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QPC Productivity Lecture

The Productivity Challenge and 'the PCs'
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The QPC Productivity Lecture

One of the legislated functions of the Queensland Productivity Commission is to promote public understanding of matters relating to productivity, economic development and industry.

The QPC Productivity Lecture aims to encourage evidence-based discussion and debate on important productivity and policy issues.

The inaugural lecture was delivered by Professor Gary Banks AO and discusses a wide range of productivity challenges in Australia as well as the potential role of productivity commission's in helping to address them. The Commission is grateful to Professor Banks for taking time out of his busy schedule to prepare this paper and deliver the 2018 QPC Productivity Lecture in Brisbane.

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About us

The Queensland Productivity Commission provides independent advice to the Queensland Government on complex economic and regulatory issues.

The Commission has an advisory role and operates independently and transparently—its views, findings and recommendations are based on its own analysis and judgments.

Further information on the Commission and its functions can be obtained on the Commission's website, www.qpc.qld.gov.au

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The Productivity Challenge and 'the PCs'

Gary Banks AO

Introduction

It is a pleasure to find myself giving this inaugural address at the Queensland equivalent of my old organisation, the Productivity Commission. And to be doing so, by definition, before a group of people who understand what 'productivity' means and appreciate its vital policy importance. This is not my usual experience!

The creation of a Productivity Commission in this state is to be applauded. It has been part of a growing trend that I must admit has taken me a bit by surprise. When I was Chairman of the federal body, I used to joke that I received many visitors from overseas who, after hearing about the Commission's role and work, vowed to push for a similar body in their own country—but from whom I rarely heard again. Creating a public institution with an independent remit to scrutinise and comment on government policies, including at times those of the government in power, is a bold move for any government and could be expected to face considerable opposition.

So it is heartening to see the Queensland Productivity Commission becoming part of the 'furniture of government' up here, and to observe initiatives to establish similar bodies in most other states. It has been even more gratifying to observe the spread of such institutions overseas. This commenced with the establishment of the NZ Productivity Commission nearly a decade ago—which is perhaps not that remarkable given how much our two countries have in common. But it has also been followed by initiatives in Latin America, Scandinavia and, most recently, the European Union. Indeed it has reached the point where a special forum has been created by the OECD to serve as an international community of practice.

The heightened challenges confronting 'Productivity Commission-type bodies' (henceforth referred to as 'the PCs'—an unsuitable acronym that has nevertheless caught on) and how they might be better utilised to achieve the reforms needed to boost productivity, provide the focus for this presentation.

A good policy narrative lost?

I wish I could begin by saying that governments' increased interest in Productivity Commissions has coincided with an increase in productivity-enhancing policies and reforms. Rather, the past decade has, if anything, witnessed more policies that detract from productivity growth than enhance it.

At the same time, public discussion about the role of productivity in securing higher living standards for citizens has fallen away. When was the last time you heard a political leader dwell on the need to raise productivity growth, or even industry competitiveness? (Those who attended the Melbourne Institute's Outlook conference last week would have heard a PM enter this territory for the first time in a long while.)

Rather, the dominant narrative of recent years has had more to do with the distribution of income than its creation; and with the demand-side rather than supply-side of our economy. The cut-through reform narrative of a previous era that 'a country cannot redistribute what its economy does not produce' has rarely been heard. And wealth creation seems to have become more associated in the public mind today with the activities of government and the public sector, than with private enterprise or the market economy.

There are no doubt multiple influences at play in these developments, some of which I will return to. However, a key one in my view has been the Global Financial Crisis (GFC) and its role in diverting government from the structural reforms needed to surmount demographic ageing and other challenges to longer-term growth—typified by the '3Ps' policy framework of the first Intergenerational Report—to a single-minded focus on bolstering aggregate demand and employment.

That there was a shift during the crisis conditions of a decade ago from promoting microeconomic efficiency to macroeconomic stabilisation, is of course understandable. And no doubt it was largely warranted at the time (although it would have been preferable to have had more 'win-win' interventions). The problem is that the course of public policy did not right itself again once the storm abated.

Instead, we have seen both monetary and fiscal policy stuck in stimulus mode: with interest rates staying at the lowest levels since, as has been said, Babylonian times; and public spending inflated by various new programs, some of which were developed on the run and are proving much more costly than anticipated (the NDIS, NBN and 'home made' submarines being prime examples).

Two perspectives on our performance

Monetary and fiscal policy have an important, indeed at times crucial, role to play with respect to economic activity and employment in the short to medium term. But they have little direct impact on growth rates over the longer term. As the '3Ps' identity makes clear, economic growth is determined by the rates of growth in population, participation and productivity. And on a per capita basis, the growth in incomes depends (terms of trade aside) almost entirely on the latter two.

Since the GFC there has been a tendency to focus mainly on the aggregate numbers, where Australia is doing pretty well. As is often recounted, we have avoided a 'technical recession' for an unprecedented 27 years. And while post-GFC economic growth has generally been below the high rates recorded previously, it has been rising again. The unemployment rate never reached high levels, at least by international standards, and is back to the pre-GFC norm for full employment.

This largely positive story is mirrored across the larger states, including Queensland. Booming property prices and mining royalties have generated substantial revenue; and this has been spent on infrastructure, community services and transfer programs that have in turn contributed to significant job creation.

Living standards and productivity are another story

But the Australian story is less impressive viewed from a per capita or household perspective, which is what matters most for living standards over time.

The reality is that our GDP performance in recent years has been underpinned mainly by surging population growth, over half of which has come from immigration. In per capita terms, GDP growth has been significantly below its historical average. And per capita or household incomes have been stagnant or declining. Real wage growth has been little better, and (apart from the public sector) well below what Australians had previously come to expect.

And while unemployment looks okay at the headline level, the story is not so good below the surface. Measures of underemployment have shown comparatively little improvement, and youth and long-term unemployment remain high.

Behind Australia's poorer performance at the 'micro' level is the reality that for much of this new century productivity growth has been historically weak. The impact of that on incomes was over-ridden initially by surging terms of trade. During the mining boom many producers could give wage increases well in excess of productivity growth and still make good profits. And consumers benefited from the impact of exchange rate appreciation on their own prices. But with the terms of trade declining again, the so-called wage 'overhang' was unsustainable and wage growth has been below par ever since.

That is not the whole picture—an influx of working-age migrants has no doubt helped contain wage growth and, as indicated, there has also been a structural shift towards those public and other services having lower (measured) productivity and wages—but it is a key part of the story.

The demand-side perspective can mislead

It is a story that has not had much airplay, however, given preoccupation with the economy's demand side. This has not only served to take oxygen from the 'productivity narrative', at times it has actually been counterproductive.

For example, the Reserve Bank (like the Bank of England and IMF) has identified heightened international competition and falling union coverage as obstacles to the higher inflation and (nominal) wage increases regarded as preconditions for raising interest rates. Although not proposing that government intervene to reverse those developments, those who seek policies to that end, such as the ACTU, might have found comfort in the central bankers' position.

Then there was the former Treasurer's public defence of high immigration based on its contribution to GDP and tax revenue. Apart from whether his department got the numbers right, focusing just on the implications for Commonwealth revenue obviously ignores the debit side of the fiscal ledger. And it begs all the deeper questions about the capacity of our economy and society to 'absorb' migration running nearly twice as fast as Treasury had previously projected. Empirical studies, including by my former organisation, have repeatedly shown that while higher population naturally equates to higher GDP, the per capita gains from migration are on average small and largely skewed to migrants themselves. Accounting for externalities, the net payoff from recent migration to the living standards of Australians is likely to be negative.

The 'to do list' is growing

Meanwhile, reforms urgently needed to boost the supply side of the economy, to enhance productivity and raise living standards, have languished.

As you would be aware, the Productivity Commission categorises such pro-productivity reforms as drivers—policies bearing on areas like competition that affect incentives to be cost conscious and productive—and enablers, those policies and regulations that bear on the capabilities of organisations (e.g. human capital and infrastructure services) or that influence their ability to respond effectively to market opportunities and challenges (e.g. industrial relations, 'red tape').

Looking back over the 'to do list' of reforms in these categories that constituted my swan song on leaving the Commission back in 2012, it is apparent that most items on that (long) list remain to be addressed.

The same goes for subsequent Commission reports delving further into such areas as industrial relations, public infrastructure and public sector services. The latter was given particular attention in the *Shifting the Dial* report, and also in the Harper Review of Competition Policy, reflecting their large (and rising) share of the economy and the evident scope for efficiency improvements. However, the leading message in these reports about the potential for gains from greater service contestability (if properly managed) has thus far got little traction.

With some exceptions, most of the reform proposals that have been taken up are in areas of lesser significance from a productivity perspective. For example, one of the few recommendations of the Harper Review to have been both accepted and implemented is that relating to the 'mis-use of market power' test in the Trade Practices Act, which arguably is of more political than economic moment.

Some pro-productivity reform actions have been taken in the 'incentives' stream, but they have tended to be offset by interventions in the other direction. Thus, while the costly automotive protection saga seems finally to have reached its denouement, assistance to Australia's latest 'infant industry', renewable energy, has been setting new records. Meanwhile, the anti-dumping regime has been made more protectionist and is being more actively deployed than ever. And government procurement at both the Commonwealth and State levels appears once again to be giving primacy to matters other than the cost-effective use of taxpayers' funds. (This is illustrated at the state level by the imposition of union-friendly criteria for winning government contracts, and the return of interstate 'bidding' for major projects and events).

In 'capability' areas such as education/training, disability services and infrastructure, there have been expenditures on an unprecedented scale. But as reviews by the Commission and other independent bodies have found, their potential contribution has often been marred by poor program design (especially around eligibility and accountability) or allocation to the wrong projects or uses (such as iconic railways by-passing proper assessment processes). In the crucial area of school education—the foundation for 'lifelong learning'—too much attention has gone into the quantum of funding and its broad socio-economic distribution and too little into improving teacher quality and other determinants of outcomes in the classroom.

Neglect of identified reforms, compounded by additional interventions, has left a policy landscape that in key respects remains unsupportive if not hostile to productivity growth and the higher living standards that depend on it. Most of these are matters requiring reforms to existing regulations and programs, not new spending.

Three of the more serious examples are:

- A taxation system that by OECD standards continues to place too much reliance on distortionary and incentive killing taxes, particularly income and transaction taxes that impose high deadweight losses.
- An industrial relations system that contains a multitude of restrictions on managerial decisions about how production is organised – imposing costs that, despite the legislation's title, are hard to justify on fairness grounds.
- And an energy sector which has seen Australia's natural advantage in low-cost gas and electricity, which had partially offset our other cost disadvantages, forfeited by governments at all levels through ill-judged bans, quotas and subsidies, such that we now have among the highest priced energy in the world.

Little wonder that we have yet to see productivity growth bounce back after the mining investment boom, as the PC had originally anticipated. And while I have reservations about the 'Global Competitiveness Index', it is hard to ignore the fall in our ranking since 2001 from 5th to 14th overall (despite being ranked first for 'macroeconomic stability') and in particular the much deeper falls in the areas of labour market flexibility, taxation and red-tape; or pretend that they have nothing to do with policy. As a former senior colleague at the Commission, Terry O'Brien, argued in his submission to the recent Shifting the Dial review, the low-productivity puzzle seems most simply explained in the Australian case by the 'too many bad decisions' hypothesis.

Yet our ability to weather the financial crisis, combined with a continuation of low interest rates and big government spending, may have served to prolong what Ross Garnaut called the Great Australian Complacency. However, Australia is much less well placed than it was, both in macroeconomic and microeconomic terms, to meet the inevitable challenges that lie ahead. These include the ongoing secular challenge of an ageing population (which immigration can only defer) and external shocks such as from an escalating international trade war and the risk of a GFC Mark II.

Moreover, the outlook in key policy areas affecting productivity, such as energy and industrial relations, provide few grounds for thinking 'she'll be right' in the future.

To take a further example, if the educational performance of today's school students is a leading indicator of the human capital available to our economy in the future—and thus to innovation and growth—our dramatic slide in international rankings for literacy and numeracy bodes ill. Declining completion rates at our universities and falling wage premia for graduates provide further disturbing news. It is notable that the slide in the performance of Australia's education system has occurred at a time when expenditure per student has been rising. As the Commission has recently argued, more than budgetary 'investment' will be needed to restore this vital sector's own productivity.

Rent seekers vs reformers

As will be apparent, most of the areas just noted have been subject to PC or other like reviews, of which there has been an unprecedented number over the past decade. How should we interpret their apparent lack of success compared to the so-called 'reform era', when such reviews became a driver of reform?

The outcomes from any given review or public inquiry obviously depend, apart from the utility of the outputs, on the political pressures on government and its capacity to deal with them. Institutions like the Productivity Commission serve government partly by acting as a counterweight to special interests. But history tells us that in many cases those forces will simply prove too strong. My original 'to do list' of unimplemented PC recommendations is testimony to this.

There is some debate as to whether the politics of reform have gotten tougher or whether the capacity of government to pursue it has gotten weaker. In my view there is evidence of both, especially in the post-GFC period, and of the phenomena being connected.

What seems clear is that the power of special interests, which had subsided (or been suppressed) during the reform era of the 1980s and 90s, has been rising again. Pro-productivity reforms or new anti-productivity policies have repeatedly succumbed to such influences either directly or indirectly. Perhaps the most topical recent instance is the second (successful) round of lobbying for removal of the so-called Tampon Tax, which as a leading (female) tax expert argued at the Outlook conference, is contrary to the desirable direction for GST reform and will probably make reform harder.

The extent of 'rent seeking' in a society—what I'd call in plainer language, 'economically unproductive special pleading'—is related to the opportunities on offer and the prospects of success. These would appear to have increased as a result of developments on the demand and supply sides of political 'markets'.

On the demand side, opportunities for special interests or vested interests to be heard and to influence public opinion have been greatly enhanced through the advent of 'new media', which is both hungry for content and uncritical of what it receives. A bad policy idea is likely to get as much coverage as a good one – indeed more so if it involves a human angle or potential to spark controversy. And those with a barrow to push naturally predominate in the 'twittersphere', which often feeds mainstream journalism.

Interest groups are also finding a more receptive audience in a post-materialist society in which people increasingly value notions of equity over efficiency, the environment over the economy, and the 'world' over the nation.

At the same time, the public's trust in government has declined to all-time lows, even as expectations of 'what government can do for me' have increased.

This is reflected in the rise of minority political parties and 'independents' and the swelling of the crossbenches of our parliaments. With their newfound political leverage, upper house members increasingly see themselves in the policy-making business rather than as mere reviewers. This has made them an attractive target for rent seekers, who may achieve more by lobbying a Senator or two than appealing to the public or trying to convince the responsible minister.

These various political pressures have in turn elicited a defensive posture in ministers' offices, the enlarged ranks of which now see political advisers and issues managers swamping policy people. With this has come a greater inclination to make policy 'on the run'—whether in response to the minor crisis of the day or to clinch a deal with interest groups or obdurate senators.

Compounding trends on the supply side that favour special interests are developments within the bureaucracy and in its relationship to the Office. Unsurprisingly, independent reviews have found the public service struggling to keep up in this hyper-charged political world, and progressively losing the capability (and possibly the motivation) to provide the evidence-based policy advice on which good political decision-making depends.

These developments help explain the willingness within government to have bodies like the PC that can assist with the 'frank and fearless' side of advice, but they also point to greater challenges to their effectiveness.

Raising the 'productivity' of the PCs

By offering analysis and advice that is technically robust and that provides a whole-of-economy perspective (whether state or national), a PC can help governments make better policy choices. Although their arms length position from the bureaucracy can make a difference, they are not unique in their ability to do such analysis. What is distinctive is the public side of what a PC does: its capacity as an independent body to engage the public in its processes, 'stress test' its findings, and help bring about a better informed public and thus a more receptive political environment for implementing good public policy.

Both the 'technical' and 'political' functions provide ongoing challenges. And like any organisation, how well a PC discharges them will vary, depending on the nature of a given task and how well it does its work. That in turn will depend on its governance, people and 'culture', and the adequacy of its resourcing.

How Government 'handles' a PC is key

But no matter how well they are structured, resourced or perform, PCs cannot be expected to provide a panacea for our policy ills. History tells us that the decisive factors are how government chooses to use them and its own capacity to carry the case for reform to the public.

For a start, an inquiry needs to be motivated by a wish to use it to achieve better policy. That has not always been the case. As noted on another occasion, some inquiries have been more about being seen to take action than any real intention to do so, or simply a wish to defer a hot issue (which can nevertheless be useful if it avoids kneejerk policy decisions).

Relatedly, there is no point a government going to a PC for advice if it is not prepared to contemplate politically challenging reforms. PCs can be expected to come up with recommendations that disturb the status quo, and that will be opposed by sections of the community. That is their job. And the evidence they produce in support of such recommendations furnishes a government with useful ammunition. (As a former Treasurer observed at a recent event to celebrate the federal PC's 20th anniversary, the Commission "gave me the bullets and I fired them.")

Given that reviews often cover politically sensitive territory, it is surprising that more attention is not given to their timing within the electoral cycle. Announcing a review late in the cycle, for reporting early in the life of a new government, can have benefits in both political and substantive terms. But releasing a report in the months leading up to an election is to court failure.

The Banking Royal Commission currently provides a particular illustration of the risks entailed. In that case, the scheduling of its final report before the Federal Election is bound to ensure unusually prompt and comprehensive acceptance of its recommendations. But given the financial sector's importance to economic performance generally, and the indifferent track record of Royal Commissions when it comes to policy (as opposed to forensic investigation), this may not be a good thing.

More broadly, a PC inquiry program needs to be approached strategically, in the context of other reviews and policy actions. This can be a (too) crowded arena. Priority needs to be given to significant policy issues that are both complex and contentious, where independence and inclusive processes come into their own.

For example, I believe that much greater use should have been made of the Commission to help government navigate the complex policy territory of global warming and its connections to energy supply and demand. The same could apply at the state level, particularly for policies relating to the development of the gas sector. Where the Commission has been invited into these areas in the past, its inquiries were well received and its findings achieved broad support. This could not be said of most other reviews over the past decade. Alternative settings, with hand-picked reviewers, are often favoured in order to get a quicker or more 'predictable' result. But the experience has been that these features have not been conducive to public engagement or trust, let alone good policy outcomes.

Having commissioned a PC inquiry or study, it is also important that a government stand back and let it get on with the job. The value added from such a review is intimately connected to its public credibility, in which perceptions of independence are central. Any sense of a report being a 'co-production' with government is likely to be fatal. (This can be affected by even apparently insignificant things, like a joint announcement with the Minister.)

Equally, it is important that a government not comment on or seek to pre-empt an inquiry's findings. In my experience this has proven most tempting at the time of a draft report. But an intervention at that point can prejudice the rest of the process and forfeit the political value to government of observing at a distance the reactions of different parties to different policy options.

Finally, it is obviously important that processes within government are conducive to a report being properly considered. It is rare for PC recommendations to be accepted in their entirety—and that may not even be desirable! But care needs to be exercised by government to avoid 'cherry picking' recommendations that are interconnected (such as happened with the Henry Tax Review) or getting the sequencing wrong. For example, the NDIS continues to suffer from having been rushed out before an election, truncating trials integral to settling key design features.

Some implications for PCs?

While the fate of a PC report will therefore often hinge on how the government of the day 'handles' it, the Commission itself is not without influence in this area.

At the front end of the process, opportunities are generally available to provide advice about the suitability of proposed inquiry topics and their timing; and that 'terms of reference' are well structured and do not exclude key aspects that would limit the inquiry's value or credibility.

At the back end, direct ministerial briefings play a key role. No matter how well presented, reports are rarely sufficient on their own. Ministers and their offices often lack the time to read them. But the filtering of content through the bureaucracy can have a 'chinese whispers' effect. It is important therefore that departmental briefings are complemented by opportunities for a PC's direct involvement. By the same token, it can be useful for Commission staff to be on hand to answer questions as responses are being formulated.

That said, PCs cannot be expected to operate on both sides of the fence. Further, it would be a mistake to believe that a PC's influence on outcomes occurs mainly through its connections within government. At least as important are its impacts on public understanding, and the building of coalitions of support for reform.

Over the years, the most 'successful' inquiries in terms of policy outcomes have tended to be those with extensive public involvement, especially through the draft report phase. Effective public engagement is very time consuming, which is not always appreciated by governments, particularly where there is a political need for speed. But in my experience, attempts to accommodate tight time frames by cutting corners on consultation can be self-defeating. (The unusual lack of a draft report for the Shifting the Dial report is putting this to the test.)

Whether certain inquiry recommendations are taken up often hinges on how a government reads the politics at the time. Having fall-back options in case the 'first best' is rejected has proven useful in preventing a policy vacuum being filled with something worse. And attention to implementation, including managing transition in ways that reduce the costs to those most affected or least able to cope, can be very important in assisting a government deal with the politics of reform.

That said, while PCs need to be astute in formulating implementable recommendations, their job is to decide what is good policy, politics aside. As US President Harry S. Truman reportedly once said to State Department officials he thought had deviated from this, 'I don't want a bunch of amateurs playing around with serious business'. The advantage of statutory independence, for those public sector bodies that have it—unfortunately not all PCs do—is that they do not need to play in that space. In the few instances where the federal PC appears to have tried, it has proven counterproductive.

Final comment

In the exchange just referred to, Truman famously went on to observe that he wanted public servants to stay focused on good policy, because 'good policy is good politics'. That proposition was affirmed in Australia during the Reform Era. But the experience then and since has also demonstrated that it does not stand alone. For good policy to prevail, it needs to be underpinned by good process. And this is where the PCs have much to offer. But they too cannot stand alone. Ultimately the contribution they make is conditioned by how well governments make use of them. In this respect, the lack of progress on pro-productivity policies over the past decade may speak for itself.

