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# Economic Knowledge and the State

## **Economic Knowledge and the State: past, present, future Symposium, ANU, Canberra, 12 December 2019**

### **Michael Brennan, Chair**

First, thank you to the ANU and the Academy of Social Sciences, and congratulations on identifying the theme we are exploring today: namely the status of economic knowledge in Australian statecraft.

As you know, I am a product of ANU Economics and come most recently from the Treasury. I now represent an agency which traces its lineage back to the Tariff Board and which has been prominent in the big economic reform debates of the last fifty years.

Maybe predictably, I will contend that:

- the influence of economics on policy in Australia, particularly since the early 1980s, has been largely positive (if not unqualifiedly so)
- the economics profession can have ongoing positive influence, but will need to adapt to meet Australia's policy challenges
- and that, as economists, we need to be alive to the shortcomings and misapplication of economic prescriptions.

I will talk about how we at the PC address complex real world issues, often but not always using a basic economic framework.

But let me start with my case for the defence: productivity growth has done wonders for Australian living standards.

Average incomes in Australia today are 7 times higher than they were in 1900. To give you a tangible illustration of what this means, in 1900 we estimate that it would take an average worker over 500 working hours (a couple of months) to earn enough to buy a bicycle, which was then a staple form of transport.

For an average worker in the 21st century, it would take about a day. And of course, in 1900 you couldn't buy anti-biotics, air-conditioning or a refrigerator.

Obviously I don't claim that this extraordinary growth is due to the economics profession. I mention it only to emphasise that the dividend from economic progress is not trivial, lest anyone want to dismiss continued productivity growth as a worthwhile policy goal.

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But policy does play a role.

Our path to prosperity has been disjointed and unorthodox — initially with a policy of trade protection, centralised wage fixing and product market regulation, followed by a substantial liberalisation of the economy from the 1980s on.

In the post war period, Australia's per capita GDP went from being nearly \$6,000 above the OECD average in 1950, to below the average in 1990.

That is partly due to the comparator — several OECD nations converged rapidly towards US living standards in the post war era.

But there is no denying that Australia's relative fortunes have improved since 1990.

Over that 30 year period, our real per capita GDP (that is, excluding population growth and terms of trade effects) has out-performed all of the G7 economies, and our incomes have risen back to being well above the OECD average.

This is for a range of reasons, not least of which was avoiding a recession during the Global Financial Crisis.

We have among the strongest fiscal positions and the most redistributive tax transfer system in the OECD — helped by two Aussie inventions: compulsory superannuation and the income-contingent loan.

By virtue of that tax transfer system and the progressive impact of in kind services (like health and education), income inequality in Australia has changed very little over the last 30 years.

Australians' average net wealth is high and wealth inequality is low by OECD standards. Our life expectancy is high, for a health spend that is modest as a share of GDP. We face neither the fiscal and demographic problems of the Eurozone, the inequality of the US or the stagnation of Japan.

I don't for a minute claim that all of Australia's recent success can be attributed to the reforms of the 1980s and 1990s — that is a complicated question on which professional opinions will differ.

But given the central tenet of the symposium — that economics has had an authoritative status in Australian policy making — there are some grounds to give the economists at least a tentative tick.

Has every economic policy prescription worked? Of course not.

There have been market-based approaches which haven't worked; policy fads that have come and gone and a few economic concepts which to this day are arguably misapplied.

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Also, for all the data and computing power we now have, I doubt you could say that economists' predictive powers are any better than they were 50 years ago.

So the role of economic knowledge is not, and should not be, unchallenged.

The test for the economics profession is to help meet the challenges that policy makers now face. I'll mention three: low productivity growth, complex disadvantage and trust in institutions.

### Productivity growth

Productivity growth sounds arcane until you see the historical relationship between it and real wage growth (when deflated by producer prices, or a real GDP deflator).

Slowing productivity growth is a global phenomenon, and you will be shocked to know that economists can't agree on the precise cause.

Lower capital investment is playing a role: in Australia the historic contribution to productivity growth from capital deepening has stalled in the last two years. Heightened risk aversion, population ageing and a slowing in technological discoveries are also nominated as potential suspects.

Suffice to say there is no present evidence of the mass automation of jobs or tasks that we so often hear about. Quite the contrary.

This does suggest that for all the success of past waves of reform, the future economic policy agenda will necessarily look a bit different. And it won't be helped by nostalgia or pessimism.

Forty years ago when economists surveyed the scene, they could see substantial allocative inefficiencies in the Australian economy — due to high trade protection, a large government owned business sector and regulated product and factor markets.

Today there are *some* areas of allocative inefficiency — in selected markets like energy or superannuation, and due to specific policy measures like stamp duty or restrictive land use planning.

But it is likely that the bigger challenge for the Australian economy today is one of dynamism: the capacity to generate new ideas, products, business models, production techniques and diffuse them quickly through the economy.

Treasury has done detailed empirical work based on firm level data to suggest that the dynamism of the economy — as measured by net new business entry and the rate at which workers switch jobs — has slowed.

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One challenge for the economics profession is that it deals more easily with problems of resource allocation than of dynamism.

The staples of comparative statics – the partial equilibrium diagram or the CGE model — are useful analytic tools, and can even provide an order of magnitude about the potential benefits from different reform options — so long as they aren't taken too literally, especially for welfare analysis.

Dynamism, and the policies that might contribute to it, are much harder to model. They aim to foster economic progress partly through increased entrepreneurship, the generation of new products and new business models.

At the PC, we think the introduction of the Consumer Data Right is an important reform which the Government has adopted. So too, boosting human capital through skills formation or improved health can have an economic dividend.

And economists are re-connecting with geography, to understand the mysterious but very real spill-over effects of agglomeration, particularly in large, dense cities.

Which is why we feel that zoning, stamp duty, road user charging, public transport reform and quality infrastructure provision are vital elements of a contemporary reform agenda.

One of the hardest business models to change is that of the public sector, which brings me to my second challenge, that of entrenched disadvantage.

### Entrenched disadvantage

I mentioned that measured inequality has not changed much in Australia over the last 30 years. That reflects the role played by government policy. The combination of the tax transfer system and in-kind benefits roughly halve the measured Gini coefficient. It's a reasonably effective system as far as it goes.

However, our research notes that there is a group of Australians who experience prolonged and multi-faceted disadvantage. And for them, the industrial technology of transfers and universal service systems might be necessary, but isn't sufficient, to provide upward mobility out of poverty.

More often, the traditional modes of service delivery are not fit for purpose.

Can economics offer insights into these issues?

I think the answer is a tentative yes, but only if the right mindset is brought to bear.

Right now, we are doing work on children's and family services in the Northern Territory, bringing us into contact with some of the most disadvantaged Australians. In this policy area,

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for all the good intent, it's fair to say that collectively government has not covered itself in glory.

We found that between them, the Commonwealth and Northern Territory Governments spend about \$538 million per annum on a range of services aimed at helping families and protecting children, but they do so through 9 different agencies, 700 grants and 500 service providers.

They make these funding decisions in relative isolation, leading to fragmentation, inefficiency and a good deal of confusion on the ground.

For the PC, in dealing with the complexity of this issue we have learned — and unlearned — a great deal. We quickly saw that any attempt to neatly define the respective roles of the Commonwealth and the NT Governments, and recommend a strict separation, would fail.

The subsidiarity principle is a good one, but can't be applied rigidly in all cases.

We also saw the challenges of evaluating policy and programs on the ground, particularly when there are multiple interventions occurring in parallel, say in a remote indigenous community.

So our focus was on trying to come up with practical measures to get two governments (and multiple departments), NGOs and communities to develop coherent local plans, an agreed service mix and shared accountability.

It's also an example of where the Commission's thinking has evolved over time.

20 years ago, we would most likely have recommended greater clarity in contractual arrangements between government and NGO service providers to specify and ensure clear accountabilities.

In our draft report, we have gone the other way — longer contracts, with more flexibility and greater emphasis on the relationship between funder and service provider, to deal with unforeseen issues as they arise.

That's still motivated by an economic frame — you could see it as a recognition of Coasian transaction costs — but it takes us in a different direction.

The draft report and recommendations are out there, so we will see how different parties react. It's not simple.

## Trust in institutions

The third challenge I mentioned was trust in institutions and expertise.

There is little doubt that the GFC led to greater scepticism of experts in general and economists in particular.

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Also some scepticism about market based solutions, and in some countries, a question as to whether public policy had favoured certain interests over others.

Can economics play a role in addressing these issues?

A first step is much greater humility on the part of the profession about what we know and what we don't.

Theoretical models with the in-built assumption of optimising agents often have some predictive power, but they only go so far. It is always dangerous to identify a stylised equilibrium as being the desired end point of a policy.

It's also important to complement theory with a real world understanding of what motivates individuals. There are instances where market competition has not worked as intended, sometimes due to naivety in market design.

Of course the opposite can also be true — we sometimes naively assume that certain markets must fail, whereas in real life, people develop their own bottom up approaches and institutions to deliver public goods, manage common resources and address externalities.

Markets tend to work best when we can put the consumer genuinely at the centre of things.

Our biggest problems have emerged in those faux markets where producer interests have come to dominate — either because government subsidies are channelled through providers rather than service users, or because weak competition or consumer disengagement have given rise to complacency and monopoly rents.

Just as we should encourage dynamism through productive entrepreneurship in private markets, we should work to remove the destructive entrepreneurship of rent-seeking.

Economists have a role to play in that, given that rent-seeking is driven by incentives, and some of those incentives are embedded in market design.

Business also has a role to play by advocating for good general economic policy, rather than specific measures aimed at individual preferment.

My view is that markets and competition, with a strong consumer focus and reinforced with appropriate regulation, remain a strong antidote to monopoly rents.

In particular, consumer choice and empowerment should continue to be a central element in policy development, so long as evidence of real world motivations and interactions is also brought to bear.

## Commission snapshot

I want to finish with a snapshot of some of the work the Commission is doing, as it reflects the changing focus of policy, and the range of contexts in which we are involved.

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In addition to the work on children's services in the Northern Territory, in the last year we have produced reports on superannuation, the Murray-Darling Basin, veterans' policy, airport regulation, mental health, transport safety and the (regional) zone tax offset.

In some of these, our analysis employs a fairly conventional economic framework. For example, in analysing the zone tax offset, we can start with some general public finance principles and then test those against the real world evidence — both quantitative and qualitative.

In an area like superannuation, we can think of it as a market, but with a specific set of regulations, incentives and its own historical norms.

Some things are unsurprising to an economist, such as the level of consumer disengagement that exists with what is essentially a compulsory product.

Other things can seem surprising on the surface, like the fact that the default market appears to out-perform the choice market. All of which underscores the need to invest heavily in the real world evidence and when in doubt, give it primacy over the theory.

With mental health, our analysis started with that well-worn economic tendency: trying to quantify the costs of mental ill health on the economy and on well-being (two different things).

Such quantification exercises are, by their nature, imprecise. But in the case of mental health, they allowed us to demonstrate a very salient feature: namely the reason why the measured cost of mental ill health is so high is that (relative to physical ill health) it affects a younger cohort — people with a lot of life ahead of them.

From there, the analysis really follows what one could describe as a general public policy framework, with a focus on incentives, the different types of funding models in place and their effects, and the experiences of practitioners and users of the system.

We don't bring any pre-determined view as to public vs private provision, or what 'market' structures would work best.

Our priors could broadly be summarised as a primary focus on the users of the system, the need for caution in advocating significant change, the desirability of pilots and thorough evaluation and an overall desire to see good outcomes delivered cost effectively.

So, as you can see, a lot of our work has us in unfamiliar terrain.

We need to marshal qualities like rigour, a systematic approach to gathering evidence and an ability to know when the basic applied microeconomic framework applies, and when it doesn't.

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So in summation, I would say the role of economics in Australian statecraft has been a qualified success, and can continue to have a positive influence, if accompanied with humility and good judgment.