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# Micro Reform's Productivity Payoff\*

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Australia was labelled a 'miracle' economy in the 1990s. It withstood the Asian financial crisis to experience strong, sustained economic growth – the best since the 1960s and early 1970s. But this was no miracle. The good results were the outcome of deliberate policy reforms, rather than mere good fortune.

Australia's improved performance was underpinned by a surge in productivity growth. The 1990s saw the longest period of continuous positive growth in productivity on record (nine years) and the strongest underlying rate of productivity growth (about two and a half times the previous average).

In other words, over this period our ability to produce goods and services from our available resources was raised to an unprecedented extent. This was reflected in higher growth in average incomes – a cumulative increase averaging about \$7000 per household.

Unlike the 1960s and 1970s, Australia's 1990s performance was not part of a world-wide productivity boom. Australia was one of only three countries to experience a strong acceleration in the 1990s (chart). Moreover, it started earlier and was stronger and longer than the much-vaunted productivity acceleration in the US economy. Clearly, some peculiarly Australian factors were at work.

Careful analysis of the possible reasons for this transformation virtually eliminates any explanation other than the extensive economic reforms of the 1980s and 1990s. Better macroeconomic management brought a more stable and predictable climate

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for investment and production decisions. But microeconomic reforms were the real key to Australia's productivity boom.

While some analysts initially resisted this conclusion, it is now generally accepted (including by the OECD). It should not have been so hard to accept. After all, the microeconomic reforms were designed to raise Australia's productivity growth. They did this by sharpening incentives to be more productive (through removing unnecessary barriers to competition and trade) and by allowing businesses greater flexibility (for example, through enterprise-based work arrangements) to adjust to the demands of greater competition and to take advantage of new developments in production methods and product markets.

These links are readily apparent in some cases. Productivity growth first took off in the 1980s in industries such as Communications and Electricity, gas & water (chart). Some technological advances were at work, but the improvement had a lot to do with the more commercial focus that came with reform of government business enterprises. There was also relatively strong performance in this initial period in the traditional sources of productivity growth – Agriculture, Mining and Manufacturing.

However the real productivity surge through the 1990s originated from some new and unexpected contributors in the services sector – especially Wholesale trade, but also Finance & insurance and Construction. The links to policy reforms were not as readily apparent in these sectors. But they were nevertheless there.

A feature of the new industry contributors has been their rapid uptake of information and communications technologies (ICTs). Australia's overall uptake of ICTs in the 1990s was stronger than in most other high-income countries. The greater competitive incentives helped transform Australian firms from technology laggards. But technology uptake alone is not sufficient to generate large productivity gains. ICTs are 'enabling' technologies that provide a platform for introducing other productivity-enhancing innovations. These depend on the ability of firms to make complementary investments and organisational changes. And it is in this area that microeconomic reform has played a key role.

Taking the case of Wholesale trade, businesses have used ICTs as part of a process of transformation from storage-based to fast flow-through systems, where distribution can be managed much more efficiently with bar-code and scanning technologies, and paperless picking and inventory management systems. These gains did not just happen. For a start, the incentives for improvement were heightened by greater competitive pressures in product markets. (For example, the automotive industry sought efficiency gains along the whole value chain, including in wholesaling, in response to cheaper motor vehicles entering the country as tariffs

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fell.) But the precondition for realising the necessary changes in the wholesale sector was the greater enterprise flexibility and autonomy that had come from reforms in labour regulation, including through the introduction of split shifts and reduced demarcations.

The 1990s productivity surge peaked in 1999-00. Does the decline in the following year herald the end of stronger productivity growth, as has been suggested?

I think not. Multifactor productivity declined in 2000-01 as the economy slowed (hours worked declined slightly, but measured capital input continued to grow). Beyond these cyclical effects there are grounds for optimism about the longer-term outlook for productivity growth. For one thing, the heightened incentives and disciplines for improved performance are not temporary. The reduction of barriers to competition and removal of impediments to innovation can be expected to have lasting effects on the dynamism of our economy. And, to the extent that the economy has become more flexible and adaptable, its capacity to deal with any future external shocks and to benefit from technological advances (including e-commerce) will have improved.

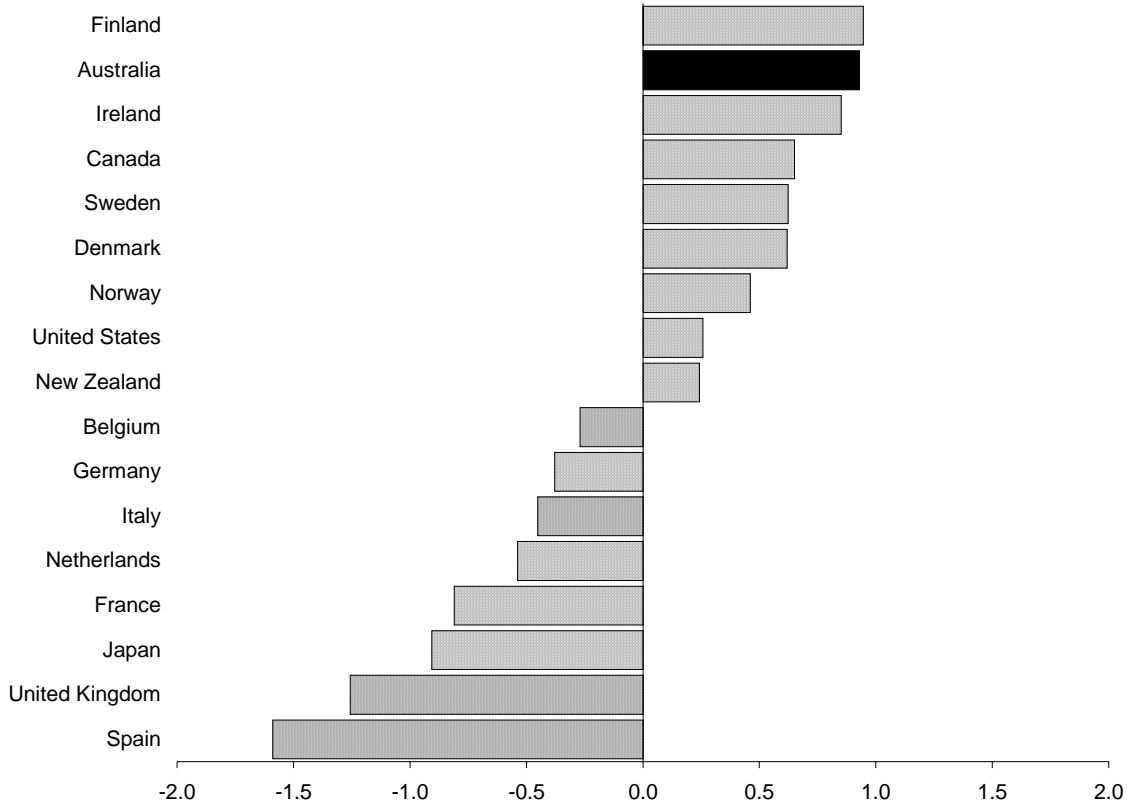
But we shouldn't be complacent. The recent experience underlines the importance of not only sharpening the incentives for enterprises to do better, but also enhancing the capacity of firms to innovate and adapt to change. IR reforms have been central to this and will remain very important. However our ability to continue performing well will increasingly depend on the innovativeness and analytical skills of people in the workforce and management alike. That in turn will largely depend on the quality and effectiveness of our education, training and research systems. Ensuring that those systems work well is therefore one of the key challenges in sustaining our productivity growth and living standards in the future.

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## Trend MFP growth

Average annual percentage change from 1980-90 to 1990-99

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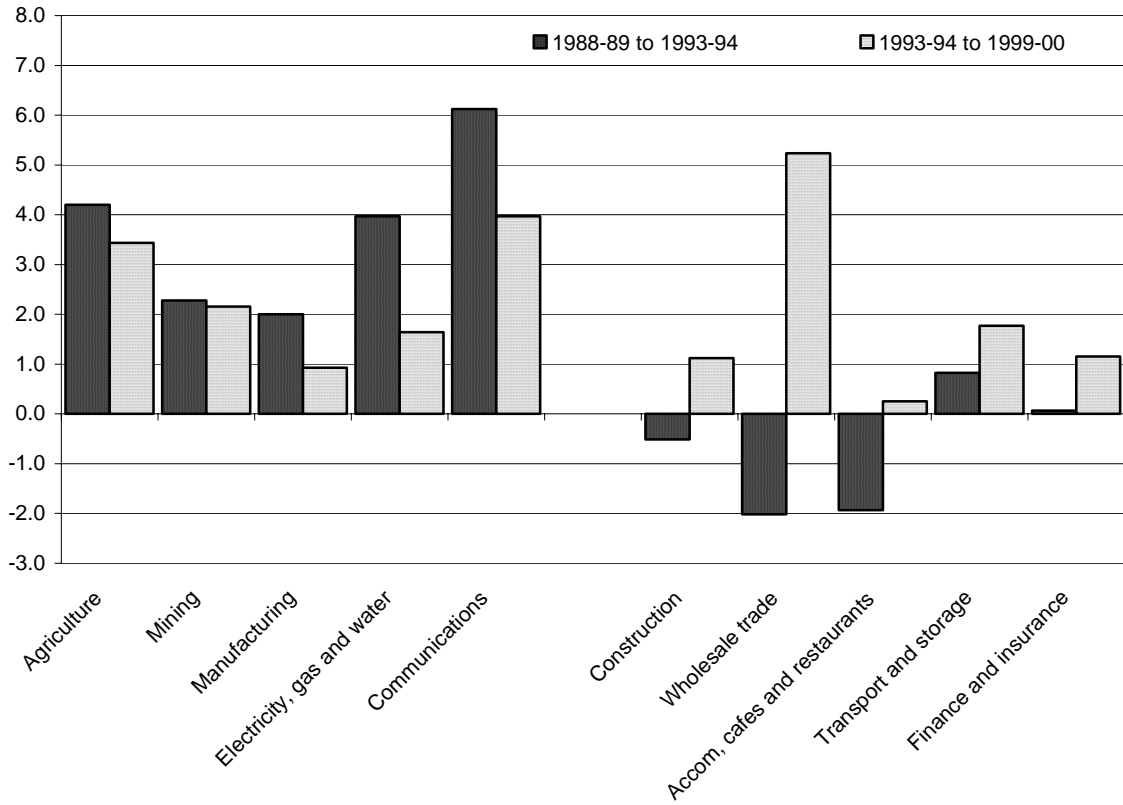
Source: OECD

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## Industry MFP growth over two productivity cycles

Percent

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Source: Productivity Commission