AFR Workforce & Productivity Summit

Speaking notes

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The developed world, and Australia more than the rest of the developed world, have experienced a collapse of productivity growth in the twenty first century so far. It should be a central objective of Australian policy to reverse this decline. Reversal is easier said than done. Progress will take time with the best of policy in the best of circumstances.

Current budget forward estimates and official inter-generational perspectives are built on unlikely presumptions that we will see an early return to high productivity growth. Plans for expenditure or taxation built around these presumptions will be disrupted either through sudden and radical revisions of policy, or from adverse reactions in international financial markets.

Australian productivity growth in the twenty first century so far is unprecedentedly low for such an extended period. This compounds other sources of lower growth in the years immediately ahead. This all calls for adjustments in expectations about growth in living standards that are no less challenging for having been with us since the Chinese model of economic growth changed decisively in 2011.

In the 4 years since the peak of the resources boom in the September quarter of 2011, real Australian national income per person has fallen by over 5 percent. The fall has its origins in declines in the terms of trade and in total factor productivity. The fall in the terms of trade came first from the new model of Chinese economic growth that has lowered growth rates and, more importantly, the coal and metals intensity of economic activity. The fall in the terms of trade has been exacerbated by the immense expansion of Australian supply capacity for the main resource export commodities—most powerfully through the years in which import demand in our largest export market ceased to grow and then began to decline for what had been the two most important export commodities.

A major part of the quarter trillion dollars of investment in expanding production and exports of the three main resource commodities since the new Chinese growth model began to be influential in early 2011 will never return the investors' cost of capital. Because the standard measures of productivity focus on volumes and not value of output, not all of the wasteful overinvestment will show up as a lower rate of productivity growth.

It is important to be clear what we mean by productivity. The broad-based measure of productivity—total factor productivity--is difficult to measure but is what matters. Total factor productivity measures the efficiency with which total resources are used. It seeks to measure the productivity of capital and labour taken together. In this presentation, when I talk about productivity I am referring to total factor productivity.

Australians in recent years have been taking comfort from a lift in labour productivity. Labour productivity can grow because more capital is applied to production, even if there is a decline in the efficiency with which labour and capital are used. Capital has a cost. Whether or not it generates a return, it can generate a deduction against taxation liabilities. Increased output that comes only from the application of more capital may or may not increase the incomes and wealth of Australians. On the other hand, increased output derived from increased total factor productivity is generally welfare enhancing.

Australian productivity growth was high by world standards in the 1990s, after nine decades of underperformance in comparison with other countries that now have high incomes. Australian total factor productivity growth averaged 0.8 % per annum in the 1990s, with higher levels late in the decade after the recessionary beginnings. This compares with 0.7 % for Europe, O.1% for Japan, 0.7% for the United States zero for Canada, 0.2 percent for New Zealand and 0.6 percent for the OECD as a whole.

The OECD's average annual productivity growth fell by half in the 2000s compared with the previous decade—from 0.6 to 0.3 percent. Australia's fell to minus 0.5 percent.

I have taken these numbers from the presentation to the June 2015 Melbourne Economic Forum by Peter Harris, Chairman of the Productivity Commission.

Productivity growth hasn't improved for the OECD since the 2000s. The OECD's average total factor productivity growth remained at 0.3 percent in 2010-14. Australia's fell further to minus 0.9 percent.

There is debate about the significance of the fall in productivity growth in the developed countries so far in the twenty first century. In my view, the standard national accounts upon which productivity calculations are based generally underestimate the value to consumers of new technologies embodied in new and improved goods and services. Some of the advances in medical and communications technology have improved welfare without lifting productivity in the standard ways. However, the standard measures are the right measures if we are focusing on the balance between investment and savings that determines conditions in labour and financial markets, or the sustainability of budget settings.

As set out in Janine Dixon's presentation to the June 2015 Melbourne Economic Forum, the Economic Outlook underpinning the official forward estimates envisage a return to the total factor productivity growth of the late 1990s. Not the average of a great decade, but the higher levels of the later years—a full percent per annum.

Is it realistic to think that we can bounce from minus 0.5 percent in the 2000s and minus 0.9 percent in 2010-14 to levels more than three times the twenty first century OECD average in the four years ahead?

Let's not spend the proceeds until we see them in the statistics—or, at least have worked out how we can lift productivity growth to that extent.

Too late. The forward estimates have already spent them.

It would be an historic achievement to replace the large declines in productivity in the twenty first century so far by the modest positives of the OECD over this period. On Janine Dixon's calculations for the Melbourne Economic Forum, the return to positive productivity growth at 0.3 percent would be associated with real output growth of 2.25 percent per annum, compared with 3.25 percent in the

DRAFT

forward estimates. A full percentage point reduction in the growth rate would reduce revenue by something like 5 percentage points over a five year period.

Other official parameters affecting the forward revenue estimates seem to be excessively rosy. The terms of trade are assumed to fall a bit over the years ahead. The terms of trade have already since the May budget fallen by roughly as much as was expected over the whole of the forward estimates. Iron ore and coal prices have further to fall.

Immigration and population growth have already fallen short of the forward estimates. So has growth in investment.

The price level—affecting real as well as nominal revenues—is not rising as fast as anticipated. The "bracket creep" that arises from the high estimates of inflation is kept entirely for the revenue.

The forward estimates count as savings the immense cuts in State health expenditure imposed in the 2014 Commonwealth budget, but not yet funded from any source.

And they assume passage of measures that may or may not find their way through the Senate.

The forward estimates in general as well as the assumptions about productivity growth in particular are fantastic. All of the delusional elements are in the direction of understating the budget challenge.

It is inevitable that the December Mid-Year Estimates will embody a major downward revision of revenues—as has every six monthly Budget statement since the China resources boom began to recede in late 2011.

The economic outlook contains risks beyond the budget, which would feed back negatively on budget outcomes if they materialized. Let me refer just to one that is closely related to the Budget. Dependence of banks on wholesale debt markets has been recognized as a main indicator of vulnerability to financial crisis. The Australian banks are uniquely dependent on foreign wholesale debt to match the assets on their balance sheets. They are more dependent now on external wholesale debt markets than at the time of the Great Crash of 2008. After the collapse of Lehmans Brothers, they were able to fund their assets only through the Commonwealth Government guaranteeing their wholesale debts, to the extent of $178 billion. They are more dependent on wholesale debt markets today than they were in 2008. But it is not at all certain that the Commonwealth Government could carry again a guarantee of $178 billion and more in an international financial crisis without a downgrade of its own credit rating, which would carry through to the ratings of the banks.

Two Prime Ministers and Treasurers were damaged greatly by the Treasury's and their own failure to come to grips with a deteriorating Budget outlook after the resources boom had passed its peak. It is important for Australia that Prime Minister Turnbull and Treasurer Morrison avoid a similar fate. The new Prime Minister and Treasurer have a chance to reset expectations about the Budget. I hope that they are realistic. Realism about the Budget will be shocking to most Australians.

The Budget and economic outlook will be better to the extent that we can lift productivity growth above the shocking levels of the twenty first century so far.

That makes this Summit an important event in Australia's public life.

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The Summit will have value only if we can all face up to the reality, that we are dealing with a really difficult problem.

Let’s not be tempted by easy answers, put forward without rigorous analysis.

I count suggestions for an across the board cut in the company tax rate as an easy answer put forward without rigorous analysis. As put forward in Treasury papers, the case depends on the presence of competitive markets for capital and products. The case is not made in relation to most of the resources sector, or much of the retail trade, or to utilities, or to banks.

My own view is that the greatest productivity gains will come from introducing competition, or simulating the effects of competition by radical reform of price regulation, in those large parts of the Australian economy that are only weakly exposed to the disciplines of international trade.

In our search for productivity gains, let us put nothing off limits that is backed by rigorous analysis.

Let us be careful not to exacerbate a dreadful budget problem in our search for productivity gains.

And let us be aware that Australia’s twenty first century economic challenges are so large that they can only be met by a major national effort. That will require Government to be mindful of perceptions of equity in the distribution of the adjustment costs. Let’s be ready to offer support for hard policies in the national interest, even when they do some damage to our own private interests.

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