

# 5-year Productivity Inquiry: The Key to Prosperity

## Comment on Interim Report

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This is an important and timely report focusing on an issue that should be central to the consideration of policy reform by the Australian policy community. As would be expected the report is comprehensive and well researched.

Given the above, I was disappointed to note some omissions which have reduced the value and potential impact of this report.

The clarification of what productivity actually means is just as important as an understanding of why productivity is important to the wider community. I am not convinced that people who are not conversant with the literature on productivity measurement will come away from reading this report with a clear idea of what productivity is and how policies and projects should be evaluated to enhance productivity growth.

Perhaps using case studies to explain what doesn't improve productivity growth would have helped.

### ***The Jobs Mantra***

The government sector plays an important part in determining the level of productivity growth through its impact on the operation of the public sector and its own activities in the infrastructure sector. One of the more depressing developments in the infrastructure sector has been the growing emphasis placed on the "Jobs" mantra and the reduced emphasis on formal, or even informal, CBAs. Selecting projects on the basis of jobs created, rather than net benefits, is just not consistent with promoting productivity growth. How could any economist charged with contributing to the direction of the productivity debate not attack the "Jobs" mantra?

We don't live in a post-scarcity world and the careful evaluation of how public funds are spent is important in fostering productivity growth. Surely this is the low hanging fruit in this debate?

### ***Childcare as a Productivity Measure***

Childcare subsidies have become central to the wider productivity growth policy discussion. It is just assumed that any government initiative that encourages more mothers into the workforce through the provision of cheap or free childcare is desirable in part because it will necessarily result in productivity growth. If the PC wanted to clarify the definition of productivity growth and promote a more meaningful policy discussion on productivity growth the childcare issue provided the obvious case.

While it is clearly possible to identify some forms of childcare subsidies that might improve productivity growth it's equally easy to consider cases where subsidies would reduce productivity

growth. By clarifying this, the PC could have enhanced the readers understanding of what productivity growth is and what it isn't. It's an interesting case but it needs unpicking. As it stands it seems just another aspect of the "Jobs" mantra.

### ***Labour Productivity***

Most of the readers of this report will have no idea about the development of the productivity literature over the last 50 years. They will not be aware that in the 1970s and 1980s many micro economists, including many at the PC, played a role in shifting the policy debate away from Labour Productivity to TFP or MFP. This debate had no impact on Macroeconomic analysis of productivity but there was a big change in how productivity growth was measured and analysed at a firm and industry level. There was a general movement away from the measurement of Labour Productivity because it was widely held that measured Labour Productivity had little relationship with the productivity of labour or the overall productivity trends in an industry.

In this report the PC seems to have turned the clock back to the 1960s and they have done so without an adequate discussion of why they have done so.

The PC suggests that Labour Productivity is an "intuitive" way of measuring productivity growth. Yes, but then protection to the TCF sector has always been an intuitive way of promoting growth in Australia.

At an intuitive level productivity growth is important because it shifts out the national PPF. Changes in Labour Productivity need not do that. Moreover, changes in Labour Productivity provide no reliable guide on changes in the productivity of labour.

The discussion of the role of Capital Deepening does not redeem Labour Productivity as a policy guide. If anything it just shows why we should not be using it as a measure of the productivity of labour and why TFP makes more sense. While I can see how the rehabilitation of Labour Productivity through the idea of capital deepening might make sense in terms of why Labour Productivity grows, I am not convinced it makes the measure any more meaningful in terms of the current debate around productivity growth and incomes.

The only way the analysis of Labour Productivity makes any sense is if you redefine labour productivity to not be a measure of the productive contribution of labour to the production system.

I can see that there is a problem for the PC when the wider community has invested so much meaning and importance in the concept of Labour Productivity. But the decision to try to rehabilitate the term doesn't come without a cost. Confusion in language and misunderstanding about systems does not improve the policy process. The fact that in parts of this report the terms productivity and labour productivity are used interchangeably shows the confusion. The general community also has great faith in the idea of Value Adding as a policy principle as well. I assume the PC is not about to embrace Value Adding as a policy framework for mining and agriculture even if it is intuitive and widely supported?

At an intuitive level it is worth noting that few firms assess their productive performance using Q/L ratios and not many concepts gain meaning in aggregation.

At a more technical level, the use of labour productivity as a performance measure amounts to tracking movements along one dimension in a multi-dimensional production space without considering the causes for the movements. This must be a problematic exercise at best.

Partial productivity measures have been widely used in the past in many industries. For example in the 1960s and 1970s it was common to see local and international comparisons of agricultural productivity based on estimates of output per acre. On this basis hopelessly inefficient agricultural systems in Europe were assessed as many times more “productive” than their Australian equivalents. Similarly, intensive high rainfall systems in Australia produced higher “productivity” or yield scores than more extensive systems in drier regions. No one with any background in these industries gave these numbers any credence as they did not relate to relative profitability or international competitiveness.

In a time series context every farmer knew they could increase yield (and potentially reduce profits) at anytime by simply adding more fertiliser or buying in more livestock fodder. And every government knew that the easiest way to increase output per acre was by lower input prices to farmers through production subsidies, not through slow and risky R&D. TFP became the dominant measure of productivity and farm profits the preferred measure of overall farm performance because they made practical industry sense and conformed to concepts of modern production economics. I suspect the use of labour productivity by the PC and others is no more meaningful than the use of output per acre in 1960s agricultural comparisons.

Because a measure is easy to calculate, has a meaningful name, and the wider community think they know what it means because it is intuitive, doesn't make it a useful guide to either policy or production.

### ***Defining Productivity***

In parts of this report there seems to be a tendency to define concepts like Productivity and Labour Productivity to be interchangeable terms. I think this is misleading – or at least it should be if your argument is conceptually sound. Getting terms right is about structuring the debate.

There is also a tendency in this report to define concepts in terms of how they are measured. How we define a concept and how we measure it are often very different things.

I suggest that the wider policy community thinks labour productivity is all about the productive contribution of labour to production. They think it's about the contribution an additional worker makes to production. They think it reflects workers working smarter or harder. But they also think it's measured as Q/L.

They think it's measured as Q/L because they don't understand the difference between the average and marginal product of labour. They don't understand the the motivation for, or impact of, capital labour substitution on the marginal product of labour.

By embracing a 1960s view of productivity the PC has not clarified much.

### ***Services Sector as Sources of Productivity Growth***

When considering the scope of for productivity growth it is fashionable to point to the limited scope for productivity growth in the services sector. I wonder if this is well founded?

At least some attempts at the measurement of productivity growth in the services area have floundered on an adequate measurement of output. Quality is just as important in the services area as it is in the goods sectors. The failure to measure TFP doesn't mean it doesn't exist and Government policy in this area is about creating productivity growth, not measured productivity growth.

At an anecdotal level I find it hard (impossible) to imagine that the authors of this report could not think of ways the PC could enhance its performance with a substantial cut in its budget. Similarly, most academics I know are fully aware that there are massive gains that could be made in the University sector. Perhaps the wider services sector is different to these two cases?

### ***The Bottom Line***

In conclusion, I think the contribution of this report should be seen in terms of how it educates the policy community on the fundamental issues surrounding policy aimed at enhancing productivity growth. If after reading this report people still endorse and accept the "Jobs" mantra and see nothing wrong with claims that childcare subsidies will always improve productivity, the report has under-achieved. And if the reading of this report results in someone from the Treasurer's Office advocating for capital equipment subsidies to drive "labour productivity" the report may well have been counterproductive.