting the balance right will be crucial both in the short and long terms.

In the case of industrial relations, legitimate concerns for workers' rights need to be balanced against the flexibility that firms need to implement the organisational changes and other innovations on which productivity growth ultimately depends. It will be important for industry performance and employment alike that enterprises preserve the ability to engage effectively with their employees, so as to implement work arrangements that best meet commercial imperatives. As the economy evolves, different firms and industries will face divergent pressures and needs that are not amenable to the enforcement of common conditions.

In relation to carbon emissions reduction, Australia faces regulatory challenges on an unprecedented scale. Abstracting from the (important) questions of initial scheme design and timing, it will be crucial to monitor CPRS implementation in a way that enables timely adjustments to the framework in the light of experience; and secondly, to rationalise the myriad of other regulatory measures directed at the same objective — which will serve mainly to raise the costs of emissions reduction. Foremost among these is the new 20 per cent National Renewable Energy Target.

The third area where we need to be careful to get the balance right in any new regulation is the finance sector. Regulatory failings in the United States were clearly implicated in the global financial crisis. While Australia did not share those failings — on the contrary — there is considerable pressure for us to impose 'stricter' regulation. There is much at stake in getting this right. Financial regulation needs to steer a course between the risks and costs of financial instability — and its potential contagion effects on the real economy — and the risks and costs of stultifying competition, innovation and ultimately the productivity of this key sector — and the adverse economy-wide impacts that these too would have.

Financial flows are the life blood of the economy. Prior to the liberalisation of financial markets in the 1980s, the system could be said to have been very 'safe', but credit was costly, hard to get and poorly allocated. The relaxation of credit controls and barriers to competition drove major innovations and cost reductions that boosted economic growth. Any response to the recent excesses and poor risk management in the USA should not overlook these benefits.

To illustrate the possible impacts of 'excessive' re-regulation among OECD countries, the Commission (conducted some simulations using the GTAP model of the world economy (PC 2009a), which suggest that for every 1 per cent decline in the productivity of financial services, and 1 per cent rise in its cost, global output would be half a per cent lower than otherwise (equivalent to $350 billion).

This underlines the importance of ensuring that any changes to the regulation of financial markets and institutions are made only with the benefit of a careful analysis of the problems being targeted and the likely costs and benefits of alternative options for addressing them. There is a particular danger in making changes to specific parts of the regulatory framework unless the likely ramifications on the system as a whole can be tested. There is no substitute for public consultation as a means of avoiding unintended consequences.

Good processes for testing the need for regulation and formulating it are going to be especially important in the fiscally constrained circumstances that lie ahead. There will be stronger pressure to resort to regulatory means of achieving policy goals that might otherwise be best pursued through budgetary measures. Are our regulatory assessment processes up to this challenge? It is still not clear that they are.

Rethinking infrastructure

Government spending on infrastructure has begun to acquire the status of a ‘cure all’ in the public conscience. Before the financial crisis, it was seen as the key to reversing Australia’s productivity slump. Once the crisis hit, it was seen as a key mechanism for stimulating employment. In reality, infrastructure spending is not and cannot be a panacea in either setting.

It is well known that major projects are not a good counter-cyclical spending vehicle because of their long lead times. Of course, as the IMF’s Olivier Blanchard has observed, if sound projects had already been identified and were ready to go, this problem would be mitigated. But that was not the case in Australia, nor in most other countries. Instead, priority was given to many smaller scale, so-called ‘shovel ready’ projects, and the pre-existing processes for identifying beneficial larger scale projects were accelerated. Further impetus to government spending in the latter area was gained from reports of the drying up of private capital as the GFC took hold.

One of the attractions of public infrastructure spending for macro stimulus purposes, is that it involves once-off budgetary outlays, rather than recurrent expenditures. But it still has long-term economic effects (PC 2008b, 2009a). Projects that are well selected, with high benefit-cost ratios, should yield social returns that more than cover the financing costs over time — with a ‘win, win’ for the short and long terms. However, poorly conceived or executed infrastructure investments can impose a double burden on the community: with future generations having to service higher debts from incomes that are lower than they would otherwise be.

Indeed, it could be argued that any stimulatory spending on economic or social infrastructure that did not yield a net benefit would be inferior on efficiency (national productivity) grounds, to giving the money to households for discretionary spending. At least such payments are likely to end up being directed to valued goods and services (even if not all domestic in origin) at prices that reflect costs.

Scope to further modify existing plans?

One consideration, much debated, is how much scope there may be to recalibrate or defer existing spending plans in order to pursue a bigger productivity bang for the taxpayer's buck.

Among the infrastructure spending that is primarily stimulus-based, the main potential candidate is the school buildings program. This was designed to provide a relatively early boost to employment across the community, given ready access to school land and its dispersed location. A need for speed was met through a degree of uniformity in the type and construction of buildings permitted, rather than potentially drawn-out identification of projects attuned to the particular needs of each school community. Might there be more scope now to change tack? It would at least seem worthwhile to consider whether changes could be made wherever clear educational benefits could be demonstrated, such that any transaction costs of change would be worth incurring.

A second potential source of productivity gain, now that some of the pressure is off, are those larger scale 'nation-building' infrastructure proposals that were brought forward and selected without the opportunity to conduct adequate cost-benefit analysis (PC 2009a). It would be desirable to delay the progression of such projects, until this can be remedied.

There are two 'urban myths' about cost-benefit analysis (CBA) that appear to be gaining currency. One is that they need to be kept confidential because of commercially sensitive material. This conflates CBA with a competitive bidding process. An effective CBA can be conducted (and made public) in advance of seeking tenders. Once the tender is chosen it can be refined and made public again without disclosing commercial-in-confidence details. Taxpayers deserve to know on what basis their money is being spent and external scrutiny provides a useful discipline on the decision-makers' calculations. The second myth is that CBAs cannot be conducted where there are non-financial costs or benefits (like environmental impacts). Such impacts will be implicitly valued anyway. CBA merely requires that those valuation judgements be transparently tested.

Removing impediments to private investment

While it is clearly important to ensure that publicly-funded infrastructure is well designed, and allocated where it can yield the highest social return, public spending is only a fraction of private spending and will face considerable budgetary constraints in the years ahead. A key issue, therefore, both for the short and long terms, is how to facilitate greater private investment in infrastructure and help ensure that it is efficiently allocated.

There is an established agenda of reforms here that have strong empirical support and could be implemented in the near term — without incurring any public expenditure.

- One is regulatory over-reach that discourages and distorts private investment. One major example identified a few years ago in the Commission's airports inquiry is the need to legislate to bring back an adequate regulatory threshold for successful third party access to major infrastructure investments (PC 2005, 2007b).
- Another is the need to rationalise or simplify the complex, multi-tiered approval processes for major projects. For example, the Commission has estimated that, in the case of upstream oil and gas projects, delays can cut billions of dollars from the NPV of major projects (PC 2009c).

Getting more out of the 'stock'

While the flow of new investments in infrastructure is important to future productivity, even more important is the efficient utilization of the existing *stock*. Much of this is in the public domain (water, transport, energy, …) and there is a further well-established agenda of productivity-enhancing reforms awaiting implementation (PC 2005, 2006, 2007a, 2008a, 2008b, BCA 2009). Two of the more important areas, which are not unrelated, involve deficiencies in the *governance* of government infrastructure businesses (including lack of independence, accountability and proper project assessment processes) and secondly, deficiencies in the *pricing of* infrastructure services.

These have been much discussed. I would just re-emphasise that without appropriate governance and pricing of public infrastructure services, existing assets cannot be used efficiently and new investments will often be mis-timed and poorly directed. Many Australians are having to cope with the consequences of this everyday in the water shortages and traffic congestion that detract from the liveability of our cities, with electricity black/brown-outs becoming more common. These problems underline the reality that infrastructure is not an end in itself, but a means of enhancing the wellbeing of the community. Policy makers need to act on the recognition that better outcomes cannot be achieved through government spending alone.

Other reform imperatives for future productivity growth

Reforms in the above three areas have been singled out because they would yield early productivity dividends without calling on scarce budgetary resources.

However, they represent only a sub-set of the wider suite of important reform areas under COAG's national reform agenda (PC 2006, 2009a, 2009d). A crucial element for the long term is the 'human capital' agenda. As the name implies, this encompasses potential reforms to improve the population's health and skill levels, which are pathways to a more productive and participative workforce, as well as improved wellbeing. While, as the Commission has shown, this ultimately holds the promise of national welfare gains at least as great as those from the previous, competition-related waves of reform, realising much of it will take time and require higher levels of public investment. The scope for such expenditure has been reduced by the stimulus spending and the new challenge of restoring budgetary balance.

Even such tight fiscal constraints should not preclude spending on human capital investments with high net social returns, provided they are indeed genuinely high returns. However, this ups the ante on conducting rigorous assessments and trials before introducing any programs. Australia's record to date, like that of many other countries, does not inspire confidence. On the basis of many *ex-post* evaluations, the eminent American sociologist, Peter Rossi, coined an 'Iron Law' that 'the expected value of any net impact assessment of any large scale social program is zero' (Rossi ????). This should give us pause.

The fact is that human services already constitute a large proportion of the total outlays of governments in Australia, with health and education alone accounting for one-third (or some 15 per cent of GDP). How effectively is this money being spent? The answer is that we don't really know for sure, but there are a variety of indications of scope for productivity and efficiency gains that would not detract from service quality. One source of these is the annual Blue Book, commissioned by COAG precisely for this purpose, which reveals significant disparities in performance across jurisdictions for many human service areas (SCRGSP 2009). In its report on the National Reform Agenda (PC 2006), the Commission found potential to increase the productivity of health services that would alone translate to a $4 billion gain in GDP.

The goal in striving for more cost-effective service delivery is not merely to achieve existing service levels at lower cost, but to improve both, thereby achieving better outcomes for the community and for the economy.

A further important issue for productivity going forward is the degree of ‘churn’ in taxation and transfers to households. The conception of what constitutes ‘welfare’ has changed over time to be far more encompassing of the population and its needs than anyone might have imagined at the dawn of the system. The taxation raised to support subsequent transfers back to households imposes productivity costs of its own, with recent estimates suggesting deadweight losses from taxation of $40-60 billion annually (excluding administrative and compliance costs). **[Lisa to provide source(s)]** For every extra dollar in tax that is levied, there is a real resource cost of up to $1.30.

It is therefore both timely and appropriate that parallel reviews are underway of the welfare and tax systems. The only regret is that the latter has not been given scope to consider making better use of the Goods and Services Tax (GST). Changes in the coverage and rate of the GST, as part of a wider package of tax reforms, could see us getting closer to the ideal of broadly-based taxation at relatively low overall rates and creating few distortions in economic activity.

In sum

Australia’s economy has once again proven highly resilient in the face of major global pressures. However the demand stabilisation measures to achieve that have left a fiscal legacy that will present additional policy challenges in the years ahead. Reforms that can reduce business costs and improve organisational flexibility and capability are needed to support recovery and generate additional productivity gains. Policy actions in this area over the past two decades have held us in good stead, but they will not be enough. Having grappled successfully with the major challenges of the past year, we now need to re-focus on a productivity agenda for prosperity into the future.

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