

# Australia's Cost of Living Challenge

## Opening Statement, Public Hearing, Senate Select Committee on the Cost of Living, 23 June 2023

### Alex Robson, Deputy Chair, Productivity Commission

Thank you for the invitation to appear before this Committee and for the opportunity to make an opening statement.

Over the last century, Australia's aggregate labour productivity – measured as output per hour worked – has increased significantly. Our main message today is that improving labour productivity growth is a key piece of the cost of living puzzle.

#### Productivity growth: What is it?

For example: in 1901, buying a bicycle cost the typical Australian 473 hours – several months – of work effort. By 2019 the cost had fallen to just 6 hours of work effort. That is close to an 8000% increase in labour productivity. It is a massive reduction in the cost of living, expressed in terms of the purchasing power of a typical hour of work.

This simple example demonstrates that lower costs of living are an important dividend of productivity growth. Other benefits include improvements in the quality of goods and services, and the invention of new goods and services.

The productivity growth dividend includes everything from a shorter working week to lower rates of absolute poverty, and better health outcomes – just to name a few. Productivity growth by itself may not have been a proximate cause of some of these changes. But it has certainly been an important enabling factor.

Productivity growth also drives growth in the social real wage – it leads directly to improvements in the delivery and quality of government services that Australians rely on. And, by growing the size of the economic pie, it helps fund these services.

#### Productivity growth: What it is not

Productivity growth is ***not*** about working harder, working longer, or working for less. That is not a recipe for sustainably reducing the cost of living.

Australians have a very strong work ethic – but the labour cost of buying a bicycle didn't fall by 8000% over the last century because we worked harder, for longer, or for less. It happened because we worked smarter – through greater investment in human and physical capital, improved manufacturing efficiency, cheaper energy, better materials and mass production, and the rise of global trade.

We found better ways of using the resources at hand; we pushed out the economic frontiers; and we diffused the fruits of human freedom and ingenuity broadly. The dividend of working smarter was higher – not lower – real wages. And it enabled a move to fewer – not more – working hours.

The close association between productivity and the purchasing power of labour – that is, real wages – is not a random coincidence or statistical artifact. In Australia, almost all sustained increases in real wages have been underpinned by improvements in labour productivity growth.

## The productivity slowdown

I emphasise all of this because Australia's aggregate productivity growth has been slowing for some time. Our productivity challenge is urgent, and it has been urgent for many years. We can and must do better.

Over the decade to 2020, our average annual labour productivity growth was the slowest in 60 years, falling to 1.1%. Several other advanced economies have also experienced a productivity slowdown. Over the year to March 2023, labour productivity slumped, falling by 4.6% – the weakest labour productivity growth on record.

But the fact that other advanced economies are also experiencing productivity slowdowns does not mean we should ignore it. On the contrary, sluggish global productivity growth means that it is more important for us to tackle the sources of our own slowdown.

When the global productivity frontier is shifting out at a reasonable rate, Australia can, to some extent, 'piggyback' off this growth. However, when global productivity growth slows, that option is no longer available.

More of any improvement in our living standards must come by narrowing the gap between our own productivity and the global best-practice frontier. In other words, rather than being an excuse for doing less, the global productivity slowdown likely means we need to do more.

And given what we know about the links between productivity, real wages, and the cost of living, it is reasonable to expect that should Australia's productivity slowdown continue, we will get more of the same: further upward pressure on the cost of living; tighter household budgets and more families struggling financially; continued sluggish real wage growth; and slower increases in living standards over time.

A separate but related issue is Australia's current inflation rate of 7% which, as the Reserve Bank of Australia has noted, is far too high. Inflation has its own supply-side costs, and it is reasonable to expect that continued high inflation would itself place downward pressure on productivity growth.<sup>1</sup>

Unanticipated inflation redistributes income and wealth; it distorts decisions to consume, borrow and save; and to the extent that it masks changes in relative prices, it distorts investment, production and consumption decisions.

Even if it is fully anticipated, high inflation can create economic costs. But as important as our current inflation challenge is, even when that problem is solved, we will be unlikely to enjoy

---

<sup>1</sup> See, for example, McTaggart, D (1992) 'The Costs of Inflation in Australia', in Blundell-Wignall, A (ed) *Inflation, Disinflation and Monetary Policy*, RBA Conference Volume, Sydney; and Brialt, C (1995) 'The Costs of Inflation,' *Bank of England Quarterly Review*, Q1, pp. 33–45.

sustained future increases in the real purchasing power of work if we fail to address the productivity slowdown.

## Advancing Prosperity

This leads me to the findings and recommendations of our recent report, *Advancing Prosperity*. The report sets out a comprehensive policy agenda, prioritisation framework and implementation roadmap for meeting and overcoming our productivity predicament.

While the report focuses on services, it does not ignore the goods sector or take it for granted. The goods sector will continue to be an important driver of Australia's future productivity growth and prosperity, led by our mining and agricultural sectors – both of which are highly productive.

But the solution to our productivity challenge is unlikely to involve pushing back against the tides of economic progress and trying to pick winners in the goods sector.

And there are other headwinds which should not be ignored, such as the productivity impacts associated with climate policy and the costs of adapting to climate change and extreme weather events. Those costs are and will be very real, and policy should strive to minimise them, while achieving our abatement goals.

The continuing rise in global trade barriers represents another big headwind. A key priority, though, is to understand this phenomenon of lagging productivity growth in the services sector; position our policy settings accordingly; and ensure that policy remains fit-for-purpose and enables Australians to take maximum advantage of economic upsides and minimise downsides.

That is exactly what *Advancing Prosperity* sets out to do. Our policy recommendations fall into five general areas:

1. Building an adaptable workforce to supply the skilled workers for Australia's future economy.
2. Harnessing data, digital technology and diffusion to capture the dividend of new ideas.
3. Creating a more dynamic economy through fostering competition, efficiency and contestability in markets.
4. Lifting productivity in the non-market sector to deliver high quality services at the lowest cost.
5. Securing net-zero at least cost to limit the productivity impact caused by climate change.

We note that the Government is addressing, in some form, many of the report's 29 policy directives.

Several of the report's 71 policy recommendations – together with other work that the Commission has undertaken – are relevant for so-called essential goods and services, some of which this Committee has focussed upon in its interim report.

The Australian Bureau of Statistics notes that these essentials are purchased because they 'meet a basic need (food, shelter, healthcare), are required to maintain current living arrangements (car maintenance, school fees), or are a legal obligation (compulsory insurance, stamp duty).'<sup>2</sup>

Purchases of essentials are likely to be less responsive to price changes, as there are few close substitutes. Thus, when the prices of these goods rise, households are exposed to relatively large reductions in wellbeing.

<sup>2</sup> ABS (2021) 'Measuring Non-discretionary and Discretionary Inflation', 25 May, <https://www.abs.gov.au/articles/measuring-non-discretionary-and-discretionary-inflation>

## Where to next? The nature of the challenge

Let me conclude with five points about the nature of Australia's cost of living challenge which, as I have set out, is a productivity challenge.

The **first point** is the power of compounding: big one-off jumps in productivity levels are great; but when it comes to *growth rates*, *small* changes over *long* periods of time can matter even more.

Consider, for example, an optimistic scenario in which productivity grows at 1.8% per annum over the next 40 years. At the end of that period, compared to today, the increase in average annual incomes would be around \$59,000. But if productivity growth turns out to be slower – increasing at 1.2% per annum over the same period – then the average annual income gain would be just \$36,000.

So over long periods of time, a seemingly minor slowdown in productivity growth can add up to a significant downgrading of the expected growth in future living standards – 40% in this hypothetical example. And, conversely, seemingly small increases in the pace of future productivity growth will add up to a lot over time.

The **second point** is that although labour productivity growth can, in a purely accounting sense, be broadly decomposed as the change accounted for by capital deepening (that is, investment) and the change due to multifactor productivity growth (for example, improvements in technology and knowledge) the decomposition should not be thought about in a purely mechanical way.

In modern, market-based economies, new ideas and new ways of doing things – and the application of old ideas in new situations – have a funny way of popping up where we least expect them. Some productivity gains even happen by accident.

So, we cannot know for sure where the next big productivity boost will come from, or exactly what it will look like. Will it be in particular industries? Or will it be widespread, such as through a general-purpose technology like AI? Will it be gradual or sudden? Will it be temporary, or will it be permanent?

Or, using the terminology of respected economist Arnold Harberger – will it be like yeast, or mushrooms?<sup>3</sup> We cannot know for sure ahead of time. So the right policy approach is not to seek to mechanically lift productivity growth by a specified numerical amount.

The **third point** is that while we don't know exactly where the next productivity surge will come from, we do know where to start looking.

When productivity growth in some sectors *consistently* lags growth in others, the progressive sectors tend to get smaller as a share of the economy, as their relative costs come down. And lagging sectors, whose relative costs rise over time due to lagging productivity growth, tend to grow as a share of the economy.

Australia is a case in point. On average over the past 35 years, productivity growth in the goods sector has been higher than in most parts of the services sector; and the goods sector has been shrinking in relative terms. Our services sector now employs almost 9 out of 10 workers and accounts for about 80% of economic output. So it is an obvious place to start looking.

---

<sup>3</sup> Harberger, A (1998) 'A Vision of the Growth Process', *American Economic Review*, Vol. 88, No. 1, pp. 1–32

---

The risk is that this so-called cost disease<sup>4</sup> and weak productivity growth in the services sector will create an ever-growing drag on future overall productivity growth. A further point is that productivity growth in these services sectors can be difficult to observe and measure.

In non-market services, incentives for providers to use inputs efficiently, maintain quality and be responsive to the needs of customers are either absent, weak or distorted. There are known ways of improving services, as we have discussed in both *Advancing Prosperity*, its predecessor *Shifting the Dial*, and other Commission work, such as our reports on chronic disease, public infrastructure and human services.

Diffusion of good or best practice would enhance service quality and lower costs across almost all areas of government provision. In some instances, exposing these sectors to greater contestability and market pressure can be an important catalyst for productivity growth – as we found in some areas of human services. Where this is not possible, it is important to try to replicate their effect through better funding models that address weak incentives for cost and quality improvements (a perfect example being reform of funding models for primary and secondary care).

A **fourth point** is that it would be inadvisable to believe that we can introduce poor policy in some areas, pull a couple of 'good' policy levers in other areas, and hope to magically change the aggregate productivity growth situation. Possible in theory, but unlikely in practice.

Improving productivity growth requires consistently applying a productivity lens across the broad policy landscape. Granted, it is not the only lens. But it is an important one.

**Finally**, applying a productivity lens consistently to the broad policy landscape *does not* mean doing everything all at once. Prioritising change, thinking about its complexity and the materiality of its impacts, and the proper sequencing of reforms are all very important practical issues – which our *Advancing Prosperity* report acknowledges and explores in some depth.

---

<sup>4</sup> Baumol, W (2013) *The Cost Disease: Why Computers Get Cheaper and Health Care Doesn't*, New Haven: Yale University Press.