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Policy Determinants of Productivity Growth in Australia

Bernard Wonder

PRODUCTIVITY COMMISSION
AUSTRALIAN GOVERNMENT

BWONDER@PC.GOV.AU

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EABER Secretariat
Crawford School of Economics and Government
ANU College of Asia and the Pacific
the Australian National University
Canberra ACT 0200 Australia

Policy determinants of productivity growth in Australia

Bernard Wonder

Head of Office, Productivity Commission

… the Productivity Commission has provided a vital, independent source of public information and advice to government on policy reforms needed to underpin Australia's long-term prosperity (Australian Treasurer, Peter Costello 2003)

Introduction

The transformation in Australia's economic performance since the early 1990s has generated much interest overseas as well as within Australia. The contribution made by microeconomic reform in this country has been a particular focus of inquiry by officials from foreign governments, national research institutes and international and regional economic agencies, not the least in East Asia. This interest reflects not only the manner in which the reforms were introduced and sustained but also the magnitude of Australia's reform requirements and the institutions associated with reform.

It was against this background that the Chairman of the Australian Productivity Commission, Gary Banks, prepared a detailed assessment of the Australian approach to structural reform (Banks 2005). Many of the views expressed by Banks are directly relevant to the interests of this conference and hence this contribution (particularly the first half) draws extensively on his paper.

The paper commences with an overview of the turnaround in Australia's economic performance before outlining the broad nature of the microeconomic reform program and associated outcomes, as well as the key elements of the reform 'strategy' and its institutional underpinnings. Particular attention is given to the contribution made by the Productivity Commission (and its direct predecessors) and the important attributes of the Commission enabling its contribution. A risk in such a presentation is to over account the significance of the Commission to the extent of reforms. The Productivity Commission is, after all, only an advisor and not a direct player or policy decision maker. However, the intention is to outline the Australian experience with a view to assisting others make their own assessment of

institutional frameworks that might help sustain reform efforts in their own countries. The Commission's track record in having much of its advice accepted by government in many areas of microeconomic policy demonstrates the potential for an agency such as the Commission to make a difference to the course of policy development.

Australia's economic performance

Australia began the 20th Century with the highest per capita income in the world. However, being blessed with abundant natural resources was not sufficient to guarantee continuing prosperity. It turns out that Australia managed to devise some special institutions and policy frameworks that, whatever their initial merits, ended up significantly handicapping economic performance.

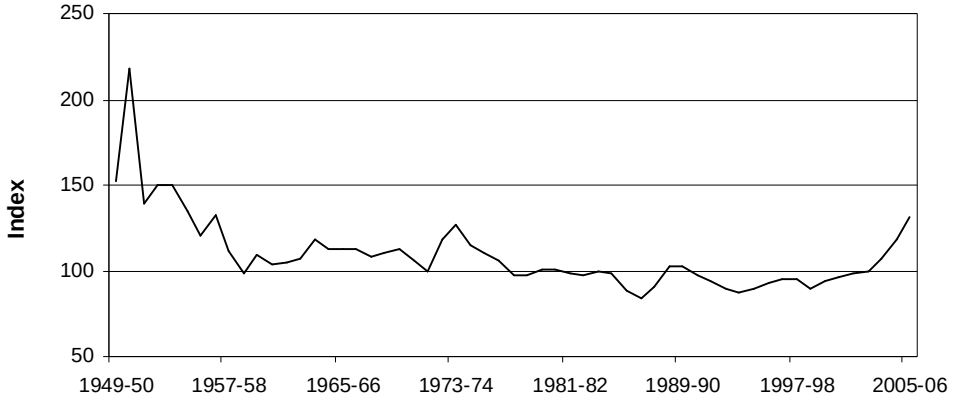
Australia's structural policies following Federation in 1901 were shaped by a social compact that came to be known as the 'Australian settlement' (Kelly 1992). Four of the elements were:

- *industry protection* — protection of domestic industry against imports;
- *wage arbitration* — protection of labour through centralised wage regulation;
- *White Australia* — protection against foreign labour through restrictive immigration policies; and
- *state paternalism* — protection against the 'market' through state monopoly provision of public utility and other services and extensive intervention by the state.

Extensive intervention by government through anti-competitive regulation and redistribution policies — captured nicely by the logically flawed expression 'protection all round' — had bi-partisan support and wide community acceptance for most of the 20th Century. For many years the economic costs of this regime were masked by the performance of our broad-acre agricultural and mining industries. Until the early 1970s, Australia was still managing to 'ride on the sheep's back'. The terms of trade favoured our primary commodities, and we had benefited from a world-wide expansion in demand following World War II. Australians enjoyed close to full employment with incomes still higher, on average, than those in most other OECD countries. But this did not last.

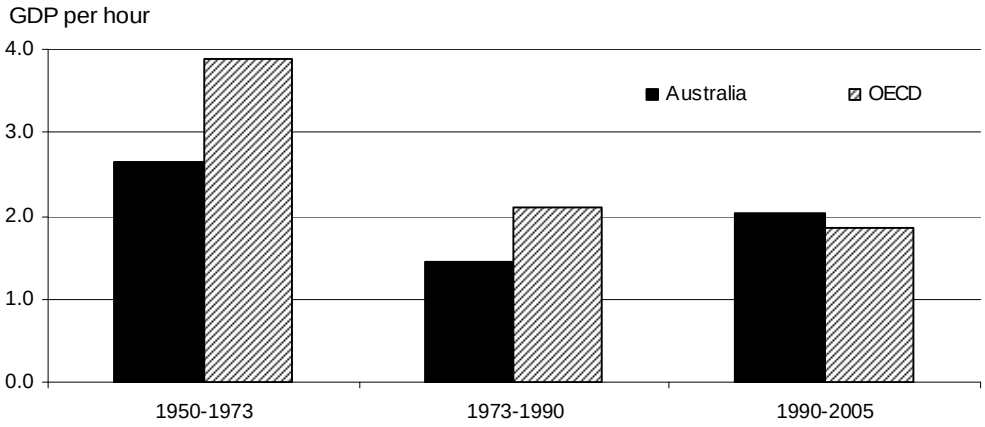
During the 1970s, the prices Australia received for our commodity exports commenced a long decline, while the costs of imports began to rise. The resulting terms of trade deterioration (Figure 1) would, in turn, expose the underlying problem of Australia's poor productivity performance.

Figure 1 **Australia's terms of trade index (2002-03 = 100)**



Even in the post-war 'boom' years, Australia's productivity lagged. Between 1950 and 1973, our annual productivity growth averaged 2.6 per cent, compared to 3.9 per cent for OECD countries as a group (Figure 2).

Figure 2 **Australia's relative productivity performance**
Average annual labour productivity growth



The reasons for Australia's relatively poor productivity performance have been described as follows:

- a fragmented, high cost manufacturing sector, focused on the domestic market;
- indulgent, inflexible work practices, powerful unions and lack-lustre management;
- outmoded technologies, low rates of innovation and skill development; and

- high cost government owned infrastructure services such as power, transport and communications, which effectively taxed business users, while cross-subsidising households (Banks 2005).

This poor productivity performance, together with the declining terms of trade, translated into a relative decline in living standards. In terms of GDP per person, Australia was still ranked 4th out of 23 OECD countries in 1950, but its position fell to 9th by the early 1970s and to 16th by the late 1980s.

Australia's reform journey

This realisation forced a re-think of institutional and policy frameworks and eventual acceptance of the need to embark on a sustained and comprehensive program of trade liberalisation and other structural reforms. A 'then' and 'now' comparison of policy frameworks in Table 1 shows the nature of the changes (Henry 2006). In essence, the reforms freed up markets, promoted competition and generally sought to ensure that prices did their job of signalling costs and relative returns.

Table 1 **Sea change in Australia's policy frameworks**

1970s	*2000s*
Fixed exchange rates	Floating exchange rates
Capital controls	Capital account and interest rate controls liberalised
High trade barriers	Low trade barriers
Weak competition policy	Stronger competition policy
Centralised labour market	Decentralised labour market
Macroeconomic policy not anchored	Macroeconomic policies credibly anchored to medium-term targets

Of course, this snapshot cannot capture that fact that such a multifaceted reform effort was not seamlessly implemented. Nor was it without adjustment costs. For example, the 25 per cent across-the-board tariff cut of 1973 turned out to be a one-off. In conjunction with other events, the cut precipitated a backlash against reform and there were only 'piecemeal' further reductions in tariffs for over a decade. But with Australia's relatively mediocre economic performance becoming increasingly apparent, the early 1980s saw the floating of the Australian dollar (facilitating subsequent adjustment to tariff liberalisation) followed by significant liberalisation of the finance sector, including the removal of exchange and interest rate controls. The reform of border protection arrangements was also reinvigorated — with the conversion or elimination of import quotas as well as reductions in tariffs

themselves. By 1996, virtually all tariffs (other than for autos and TCF, which were on their own liberalisation paths) had fallen to 5 per cent or less.

A consequence of increased international competition in Australia's traded goods sector was pressure for reductions in input costs, notably in labour markets and (non-traded) public utility services. The option for local firms to pass excessive input costs onto user industries and consumers was no longer possible once accommodating 'made-to-measure' increases in border protection stopped.

The various 'spot fires' of microeconomic reform — especially in different sectors of economic infrastructure and in different Australian jurisdictions — began to coalesce. In 1995, various strands of the structural reform process were consolidated and extended in a coordinated National Competition Policy (NCP) agreed to by all governments in Australia's federal system. Among other things, the NCP program entailed: an extension of anti-competitive conduct laws to cover previously exempt government and unincorporated enterprises; the review of some 1800 items of anti-competitive regulation; reforms to public monopolies, including 'competitive neutrality' mechanisms, certain structural reform requirements and prices oversight mechanisms where public monopolies were retained; and an access regime for network infrastructure (PC 2005a).

Thus, towards the end of the 20th Century, Australian governments were committed to an increasingly broad-ranging program of domestic microeconomic reform. The reforms ultimately embraced all product (goods and services) markets, factor markets (including the labour market), and the public and private sectors (Box 1). (This 'micro' story overlooks the important and complementary role of macroeconomic reforms — whose outcomes were low inflation, greater flexibility to respond to internal and external shocks, and reduced distortions and improved business incentives from tax reforms. But that is a subject in its own right.)

Box 1: **Two decades of economic reform**

Trade liberalisation — reductions in tariff assistance (that began in 1973) and the abolition of quantitative import controls — mainly in the automotive, whitegoods and textile, clothing and footwear industries — gathered pace from the mid 1980s. The effective rate of assistance to manufacturing fell from around 35 per cent in the early 1970s to 5 per cent by 2000.

Capital markets — the Australian dollar was floated in March 1983, foreign exchange controls and capital rationing (through interest rate controls) were removed progressively from the early 1980s and foreign-owned banks were allowed to compete — initially for corporate customers and then, in the 1990s, to act as deposit taking institutions.

Infrastructure — partial deregulation and restructuring of airlines, coastal shipping, telecommunications and the waterfront occurred from the late 1980s. Across-the-board commercialisation, corporatisation and privatisation initiatives for government business enterprises were progressively implemented from around the same time.

Labour markets — the Prices and Incomes Accord operated from 1983 to 1996. Award restructuring and simplification, and the shift from centralised wage fixing to enterprise bargaining, began in the late 1980s. Reform accelerated in the mid 1990s with the introduction of the *Workplace Relations Act 1996,* further award simplification (through limiting prescribed employment conditions in enterprise bargaining agreements) and the introduction of individual employment contracts (Australian Workplace Agreements).

Human services — competitive tendering and contracting out, performance-based funding and user charges were introduced in the late 1980s and extended in scope during the 1990s; administrative reforms (for example, financial management and program budgeting) were introduced in health, education and community services in the early 1990s.

'National Competition Policy' reforms — In 1995, further broad-ranging reforms to essential service industries (including energy and road transport), government businesses and anti-competitive regulation was commenced by all Australian governments through a coordinated national program.

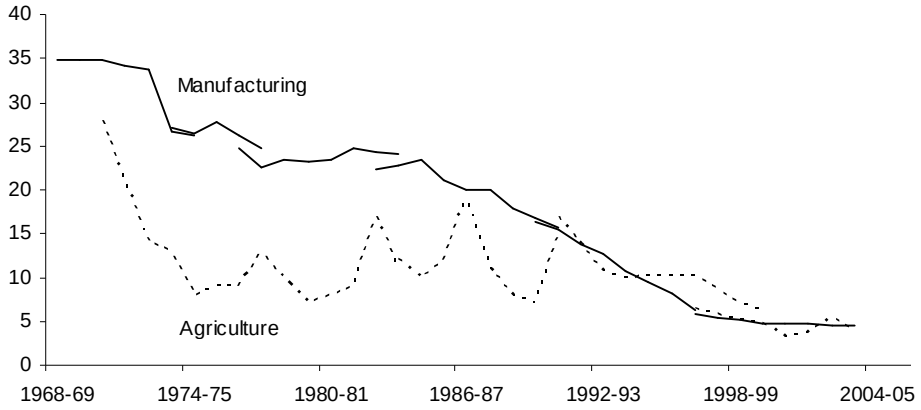
Macroeconomic policy — inflation targeting was introduced in 1993. From the mid 1980s, fiscal policy targeted higher national saving (and a lower current account deficit) and, from the mid 1990s, concentrated on reducing government debt, primarily financed through asset sales (privatisation).

Taxation reform — capital gains tax and the dividend imputation system were introduced in 1985 and 1987, respectively. The company tax rate was lowered progressively from the late 1980s. A broad-based consumption tax (GST) was implemented in 2000, replacing the narrow wholesale sales tax system and a range of inefficient state-based duties. And income tax rates were lowered at the same time.

Source: Banks (2005).

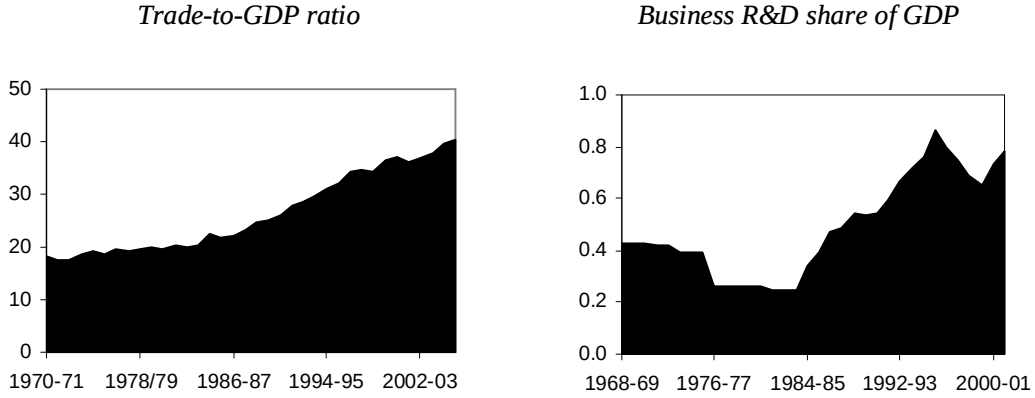
No single indicator adequately summarises the extent of structural reform in Australia. Perhaps one that comes closest is the extent of net assistance to Australian industry. The effective rate of assistance for manufacturing has declined from 25 to 5 per cent over the past two decades, while agricultural assistance has also fallen (Figure 3).

Figure 3 **Falling effective protection for manufacturing and agriculture**



Other aggregate-style indicators of the extent of structural and behavioural change are found in the coincident rise in the trade intensity of Australia's economy, from around 22 per cent in the mid 1980s to 40 per cent now, and the sharp increase in business R&D spending as a share of GDP (Figure 4).

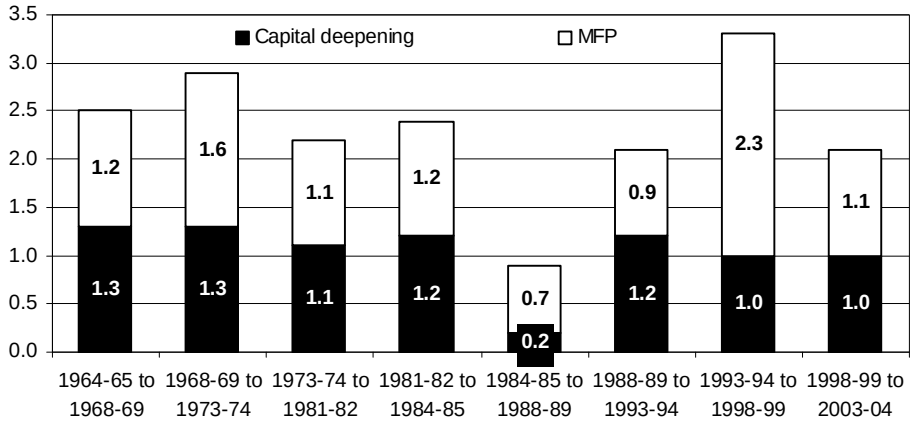
Figure 4 **Increased trade and R&D intensity**



Reform outcomes

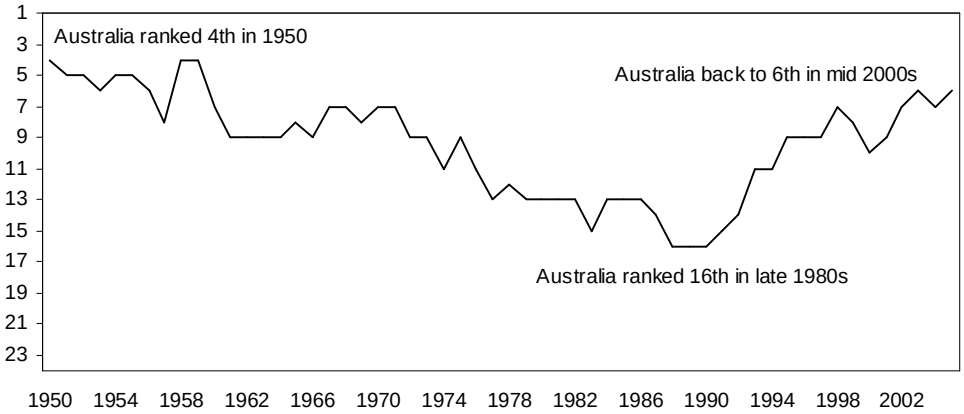
At the aggregate level, Australia experienced a surge in multifactor productivity (MFP) growth during the 1990s, averaging 2.3 per cent, more than double its previous rate (Figure 5). Australia's MFP performance was also among the best in the OECD and its labour productivity growth exceeded even that of the USA.

Figure 5 **Australia's productivity turnaround**



Accompanied by rising labour utilisation, this translated into annual growth in per capita incomes of around 2½ per cent in that decade, well above the previous average and that for the OECD as a whole (1.7 per cent). As a consequence, Australia has seen its position on the international per capita GDP scale rise from 16th to 6th over the past decade or so (Figure 6).

Figure 6 **Fall and rise of Australia's economic ranking**
Rank based on GDP per capita, in 2005 EKS$, 23 OECD countries



The productivity story was also repeated at the industry level. For example, MFP growth in electricity, gas and water jumped by 60 per cent in the 1980s; and the MFP growth rate in transport/storage and communications doubled in the 1990s. Empirical analysis by the Commission found that the price reductions and productivity gains in the infrastructure sector alone yielded a 2½ per cent gain in GDP (PC 2005a).

The reform program also contributed, indirectly, to sharp productivity improvements in wholesale trade and the finance and insurance industries, where business reorganisation involving the innovative use of ICT was driven by the heightened competitive pressures on customers as well as within the industries themselves, facilitated by a more accommodating industrial relations framework (Johnston et al. 2000; Gretton et al. 2004).

The Commission has investigated the sources of Australia's productivity turnaround and, like others, concluded that microeconomic policy reforms have played a central role. (For a summary of the evidence, see PC 2003a). These reforms, with their focus on openness to foreign trade and investment and enhanced domestic competition, were the drivers and enablers of productivity growth. Together with stable macroeconomic settings for monetary and fiscal policies, the productivity surge allowed Australia to pursue higher economic growth and living standards with fewer fears of inflationary pressures.

Reform strategies that worked for us

While many of Australia's structural reforms followed standard economic prescriptions, the way the reforms were implemented had some features that are perhaps more distinctive (Banks 2005).

'Opening the borders' became the first domino

Opening the borders to foreign goods, services and capital played a critical role in exposing inefficiencies elsewhere in the Australian economy as well as building a constituency for reforms in government utility service provision and in labour market regulation. The prospect of adjustment costs provided the motivation as well as a constituency for further reforms that, together with a gradualist approach (see below) and a floating exchange rate, ultimately served to contain those costs.

A key lesson from Australia's experience is that external liberalisation has distinct advantages as a first-mover strategy.

We liberalised unilaterally

Unlike other OECD countries, most of Australia's trade liberalisation has been undertaken unilaterally, rather than in exchange for reciprocal concessions by other countries. With agricultural trade — at that time Australia's main export interest — effectively quarantined in the then GATT (now WTO) system, Australia had little incentive to do reciprocal deals. This brought into sharp focus the question of whether reducing our own import protection would yield national gains, regardless of what other countries chose to do. Moreover, Australia generally got 'credit' for its liberalisation measures in subsequent rounds of multilateral trade negotiations while, benefiting from the reciprocal liberalisation of the larger trading powers through application of the non-discrimination rule.

We hastened slowly

Australia adopted an incrementalist rather than 'big bang' approach to reform. The experience with tariff cut 25 per cent tariff cut may have reduced the appetite for big bang approaches. The cut was not pre-announced by the government, was immediate and was explained more in terms of constraining inflation rather than its microeconomic benefits. It surprised the inefficient manufacturing sector and was soon followed by reversals of protection for 'sensitive' sectors and thus a widening of disparities in industry assistance. Later tariff liberalisation programs involved pre-announced and graduated reductions and made special transition provisions for sensitive sectors.

Australia has also taken a gradual or incremental approach to reform in the other key areas.

- The reform of public-owned utilities that initially began with commercialisation and then corporatisation initiatives in the 1980s were followed by the 'stronger medicine' of structural separation, removal of entry restrictions against new competitors, privatisation (in some jurisdictions), and, for network infrastructure, regulated provision for third-party access.
- Labour market reforms began with a gradual transition from the traditional, highly centralised prescriptive arrangements. Award restructuring and an 'accord' between the government and the unions to limit wage demands gave way to enterprise bargaining, and later to the introduction of individual employment contracts constrained by limited core requirements.

We acted on a broad front

Notwithstanding the substantial challenges involved, undertaking reform on a broad front can reduce resistance to change. Those adversely affected by one reform may receive offsetting benefits from reforms in other areas, thus avoiding undue adjustment and making reform more 'palatable'. For example:

- The Commission's modelling of the economy-wide impacts of reducing trade barriers while also implementing reforms to energy, communications and the public sector, demonstrated that although trade liberalisation alone would reduce manufacturing employment by 0.3 per cent, reforms across all the areas would increase employment in the manufacturing sector by 1.3 per cent (IC 1996).
- While reforms to public utilities have seen apparently regressive price rises for households, modelling of the indirect effects on other prices and factor incomes has demonstrated net benefits across all household income bands (though greater at higher income levels) (PC 2005a).

We 'oiled the wheels' in sensitive sectors

In the main, Australia used the phasing of reforms to minimise adjustment costs, relying on general retraining schemes and the (relatively generous) welfare safety net to address the needs of displaced workers.

However, particularly in sensitive sectors, governments also introduced some specific measures to deal with adjustment issues. For example:

- The post-2005 TCF plan includes $50 million for this purpose and automotive tariff reductions to 2010 have been accompanied by assistance of around $600 million annually under the Automotive Competitiveness and Investment Scheme (PC 2002).
- When price support mechanisms in the dairy industry were abolished in 2000, existing farmers were provided with a substantial direct compensation financed from a levy on milk consumers, to reflect the reduction in the value of their dairy holdings and to facilitate adjustment within (or out of) the industry.

Governments have also provided specific support for regions in which the costs of reform were concentrated. For example, the energy reforms of the early 1990s led to significant labour shedding from electricity generation in the Latrobe Valley in Victoria, which in turn led to a severe downturn in the region. Support has ranged from grants to encourage industry relocation to the region, to retraining, and social and development initiatives. These measures have contributed to strong employment growth since the mid-1990s (PC 2005a).

Institutional underpinnings for Australian reforms

Structural reforms of the kind Australia has implemented have long been recognised as economically desirable by most economists, but have typically faced strong opposition. Various obstacles to reform outlined in Box 2 are undoubtedly not unique to Australia, although its particular federal system of government can pose additional challenges in securing nationally beneficial reform.

Box 2: **Obstacles to structural reform**

1. The costs of reform are concentrated on particular groups, whereas the benefits are more diffuse.
2. The potential winners from reform tend to be (rationally) poorly informed about the tradeoffs.
3. Bureaucratic structures are typically aligned with particular sections of the economy or community.
4. The costs of reform tend to be front-loaded, whereas the benefits arise over time.
5. Multiple jurisdictions increase the difficulty of achieving nationally consistent approaches.

Source: Banks (2005).

A range of other factors also come into play: political commitment and leadership, reform champions within the bureaucracy (particularly in central agencies) and pro-reform lobbies in the broader community.

However, Australia appears to differ from other countries in fashioning domestic institutional arrangements expressly to promote and sustain reform by both neutralising the power of vested interests and building wider political and community support for reform. An institution that is arguably the most distinctive of the Australian approach in this respect is the Productivity Commission, and its direct forebears, the Industries Assistance Commission and the Industry Commission.

The role of 'the Commission'

While the Commission today is identified with the microeconomic reforms in Australia over the past few decades it paradoxically had its origins in an institution that had underpinned the industry protection element of the Australian settlement for much of the proceeding 50 years (Banks 2005; PC 2003b). The Tariff Board's remit since 1921 was to offset local industry's 'margin of cost disadvantage' against imports while avoiding 'excessive' protection', for which its statute provided only

vague guidance. Nevertheless, it embedded the role of an independent inquiry and advisory body in Australia's institutional framework, albeit restricted to tariff policy. At the Government's request, the Tariff Board would examine the claims of particular industries for increased protection through a public inquiry process, and issue public reports with formal recommendations.

In the mid-1960s, under the combined influence of new leadership, a separate public inquiry into Australia's economic policies (the Vernon Committee) and academic work providing an intellectual basis for protection reform (notably by Max Corden), the Board began to question the effects on the wider economy of its long-standing practice of granting protection to individual industries according to need. This was the genesis of an approach which made advancement of the overall interests of the Australian community paramount over the interests of particular firms, industries or sectors.

All this came together in the blueprint commissioned by the Government for a new organisation providing for the development of coordinated policies for improving resource allocation and public scrutiny of industry assistance measures and their costs (Crawford 1973). The Industries Assistance Commission was designed to provide a counterweight to the sectional and other political pressures that militated against liberalisation.

There are three features of the organisation's design that collectively distinguished its contribution:

- *Independence.* The Commission operated under the protection and guidelines of its own legislation. It had an arm's length relationship with government which could tell it what to do but not what to say. Its role was purely advisory, having no judicial, executive or administrative functions. Members of the Commission were appointed for fixed (renewable) terms and could not be removed by the government of the day.
- *Transparency.* The Commission was required to hold public hearings and release draft reports before finalising its recommendations to government. The Commission was also required to prepare an annual report covering its operations and analysing the structure of assistance to Australian industry and its effects. And the government was obliged to release publicly all Commission reports within a specified period.
- *Community-wide mandate*. Guidelines in the legislation stated that the Commission should be concerned with improving the efficiency with which the economy uses its resources and to take account of the wider interests of consumers and users of products affected by its proposals.

With some variation, these three features remained fundamental to the role and operations of the two organisations that succeeded the IAC; namely the Industry Commission (from 1990 to 1998) and today's Productivity Commission, which was established in April 1998. (For a short history of the Commission, see PC 2003b).

The main differences between the organisations have been in their coverage, which has been progressively extended beyond industry assistance matters to cover structural reform issues across all sectors of the economy, and in social and environmental as well as economic spheres. Around 80 per cent of the IAC's inquiry reports concerned assistance for manufacturing industries. These days, around 80 per cent of Productivity Commission inquiries relate to cross-sectoral, infrastructure, social and environmental policy issues. Box 3 illustrates the breadth of matters that the Productivity Commission has addressed in recent years.

The Commission's contribution to government policy

The Commission assists the reform effort of governments in a number of ways.

- The Commission provides well researched advice on structural reform that is impartial and concerned with the longer term interests of the community as a whole. The Commission's processes ensure that the arguments of vested interests are subjected to rigorous scrutiny, weakening their influence if they don't hold up. Moreover, the robustness of the Commission's final analysis and advice is increased through its own processes, draft reports and the like, which test its preliminary views through public input and feedback.
- The Commission's transparent inquiry processes — including public submissions, hearings, draft and final reports — allow governments to gauge at arms length the likely reactions of the community and interest groups to different policy approaches. This can reduce the prospect of unanticipated responses from these groups forcing policy reversals.
- Governments can use the Commission's reports and analyses in making the case for policy changes, or in resisting pressures to introduce policy measures that would be costly nationally.
- The Commission's public inquiry processes and reporting can in themselves engender a wider awareness within the community of the costs of existing policies and the benefits from reform. In effect, the Commission helps enfranchise those interests who would benefit most from reform, by alerting them to the costs they are currently bearing, and by providing a ready public forum in which to put their case.

Box 3: **A selection of Productivity Commission studies**

Trade liberalisation/industry assistance

- Review of Australia's general tariff arrangements
- Review of automotive assistance
- Review of TCF assistance
- Pig and pigmeat industries: safeguard action against imports
- Review of the pharmaceuticals industry investment program
- Multilateral liberalisation of services trade
- Trade and investment effects of preferential trading arrangements
- Removing tariffs on goods originating from Least Developed Countries
- International air services

Productivity studies

- Productivity in Australia's wholesale and retail trade
- ICT use and productivity
- Microeconomic reforms and Australian productivity: exploring the links
- R&D and Australia's productivity

Infrastructure reform issues

- Review of the gas access regime
- Price regulation of airport services
- Telecommunications competition regulation
- Progress in rail reform
- Road and rail freight infrastructure pricing

Labour market issues

- Australia's health workforce
- Independent review of the Job Network
- National workers' compensation and OHS arrangements
- Non-traditional work in the Australian labour market
- Work arrangements in container stevedoring
- Role of training and innovation in workplace performance

Environmental issues

- Rural water use and the environment
- Energy efficiency
- Waste management
- Conservation of historic heritage
- Pricing of irrigation water
- Impact of a foot and mouth disease outbreak in Australia
- Water quality in the Great Barrier Reef
- The environmental performance of commercial buildings

Social issues

- Australia's gambling industries
- Indicators of indigenous disadvantage
- Social capital
- Review of the Disability Discrimination Act
- Nursing home subsidies
- Inquiry on first home ownership

Regulatory reviews

- Broadcasting
- Impact of native vegetation and biodiversity regulations
- Reform of building regulation
- Radiocommunications
- Liner cargo shipping
- Regulation of the taxi industry
- Review of the Prices Surveillance Act
- Review of mutual recognition
- Review of legislation regulating the architectural profession

Other studies

- Impacts of medical technology in Australia
- Report on Government Services
- Cost recovery by Commonwealth agencies
- Resourcing universities
- GP compliance costs
- Impact of indirect taxes on exporters
- Public liability claims management
- GTE financial performance

The Commission's impacts on government policy can be demonstrated across a range of policy areas. Such a review is necessarily selective and abstracts from much of the 'drama' along the way. The Productivity Commission's predecessors went through some difficult times, facing strong opposition from sections of industry and the union movement, as well as within government itself. At the same time, it had its supporters. They included some industry groups which did not always like its findings, but valued the transparency and consultative nature of its processes. And, as noted above, successive governments from both sides of politics have seen sufficient value in the institution to re-new and expand its mandate over the last 30 years.

Reforming industry protection and assistance

High level political judgements on the Commission's contribution to government policy on industry protection reforms spanning three decades accord it a significant role. At the time of the formation of the Industry Commission in 1989, the then Treasurer stated:

> The new Industry Commission (IC) will further the important role that the IAC has played in the structural adjustment process in Australia. It will build on the IAC's earlier work which was instrumental in awakening the community to the enormous costs of many industry assistance policies. … As an institution, the IAC has been an important force, building community awareness of the need for Australian industry to be outward looking and internationally competitive. (IAC 1989, p. 15)

More recently, the current Prime Minister commented on the Commission's long term contribution to trade and industry assistance policy formulation in the following terms:

> The dynamic supporting trade liberalisation in democracies will only succeed if communities in each country believe it's in their interests to liberalise. In the Australian context, the work of the Productivity Commission and its predecessors … has been fundamental to building and maintaining Australian public understanding of the benefits of greater openness to international competition … Because of the Government's belief in the robustness and transparency of the Australian institutional framework, we have regularly advocated the Productivity Commission as a model for other countries to adopt. If other countries could adopt similar transparent institutional responses, public opinion would be better informed on the cost of trade barriers, and support would be built for good policies in broader areas of industry protection. (Howard 2003)

Notwithstanding these endorsements, the realities of tariff reform were of slow and chequered progress following the 25 per cent tariff cut of 1973 through until the general tariff reduction program of 1988 (Figure 3). The Commission had to work in a world of piecemeal assistance inquiries — often only parts of industry were

referred to it at any one time. Strong substitution possibilities in production and/or consumption and adjustment considerations constrained the pace at which assistance levels could be lowered. And the Commission's assistance recommendations, even when (typically) implemented by the Government, could be quickly overtaken through rounds of 'temporary' safeguard action against imports, often in the form of import quotas. (The main institutional mechanism for this, the Temporary Assistance Authority, focused on 'injury' to domestic producers, not the wider effects of temporary protection on user industries, consumers and the community at large.) Although average levels of assistance for manufacturing industries declined gradually in the decade after the 25 per cent tariff cut, disparities in assistance levels, and thus potential resource misallocation costs, increased.

Arguably, the Commission's most crucial contribution during this period was its educative role — quantifying levels of assistance to industry and explaining to the broader community how assistance provided to one industry can harm producers in other Australian industries, as well as consumers and taxpayers.

How did it do this? Among other things, the Commission developed the use of effective rates of assistance, building on the pioneering work of Australia's Professor Max Corden. Tariffs, quotas and subsidies on inputs *and* outputs were assessed so as to show the net effect on an industry's level of assistance and the overall structure of protection in Australia. Over the years the Commission extended its assistance measurement framework to encompass agricultural and mining industries and budgetary assistance to services. The reporting on assistance to Australian industries continues to the present day in the Commission's annual *Trade & Assistance Review* which, as the WTO's *World Trade Report 2006* observed, is one of only three such detailed, comprehensive and publicly accessible reports world-wide (the others are by the European Commission and the German Ministry of Finance).

Emboldened by improved economic conditions in the early 1980s, the Government sent the Commission a broad reference asking for options for general reductions in protection. While the report had no impact when the Commission reported in 1982, it became a key reference later in the decade in the lead up to the 1988 announcement of general phased tariff reductions. A further general reduction program was announced in 1991. The fact that a government may not initially accept or act on key recommendations in a particular Commission report does not mean that that report has no influence in the longer term.

The most contentious of the Commission's industry assistance reports down the years have typically concerned Australia's highly assisted manufacturing industries — passenger motor vehicles and TCF. A measure of the Commission's ultimate success in helping to shape long term assistance policy for these industries was

government endorsement of the Commission's findings on post-2005 tariff reductions and transitional assistance for the automotive industry (following the Commission's 2002 inquiry report) and the acceptance of the Commission's preferred tariff option for the TCF industries and quantum of transitional assistance post-2005 (following the Commission's 2003 TCF inquiry report).

Assistance to Australia's rural industries has varied considerably, from little or no assistance (as with beef), to substantial assistance to industries such as tobacco and market milk. The policy instruments of choice in agriculture in the post-war period were regulatory — domestic pricing arrangements, anti-competitive statutory marketing arrangements and restrictions on substitute products — supplemented by various tax concessions, output and input subsidies and assistance for promotion activities, with tariffs playing a relatively minor role.

Around one fifth of the inquiries conducted by the IAC/IC during the 1970s and 1980s concerned assistance arrangements for agricultural industries. As with manufacturing protection, the reform process was incremental and spanned decades, but few remnants of the original industry-specific policy settings remain — the statutory monopoly on wheat exports being the most significant exception.

Against this background of reform, assistance issues for Australia's manufacturing and agricultural industries have not figured prominently in the Productivity Commission's work. Nevertheless, its influence is evident in government acceptance of Commission recommendations:

- for the automotive and TCF industries (noted above);
- for a substantial liberalisation of the regulatory regime for international air services (though not to offer unrestricted access to Australia's major airports or to abolish cabotage restrictions);
- to eschew tariff and quota options for safeguard action against pigmeat imports in 1999 and to opt, instead, for adjustment assistance for pig producers;
- not to provide special assistance to citrus growers under competitive pressure but to address the trade negotiation, market access, export control and other issues identified by the Commission; and
- to reorient pharmaceutical industry assistance to R&D, where spillover benefits would generate net benefits for Australia as a whole.

Nevertheless, tariff reform remains incomplete. In 2000 the Australian Government deferred implementing the Commission's recommendation to reduce the remaining general tariffs of 5 per cent to zero, preferring to delay removal until a time 'consistent with trade and fiscal objectives'.

Reforming economic infrastructure

With Australia's tariff walls falling, policy impediments in other parts of the economy began to attract the attention of governments and industries under increased competitive pressure. The IAC's 1989 report on government (non-tax) charges highlighted the significance of government supplied inputs to industry and the adverse effects of inefficiencies in service provision on business competitiveness. The report had the long-term impact of widening the microeconomic reform agenda beyond industry assistance and initiating a series of references to the Commission on economic infrastructure services covering energy generation and distribution, water, rail, ports and postal services. The Commission helped establish a widely adopted reform program for government business enterprises encompassing:

- the removal of barriers to competition (for example, legislative barriers to entry) and structural separation of activities to promote competition;
- institutional and administrative reforms designed to enhance commercial focus and accountability;
- privatisation, when appropriate, to promote on-going cost reductions; and
- other measures, such as pricing reform.

The Commission was the secretariat to a committee of all governments (Commonwealth, State and Territory) which began monitoring the economic and financial performance of government enterprises providing economic infrastructure services so as to provide benchmarks against which their performance could be benchmarked. The Productivity Commission has maintained this regular benchmarking, latterly enhancing it with analysis of the scope to improve external governance frameworks and capital management practices. This work continues to be supported by governments in all jurisdictions and the benchmarking outcomes are used in political, media and community debate on the performance of these service providers.

Governments have embraced one of the principal policy messages arising from a series of Productivity Commission reports on the regulation of economic infrastructure — the need to rebalance the emphasis in the regulatory frameworks away from achieving immediate gains for users and consumers to also facilitate efficient investment in new or augmented facilities. More specifically, the Australian Government:

- broadly endorsed Commission recommendations on rail reform in areas of Commonwealth responsibility but deferred consideration of other recommendations relating to State or joint responsibilities, preferring to see

whether existing reform initiatives could be progressed within existing institutional settings;

- endorsed the thrust of the Commission's recommendations to retain telecommunications-specific parts of the competition policy regime, speed up dispute resolution processes and provide greater upfront certainty for investors (though rejecting other recommendations);
- endorsed, together with the States and Territories, the majority of the Commission's recommendations on the national access regime for essential infrastructure;
- implemented all major elements of the Commission's preferred approach for light-handed regulatory regime for airport services involving a probationary period of price monitoring;
- accepted all the Commission's recommendations on the economic regulation of harbour towage services, with only minor modifications to the suggested price monitoring regime; and
- with the agreement of the inter-jurisdictional Ministerial Council on Energy, supported the Commission's key recommendations for reforming the gas access regime.

Improving the functioning of the labour market

In the early 1990s the Industry Commission's first direct foray into industrial relations issues was its inquiry on impediments to regional industry adjustment and on what needed to be done to help people and businesses within regions adjust to pressures for change (IC 1993). A central theme of the Commission's report was the difficulty that uniformity in policy and regulation can pose for regional adjustment and development, given the diversity among Australia's regions.

The Commission focused its analysis on arrangements that were amenable to government or community action, including aspects of labour market regulation; social security and taxation systems; problems with government provision of infrastructure services; and confused responsibilities across tiers of government. It was the Commission's findings on labour adjustment that were most contentious, provoking a strong negative reaction from unions and welfare groups in particular. Nevertheless, the Government considered the report in the context of its white paper on employment and growth and the Commission's report provided a focus for continuing public debate on enterprise bargaining and labour force flexibility.

One of the early tasks given the new Productivity Commission was to identify restrictive work practices that added to the cost of doing business. The first of these

reports — on container stevedoring —highlighted the productivity sapping nature of the complex, inflexible and prescriptive work arrangements on Australia's waterfront. The key impediments identified by the Commission were subsequently addressed in waterfront enterprise bargains. Similarly, the Commission's analyses of productivity restricting work practices in coal mining and meat processing were addressed in subsequent decisions by the Australian Industrial Relations Commission and government legislation on the meat 'tally' system.

The Commission has also influenced government policy making on broad labour market issues. For example:

- The Job Network, established in 1998, is one of the first comprehensive attempts internationally to apply market principles to the provision of active labour market assistance to disadvantaged job seekers. The Government credited the Commission's 2002 review as being 'authoritative' and implemented a range of its recommendations but also deferred addressing some key ones until employment services policy further evolved.
- A 2004 Productivity Commission review into national frameworks for workers' compensation and occupational health and safety, identified clear net benefits in creating a national framework, but this was not fully supported by the Australian Government at the time. Nevertheless, it has since set about creating an opt-in nation-wide alternative to State-based regimes.
- And just recently, all Australian governments (through the Council of Australian Governments, COAG) announced substantial agreement with the institutional, regulatory and funding measures the Commission proposed to improve the efficiency and effectiveness of Australia's health workforce and to improve its distribution. In addition, COAG decided that the Commission should be asked to conduct another review in five year's time.

Reforming regulation

Almost all of the matters referred to the Commission for investigation involve some form of regulation. However, an important element of the Commission's workload following the 1995 inter-jurisdictional agreement on National Competition Policy was a stream of inquiries reviewing anti-competitive regulation. Many of these involved economic infrastructure, discussed above, but also included:

- radiocommunications, where the Government accepted most of the Commission's recommendations for reform of radiofrequency spectrum regulation, although it postponed consideration of issuing licences with perpetual tenure and rejected some other recommendations;

- broadcasting, which the Australian Government largely ignored even though the Commission's 2000 report continues to be used extensively in political, media and community debate on foreign ownership of print, radio and television media, cross-media rules and the regulation of digital and analogue television;
- regulation of the architectural profession, where the States and Territories rejected the Commission's preferred option to repeal Architects Acts and remove statutory certification, but supported a range of recommendations to remove anti-competitive elements from their legislation regulating architects; and
- prices surveillance legislation, where the Government accepted the recommendation to repeal the Prices Surveillance Act but decided to retain more extensive price controls and prices in the Trade Practices Act than recommended by the Commission.

In conjunction with these NCP-related inquiries, the Commission has been asked to report on a wide range of other regulatory issues. For example, the Australian Government:

- accepted all of the Commission's recommendations on native vegetation and biodiversity regulation and indicated that it would pursue implementation of them by the States and Territories though COAG processes;
- agreed to implement the Commission's principal findings on building regulation reform through a new intergovernmental agreement on the Australian Building Codes Board and the Building Code of Australia;
- agreed with the Commission's key recommendations in its smash repair and insurance inquiry on the development and nature of a *voluntary* code of conduct for the industries; and
- together with the New Zealand Government, endorsed the Commission's work program to more closely integrate the competition and consumer protection regimes of the two countries.

In addition to its inquiry role, the Commission has within it a separate unit charged with the role of improving regulation making processes. The Office of Regulation Review provides advice to government departments and regulatory agencies on the development of regulatory proposals and monitors compliance with the Government's mandatory requirements for the preparation of a Regulation Impact Statement (RIS) for major proposals affecting business or restricting competition. The Commission reports on these activities annually in its publication, ***Regulation and its Review***. In August 2006 the Treasurer announced that, as part of the Australian Government's new regulatory reform agenda, the Office will have its role and responsibilities enhanced and upgraded and become the Office of Best Practice Regulation. The RIS process is being strengthened, in particular through

greater oversight of and attention to the cost-benefit, risk and compliance cost analysis accompanying regulatory proposals.

Contributing to environmental and social policy formulation

The Commission has a long history of addressing environmental and natural resource issues in its inquiry program. Examples pre-dating the Productivity Commission include reports on mining and mineral processing, fisheries, water, recycling, the discharge of pulp and paper wastes, greenhouse gas emissions, ecologically sustainable land management and urban transport.

The Productivity Commission has continued this focus through, for example, its 1999 inquiry report on the implementation of ecologically sustainable development by Commonwealth departments and agencies — in response to which the Government agreed to integrate ESD principles into decision making and agency reporting and to improve data collection — and its 2003 report on the impacts of native vegetation and biodiversity regulation (noted above). The Commission's report on industries, land use and water quality in the Great Barrier Reef was jointly acknowledged by the Commonwealth and Queensland governments as a valuable contribution to policy development and implementation for what is the world's largest World Heritage Area.

More recently, the Government announced agreement with all of the Commission's recommendations on the private cost effectiveness of improving energy efficiency and that it would work with the States to consider the Commission's findings and analysis. Major reports — on the conservation of Australia's historic heritage; on waste management; and on the feasibility of establishing market mechanisms to provide incentives for greater investment in rural water use efficiency and for dealing with environmental externalities — have only recently been completed and are yet to have a government response. (In addition to its inquiry work, the Commission has a strong research program that has contributed, inside and outside government, to environmental policy development.)

There has been a growing recognition that the economic analytical tools and community-wide focus of the Productivity Commission and its predecessors can contribute to policy issues with important social dimensions. Early examples in this regard include rural adjustment, charities and private health insurance. The Commission's 1997 inquiry into private health insurance, for example, led to changes to regulation which prevented health funds discriminating on the basis of age. Thought by many to be sacrosanct, the Commission showed that it led to adverse selection problems and ultimate inequities, with younger people not contributing to the pool causing premiums for remaining (generally older) members

to spiral up, resulting in further exits. The Commission's recommendations — that people entering insurance late pay higher premiums than those who enter early — were later adopted by the Government.

The Productivity Commission's 1999 report on Australia's gambling industries broke new ground. It provided an analysis not only of the regulatory framework for the gambling industries, but also the social costs and benefits of these industries, including a comprehensive assessment of the extent and impacts of problem gambling. The Prime Minister commented:

> I commend to all people who are concerned to achieve a balance in social policy a careful study of the Productivity Commission's final report … it represents the first really comprehensive analysis of the gambling industry in Australia. I think it's a very balanced attempt to strike the right pitch … I think it makes very interesting and very compelling reading. (Howard 1999, p. 2)

A further recent example of the Commission's contribution to social policy formulation was its 2004 review of the Disability Discrimination Act. The Government subsequently accepted the majority of the Commission's recommendations, including many of the more significant ones.

Through performance monitoring, the Commission also helps governments achieve their social objectives. Since 1993 the Commission has been providing the secretariat to the Steering Committee for the Review of Government Service Provision. The Committee is charged with monitoring the equity, effectiveness and efficiency of a wide range of government services including hospitals, schools, community services and public housing. The annual *Report on Government Services* is widely used by governments at all levels, service agencies and the wider community. It has improved accountability and enabled more analysis by governments and agencies of variations in performance, with consequent benefits in the effectiveness and efficiency of service delivery. Since 2002 the Commission has also assisted in the preparation of the reports *Overcoming Indigenous Disadvantage: Key Indicators*. A key task of this reporting is to identify indicators that demonstrate the impact of programs and policies on outcomes for one of the most disadvantaged sections of the Australian community. The two reports to date are acknowledged within government and among Indigenous leaders as creating the framework in which progress in reducing the disparities between Indigenous and other Australians can be assessed.

Improving the information base for policy making

The Commission's contributions to government policy also encompass those of its analytical and modelling outputs which influence the policy agenda rather than

specific policy outcomes. The role played by the Commission's early use of effective rates of assistance to industry in helping to reshape the tariff debate in Australia has already been noted. The Commission's promotion and use of general equilibrium modelling to demonstrate interdependencies between industries and the importance of taking the indirect effects of policy into account was another means of advancing the reform agenda. Examples of a range of the Commission's contributions include:

- Commission modelling in the late 1980s suggested that across-the-board tariff liberalisation and some other microeconomics reforms could increase Australia's GDP by some $16 billion, or $1600 per household per year (1988 dollars). These headline grabbing numbers proved important in the subsequent successful implementation of reforms.
- In seeking to reach agreement on National Competition Policy in 1995, State and Territory governments expressed concern about whether they would share adequately in the gains from the reforms that they would undertake. As a result, the Commission was asked to quantify the impact of implementing a range of reforms, including the impact on government revenue. The findings of this research reinforced the emerging consensus on proceeding with competition policy reforms, and laid the basis for a fuller understanding of the gains from those reforms and for competition policy payments by the Commonwealth to the States and Territories.
- Claims by opponents of national competition policy that depopulation and other problems in regional Australia were attributable to the policy were examined by the Commission in 1999. The Commission found that longer term factors — including technological advances, changing consumer tastes and lifestyle preferences, and declining prices for agricultural commodities — were primarily responsible and that National Competition Policy should not be made the 'scapegoat'. Further, modelling undertaken as part of the inquiry indicated that NCP was likely to increase net income in all but one region.
- Various streams of Commission research provide analysis and information that help governments both promote the benefits of reform and respond to the critics of reform. The Commission's widely cited analysis of productivity trends and the links to microeconomic reform and the Commission's sophisticated analysis of the role of non-traditional employment in today's labour market are two examples. (See Dee 2005 for other examples of the contribution of Commission modelling to policy impacts.)

After more than two decades of seemingly relentless microeconomic reform, some might have supposed that little more by way of structural policy remained to be done. In April 2004 the Australian Government asked the Commission to review

National Competition Policy and report on further opportunities to remove impediments to efficiency and enhance competition. The Commission showed that productivity and price changes in key infrastructure sectors during the 1990s had increased Australia's GDP by some 2.5 per cent and that the benefits had been widely spread across the community (PC 2005a). But the Commission also highlighted known challenges facing Australia, including the economic and fiscal pressures arising from an ageing population with its implications for workforce growth and public spending on health and aged care (PC 2005b). Notwithstanding improvements to Australia's economic performance in recent years, the Commission's review of NCP pointed to performance gaps in a number of areas where further nationally coordinated reforms could provide substantial pay-offs to the community (Box 4).

Box 4 **The Productivity Commission's proposed agenda from its review of NCP**

- In a number of reform areas, national coordination will be critical to good outcomes. These areas — some of which were encompassed by NCP — should be brought together in a new reform program with common governance and monitoring arrangements. Priorities for the new program include:
  - strengthening the operation of the national electricity market;
  - enhancing water allocation and trading regimes to better address scarcity and negative environmental impacts;
  - delivering a more efficient and integrated freight transport system;
  - addressing uncertainty and policy fragmentation in relation to greenhouse gas abatement policies;
  - improving the effectiveness and efficiency of consumer protection policies; and
  - introducing a more targeted legislation review mechanism, while strengthening arrangements to screen any new legislative restrictions on competition.
- An 'overarching' policy review of the entire health system should be the first step in developing a nationally coordinated reform program for this sector to address problems that are inflating costs, reducing service quality and limiting access to services.
- National action is needed to re-energise reform in the vocational education and training area.
- A future review could identify areas of natural resource management (beyond water and greenhouse gases) where the pay-offs from new nationally coordinated reform could be high.

While reform is important in other areas, including industrial relations and taxation, there would be less pay-off from new nationally coordinated initiatives in these areas.

Source: PC (2006)

COAG drew on the Commission's analysis of the benefits of past NCP reforms and important elements of COAG's new National Reform Agenda reflect the Commission's recommendations and approach. Further, the Commission has been asked to assist COAG progress its reform agenda by reporting by the end of 2006 on:

- the implementation of efficient pricing of road and rail freight infrastructure given concerns that current charging arrangements might be resulting in distorted modal choices and inefficient infrastructure investment decisions; and
- the potential economic and revenue impacts of the National Reform Agenda so as to help governments better understand the scale and distribution of the pay-off from competition, regulatory and human capital streams of reform to which all Australia's governments are now committed.

Conclusions

These observations on the Commission's contribution to government policy should not be interpreted as suggesting that the Commission has been the sole, or even main, driver of trade liberalisation and wider microeconomic reforms. Besides the role of other review bodies — particularly for financial, tax and competition policy reforms — governments and ministers have championed and taken forward the reform agenda. Moreover, as for all such bodies, the Commission's role is informational and advisory. It is reliant on others to initiate much of its work and to consider and implement worthwhile reforms.

Nevertheless, any fair reading of the record shows that the Commission has made a difference to the microeconomic reforms implemented in Australia over the last two decades. The Commission's record in having its findings and recommendations accepted by government is a good one. And while the focus of this paper has largely been on government responses to its reports, the Commission's influence extends much wider. As the Commission's annual reports document, its work is used in policy debate by parliamentarians, government agencies, the media, peak business and community groups, policy analysts and others. The contribution that a body such as the Commission might make in different institutional and policy settings is, of course, something for others to judge.

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