Economic Reform and Growth in Australia

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Abstract

The Australian economy has performed well over the past decade, with average growth of 4 per cent a year. It has also become substantially more flexible and resilient to domestic and international adverse events or 'shocks'. This is in large part due to the wide-ranging structural change and reform that Australia has undergone in the past two decades. These reforms have demonstrably raised economic growth and living standards in Australia. The reform process has been difficult and controversial but it was facilitated by having independent and credible institutions which were able to set out the benefits of reform and provide advocacy for reform. The process of reform is ongoing and further deep reform is still required. As in the past, being actively engaged with its partners in the region and beyond will be important in ensuring that Australia can meet this challenge.

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1. Overview

The Australian economy has performed well over the past decade. Growth has averaged 4 per cent a year over this period at a time of great shocks to, and instabilities in, economies elsewhere in East Asia and the rest of the world. At the same time, Australia has undergone widespread and substantial structural reform and change over the past two decades. The argument of this paper is that these two outcomes are not unrelated.[1]

This argument has been widely acknowledged internationally. For example, in its most recent survey of the Australian economy, the OECD (2003: 9) noted that:

> Dogged pursuit of structural reforms across a very broad front, and prudent macroeconomic policies firmly set in a medium-term framework, have combined to make Australia one of the best performers in the OECD and also one notably resilient to both internal and external shocks.

Structural reform in Australia has covered many, if not all, aspects of economic behaviour and interaction. They include: deep reductions in tariffs; the removal of exchange controls and floating of the exchange rate; the deregulation and liberalisation of the financial sector; an expansion and diversification of labour migration; labour market reform and deregulation; the development of a national competition policy; governance reform; tax reform; reform of the system of financial supervision; and the introduction of medium-term frameworks for monetary and fiscal policy.

These reforms have had a radical effect on the structure of the economy and on the way that the economy has performed. They have made the economy much more internationally open than it was before. They have made the economy more flexible and resilient to domestic and foreign based 'shocks', disturbances or adverse events (like the Asian financial crisis), as well changing the nature of the shocks that affect the domestic economy. And they have lifted productivity growth in the economy, which means faster economic growth and higher living standards for Australians.

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[1] Pusey (1991), Dutta and Heininger (1999) and Jones (2000) take a critical view of the reform process in Australia.

The paper focuses primarily on the substance of these reforms and the process by which they have been implemented. It also looks at some of the benefits that they have provided to the Australian economy and society. The challenge now is to continue the domestic reform process: continuing engagement with its partners in the region and elsewhere is an important part of doing this.

2. The Substance of Economic Reform

There has been deep and wide reform of the Australian economy over the past few decades. These cover most areas of economic behaviour and interaction.

International Trade and Tariff Reform

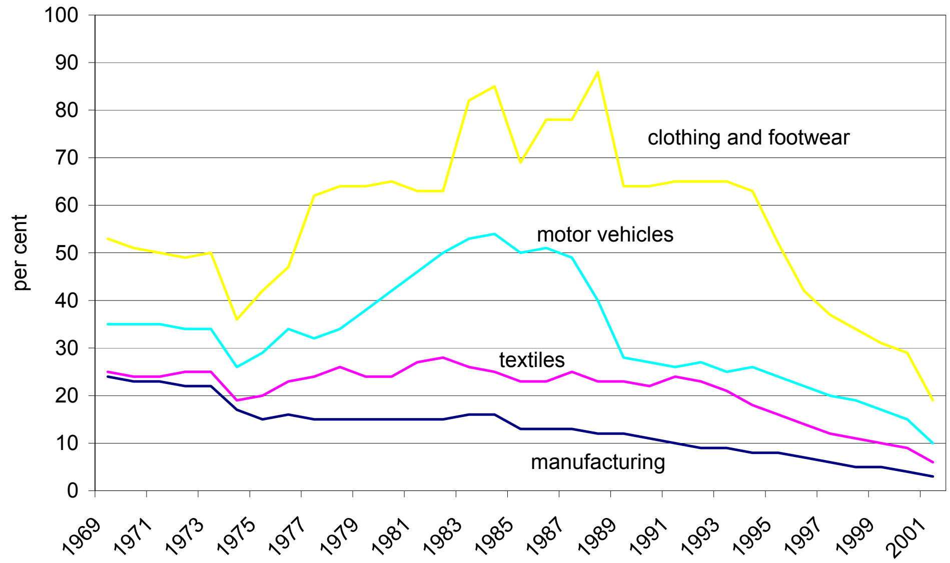
Figure 1 shows average simple tariff levels for manufacturing, textiles, clothing and footwear, and motor vehicles in Australia since the 1960s. Traditionally, these have been the most highly protected sectors in the Australian economy. Figure 2 shows the effective rates of protection (ERPs) for these sectors, where the ERP takes into account not just the tariff rate but also other forms of support and assistance, including on the cost of inputs.

As at 2003, simple and effective rates of protection are now at historically low levels in all industrial sectors in Australia. Protection of the manufacturing sector had been a basic tenet in Australian industry policy for most of the twentieth century. Indeed, before the various colonies joined together in January 1901 to form the Commonwealth of Australia, there was a split between the colonies in their individual approaches to protection, with Victoria fiercely protectionist and New South Wales firmly free trade. Industrial protection became deeply entrenched at the national level in 1920, when Walter Massey-Greene, minister for Trade and Customs, sharply increased industrial tariffs and set up the Tariff Board with the explicit aim of protecting Australian industry from foreign competition.

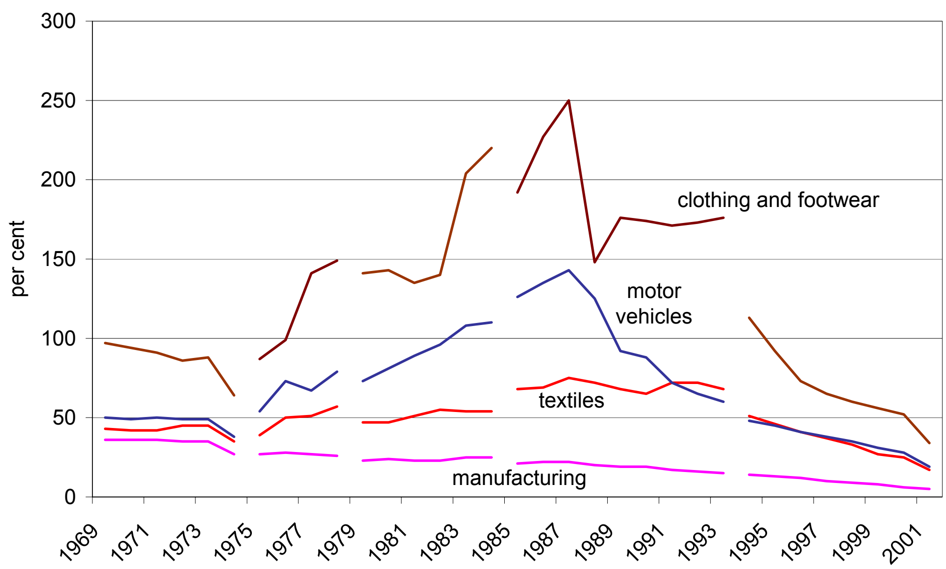
Over time, this view started to unravel. In 1965, the Vernon Committee critically examined the nature of the economy and one of its recommendations was a systematic review of industry protection. This was dismissed by the Menzies Government (1949-66) but it set the tone for thinking about the benefits and costs of protection and insularity in the debate in ensuing years. In a bold and controversial move, the Whitlam Government (1972-75) reduced tariffs across the board by 25 per cent in 1973. This is apparent in both Figures 1 and 2.

The Fraser Government (1975-83) oversaw substantial back-sliding on the Whitlam tariff reform. While it did not widely increase tariffs, it did introduce further structural assistance to affected sectors (including by lowering import quotas), which substantially increased the effective rates of assistance to these industries and slowed structural adjustment.

Figure 1: Industry Protection



Panel A: Simple Tariff Rates



Panel B: Effective Rates of Protection

Source: Emmery (1999)

The Hawke Government (1983-91) reversed this momentum. It was concerned about the excessive domestic orientation and lack of export focus of manufacturing in Australia. Through special industrial restructuring plans for the motor vehicle industry, textiles clothing and footwear, heavy engineering, steel, and ships, it injected temporary funds into these industries to help modernise them and substantially wound down the high levels of protection afforded to them. The approach shifted throughout the term of the Hawke Government from special industry plans to across-the-board reductions in tariffs, especially in March 1991. As shown in Panel A and B in Figure 1, the reduction in protection at this time was substantial. An important element in the domestic debate was that tariff reform in Australia was necessary to position Australian business to be able to take advantage of the rapidly expanding commercial opportunities in North East Asia (Garnaut 1989).

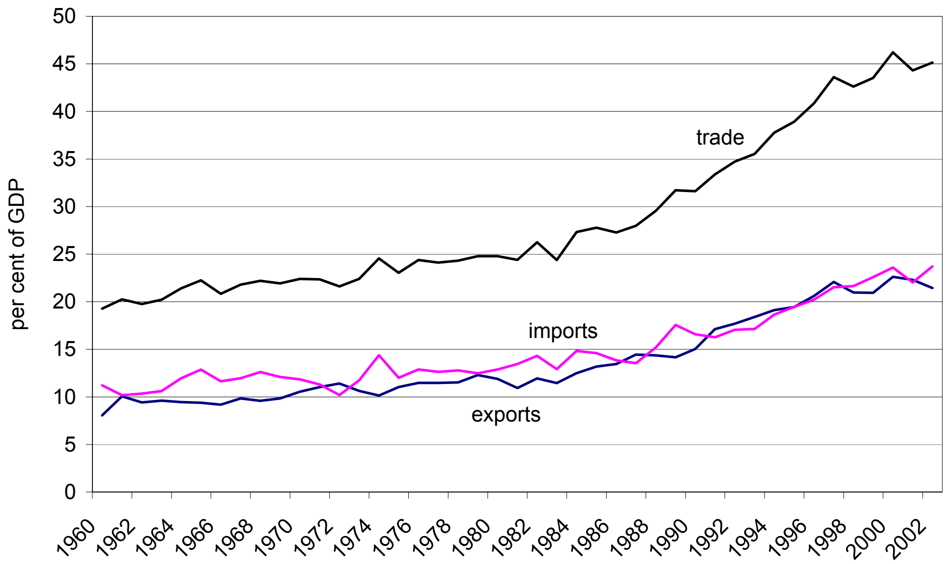
This continued throughout the life of the Keating Government (1991-96), with average tariffs having fallen to 5 per cent at the end of this period. The Keating Government, however, rejected the view that tariffs should be eliminated by 2000 but adopted APEC's Bogor commitment to reduce tariffs to zero by 2010. The Howard Government (1996-), while accepting the Bogor goals, has not taken any concrete steps towards achieving these goals apart from a commitment to lower tariffs on motor vehicles and textiles in 2005.

The primary forms of assistance to industry are now not in the form of tariffs, as shown in Figure 1, but in output bounties, export incentives to specific industries (motor vehicles, TCF and pharmaceuticals) and incentives for R&D, innovation and SMEs. These subsidies are paid through the budget rather than directly by consumers, as is the case of tariffs. The use of non-tariff barriers in Australia has also declined substantially (Emery 1999).

One remarkable effect of the reduction in tariffs and industry protection has been the sharp rise in international trade in the Australian economy, as shown in Figure 2. Exports and imports as a share of national income have more than doubled in the past two decades. International trade is now about 45 per cent of the economy, up from 20 per cent of the economy in 1980. More firms are also engaged in exporting than before, including small and medium sized enterprises.

The increased openness to trade in the Australian economy has also created self-reinforcing mechanisms which promote flexibility and openness. For example, almost two-thirds of Australia's exports go to East Asia and so there was serious concern that East Asia's recession due to the financial crises of 1997 and 1998 would also spread to Australia. The crisis did hurt exports to the region, but Australian exporters also quickly looked for alternative markets, such as the Middle East, the United States and Europe. This flexibility was possible because firms had become much more aware of, and sensitive to, international markets as a result of the forced opening due to tariff reductions.

Figure 2: International Trade and the Australian Economy



Source: Australian Bureau of Statistics Catalogue No. , Table 5

Deregulation and Liberalisation of Financial Markets and Institutions

Financial reform in Australia has both external and domestic aspects.

The external or international aspects of reform are embedded in the removal of controls on the capital account of the balance of payments. There have been three key elements of this reform program:

- the broad removal of capital controls in December 1983. The only restrictions on capital movement that existed after December 1983 were requirements for approval of investment by foreigners in some kinds of residential real estate and in sensitive sectors like media and airlines. Portfolio, derivatives and other cross-border capital flows are all free.
- floating the Australian dollar in December 1983; and

- allowing the entry of foreign financial institutions (notably banks) into domestic markets in 1985.

The domestic financial reforms also comprised three main elements:

- the removal of controls and requirements over financial institutions' assets and liabilities. These included, for example, removing forced acquisition of government bonds by banks in the early 1980s and eliminating forced segmentation of financial markets according to financial institution.
- The liberalisation of interest rates on loans, deposits and other financial instruments. Interest rates were mostly liberalised by the early 1980s and were fully liberalised by 1987 with the removal of limits on interest rates for housing loans.
- Consolidation of the regulatory and prudential systems governing the financial system as a whole. From 1998, this system comprises the Australian Securities and Investments Commission (responsible for all regulation of financial services, financial products and markets), the Australian Competition and Consumer Commission (responsible for preventing anti-competitive behaviour in markets and protecting consumers' interests) and the Australian Prudential Regulatory Authority (responsible for supervising all financial institutions, including deposit-taking institutions, insurance companies, and superannuation funds). The Reserve Bank also has responsibility for the stability of the financial system. From 2002, licensing and disclosure arrangements have been made uniform for all providers of financial products.

These reforms have had a dramatic effect on the Australian economy and financial system. The financial sector is now the third largest industrial sector in Australia, accounting for about 7½ per cent of output.[2] This sector has been an important contributor to growth, and it has grown faster (about 5½ per cent a year) than the economy has on average (4 per cent a year) in recent years.

Finance is important to growth.[3] One dimension of this in Australia has been that the nation's large and open financial markets have enabled firms and households in Australia to be able to effectively manage and limit their

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[2] See de Brouwer (2003).

[3] See Levine (1997).

financial risks. For example, Australian firms and banks borrow substantially from overseas in both Australian dollars and foreign currencies. Being able to borrow in one's own currency internationally means that foreign exchange risk is borne by foreigners, not locally. This is only possible because there is a large offshore market in the Australian dollar (the Australian dollar is the seventh most traded currency in the world – in turn, this reflects the country's solid economic fundamentals). And the foreign borrowings that are denominated in foreign currency are usually converted in 'swap markets' into Australian dollars. This means that Australian firms and banks typically have low contingent foreign currency exposures in their balance sheets and income statements. The big movements of the Australian dollar that can occur over time (say, shifts like 30-40 per cent in value) do not have the terribly damaging effects that we saw happen elsewhere to banks and firms in financially undeveloped economies in East Asia during the financial crises of 1997 and 1998.

The growth of financial markets in Australia has had two other positive effects. In the first place, it has had a dramatic effect on the efficiency of the financial sector and the provision of financial services in the economy. Figure 3 shows the spread between the basic home loan rate from banks and the cash rate. This spread narrowed substantially over the 1990s as the range of financial firms and instruments in the market expanded. Securitisation of home loans has been one key element in this process, providing greater competition to banks.

Figure 3: Interest Margin on Housing Loans

Source: RBA Bulletin Tables F.1 and F.5

The other impact of growth in finance has been the sharp rise in financial assets and liabilities of Australians. Table 1 and Figure 4 show that Australian financial institutions have grown rapidly over the past few decades, especially after liberalisation. This has two important economic effects. It enables Australian households and firms to diversify their asset base by having access to a wide range of different financial instruments. Of particular importance here is the rise in long-term or retirement savings, as shown by the rise in assets of superannuation (pension) funds and life insurers. These assets have also risen because Australia has a compulsory saving scheme. The other side of the coin to assets is liabilities. The rise in financial assets of households and firms also means that they can borrow more to acquire assets and smooth income over the life cycle.

Table 1: Total Assets of Australian Financial Institutions, A$ billion

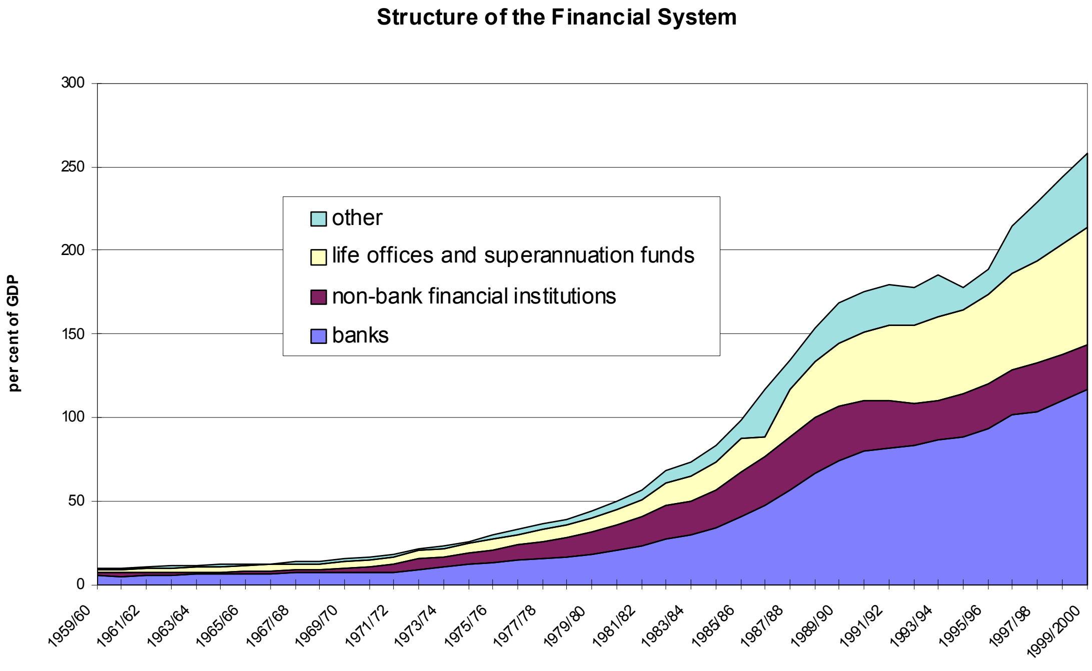
	December 1978	December 1984	December 1990	December 2002
Banking	47.3	185.8	486.6	1,320.5
Banks	47.3	109.6	348.0	993.0
Building Societies	N/a	19.7	21.4	12.3
Credit Cooperatives	N/a	4.6	8.7	27.4
Money Market Corporations	N/a	20.0	48.5	80.2
Finance Companies	N/a	24.1	38.8	46.4
General Financiers	N/a	2.9	12.0	30.7
Pastoral Financiers	N/a	4.9	2.0	12.7
Securitisation Vehicles	N/a	n/a	7.2	117.8
Insurance	N/a	n/a	n/a	80.8
General Insurance	N/a	n/a	n/a	80.8
Funds Management	11.8	24.1	203.6	634.5
Superannuation Funds	N/a	n/a	81.0	296.4
Life Insurance	11.8	24.1	78.7	164.0
Cash Management Trusts	N/a	n/a	5.3	28.1
Common Funds	N/a	n/a	6.9	8.1
Friendly Societies	N/a	n/a	7.7	5.0
Public Unit Trusts	N/a	n/a	24.0	132.9
Total	59.1	209.9	690.2	2,035.8
(per cent of GDP)	*59 per cent*	*103 per cent*	*179 per cent*	*286 per cent*

Source: Reserve Bank of Australia (2003), Table B1, B3.

Notes: n/a indicates not available; excludes the Reserve Bank of Australia; bank assets include A$ assets in Australia only.

The international dimension has also been an important part of this. Australians have diversified their asset and liability base by acquiring foreign assets and borrowing overseas. The floating exchange rate has also proved to be an essential element in dealing with the big fluctuations that occur in the world economy (be they in swings in the US dollar, yen and euro, economic cycles of the major economies, or changes in the prices of commodities in international markets). The value of the Australian dollar can fluctuate by 30 to 40 per cent over a business cycle. It tends to do this in a way which stabilises domestic income; for example, it depreciates when foreign demand weakens or when the world (US dollar) price of Australia's exports weaken. This happened most spectacularly in the East Asian financial crisis; it was this flexibility too, which kept growth stable at around 4 per cent a year during a time when many of Australia's trading partners were in deep recession.

Figure 4: Structure of the Australian Financial System



Source: Reserve Bank of Australia Bulletin Table B.1

Financial deregulation and liberalisation have also posed challenges . The challenges also need to be kept in mind in thinking about the process of reform. Three challenges have emerged.

First, financial markets focus on expectations about the future and so are very sensitive to how policymakers set fiscal and monetary policy. If participants in financial markets are concerned about the credibility or sustainability of a policy regime or decision, they will sell assets in financial markets, causing the exchange rate to depreciate, stock prices to fall, and interest rates to rise. Financial openness increases the pressure on governments to perform. This has certainly been the case in Australia.

Second, financial reform can also affect the way monetary policy is implemented and how it affects economic behaviour. This means that policymakers have to be vigilant and open-minded. In Australia, financial deregulation created a lot of instability in standard measures of money and made it hard for the authorities to judge whether monetary policy was right or not. This was ultimately resolved by the adoption of inflation targeting.

Before it was adopted, it did lead, however, to substantial confusion in policy and some serious policy errors.

Finally, financial markets are also prone, like some other asset markets such as property, to speculative dynamics, herding, overshooting and bubbles. This means that prices on assets like bonds, foreign exchange, stocks, commodities (gold) and real estate can at times be (substantially) above or below their 'fair market value' (as hard as that is to measure).[4] This is especially problematic if it damages the asset quality and collateral value of banking, insurance and pension funds systems, since these also affect a wide range of economic activities, like consumption, saving and investment. When this happens, swings in asset prices create swings in economic activity, increasing the depth of recessions and the terrible effect that has on employment and social stability. Australia had such a crisis in the late 1980s (at the same time as Japan) but resolved the problems in the banking and business sectors fairly quickly (3-4 years) by forcing adjustment and correction on the banks. Forebearance was not a viable option.

International and Domestic Labour Reform

Governments have progressively but slowly changed the structure of labour market regulation in Australia over past decades. Changes to the international dimension of labour markets have gone back over decades. Until the Second World War, labour migration was largely confined to people from the United Kingdom. After the war, concerns about invasion and the seemingly steady rise of communism led to the general view was that Australia needed to 'populate or perish'. Migration remained focused on Western Europe. The racial constraint on migration changed in the mid 1960s when the Holt Government (1966-68) formally abandoned the White Australia policy and the Whitlam Government introduced a non-discriminatory points-based immigration program.

From the 1980s, under the Hawke Government, migration from Asia increased substantially. This continued under the Keating and Howard Governments. About 1.3 million Australians now describe themselves as coming from an Asian background (more, incidentally, than from Italy, Greece and Malta combined). Diversification of the migrant intake has allowed Australia to deepen its social and economic links with East Asia. And the development of a multicultural multi-linguistic society has

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4 See de Brouwer (2001).

underpinned the positioning of Australia (and especially Sydney) as the Asia Pacific base for many international firms in the services (especially finance) sectors. About a quarter of all Australians were born overseas. The consensus now is that migration underpins employment and productivity growth. It has also made Australian society and culture more vibrant.

There has also been a compositional shift within migration to those with higher skills. The proportion of migrants with less than final year of school education has fallen from 55 per cent of all migrants in 1980 to 12 per cent more recently. These numbers reflect a shift from refugee and family-reunion migration to business/skilled-based migration. Garnaut argues that this has helped low skilled workers in three ways.[5] First, skilled migration makes Australia more efficient which in turn raises average incomes and employment, including in low paid jobs. Second, young migrants pay taxes but consume fewer government services, like health, which increases the net revenue of government. Third, the rise in skilled employment also tends to also increased unskilled employment through dynamic multiplier effects.

Domestic reform of the labour market occurred later than many other reforms. Since 1907, Australia had had a centralised wage system which guaranteed a 'living wage' for the lowest skilled workers and margins above that for other workers. This was effected by a central labour and wages arbitration system. The greatest changes to this system occurred under the Howard Government, which sought to decentralise wage fixing to individuals or the collective workplace (preferably without unions) by shifting to employment contracts, reducing the role of centralised wage-setting bodies, and making unions liable for the economic consequences of industrial action on firms.

Figure 5 shows total working days lost over the past year due to industrial disputes since March 1983. This was lower in the 1980s than the 1970s, under the labour Accord between the Hawke Government and the trade unions, but its most radical fall was in the 1990s. Australia is now a country with low unionisation rates (about 15 per cent in the private sector, similar to the United States) and low industrial disputation. This has meant that the frequency and depth of labour and wages 'shocks' – by which labour has sought to increase its share of national income – have declined in Australia.

These changes are in part due directly to the effects of labour market deregulation. But they are also due to other structural changes in the

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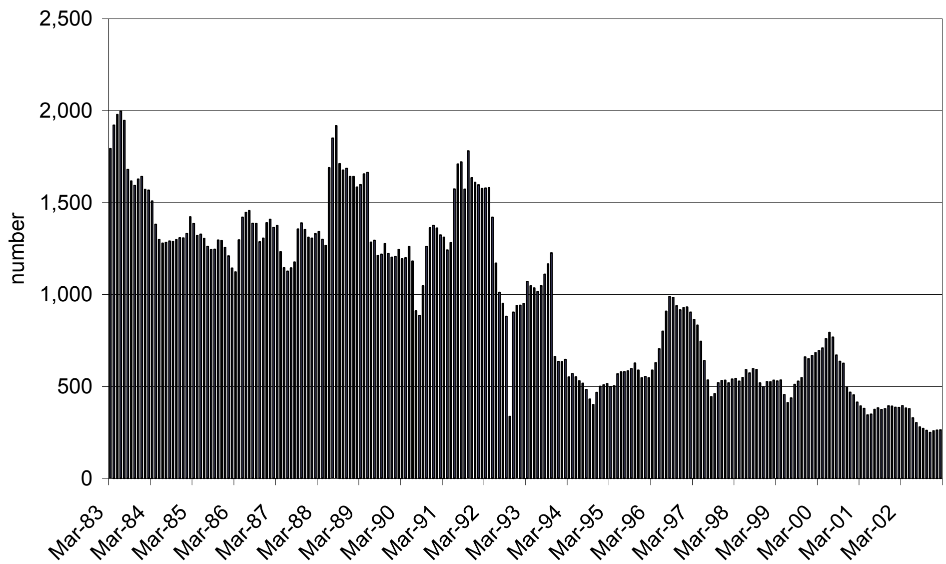
5 *Australian Financial Review*, 30 May 2003.

economy. One of these is the effect of increased international competition in goods and services markets in Australia due to lower tariffs. Another is the introduction of inflation targeting in the early 1990s. As discussed below, the Reserve Bank of Australia, the central bank, sets interest rates to achieve a medium term inflation target of 2-3 per cent a year. Wage rises in substantial excess of productivity growth are a key indicator of future rises in inflation: under inflation targeting, pushing for higher wages which are not supported by further productivity growth just end up in temporarily higher interest rates, lower growth and fewer jobs in the short term. Unions and others understand this and have modified their behaviour.

Figure 5: Days Lost in Industrial Disputes Over the Past Year



Source: ABS Catalogue No. 6321.0 Table 3

National Competition Policy and Business Reform

A basic result in neo-classical micro-economic models is that prices are lower and output is higher when there are competitive markets. Competitive markets are markets in which sellers of goods, services or inputs (like labour or capital) do not have price-setting power; typically, the more players there are (or the greater the threat of entry of more players), the more competitive is the market. Australia's national competition policy, implemented in the 1990s, is designed to reduce market power of monopolies and oligopolies and hence maximise consumer wellbeing.

The Howard Government has also looked closely at ensuring that laws covering companies, corporate governance, corporate insolvency, corporate financial reporting, and electronic commerce meet international best practice. It has done this through the Corporations Law Economic Reform Program (CLERP) involving substantial changes in nine areas of corporate law referred to above.[6]

Tax reform

The Howard Government also introduced substantial tax reform. The Government introduced A New Tax System (ANTS) in 2000. The main elements of ANTS were the introduction of a goods and services tax on all goods (except food) and services, elimination of the wholesale tax system (so that taxes were only imposed on final goods and services), reductions in income tax (to keep the overall personal tax burden unchanged) and changes to business tax payment arrangements.

The shift to an indirect tax system was controversial in the sense that indirect taxes are more regressive than income tax systems. But the advantage of the shift was that it broadened the structural tax base, which is important given the size of services in the economy (about three-quarters of the economy) and the aging of the population.

Monetary and Fiscal Policy Frameworks

Having clear frameworks for the operation of monetary policy and fiscal policy are essential for ensuring macroeconomic stability. Clear frameworks mean that policymakers have a reference with which to set policies. This is important in ensuring that policymakers act consistently with the desires of the community, as well as in reducing the risk of policymakers making mistakes. Clear policy frameworks are also important because they provide a benchmark by which to hold policymakers accountable to the public for what they do.

The Reserve Bank of Australia sets interest rates so that inflation averages between 2 and 3 per cent a year in the medium term (that is, over the business cycle). The central bank chose this formulation for itself in the early 1990s but the Treasurer later exchanged a letter of understanding with the Governor of the Reserve Bank in 1996 to formalise this. There is bipartisan support for this arrangement in Australia. Since the 1990s, underlying or core inflation has averaged about 2½ per cent a year, as shown in Figure 6.

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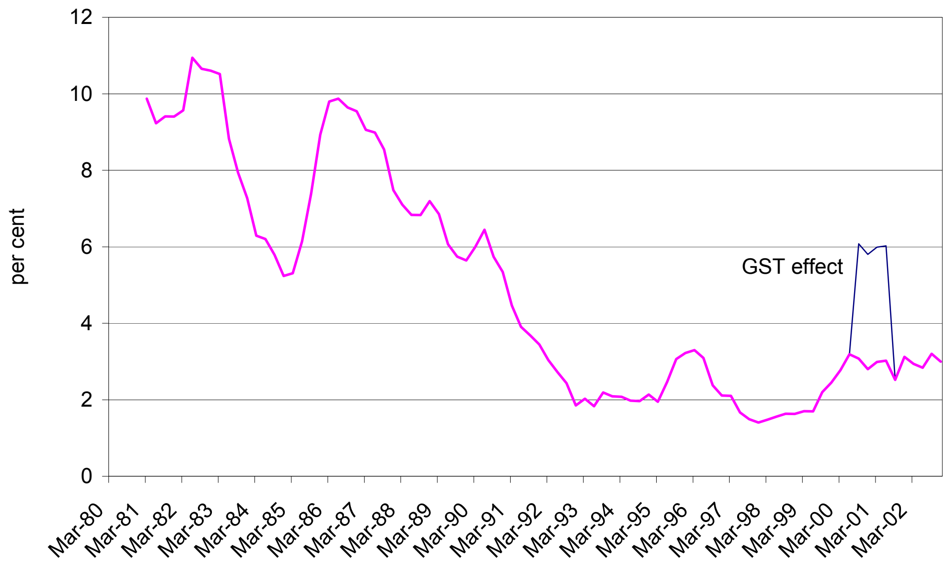
6 See www.treasury.gov.au.

Figure 6: Underlying Annual Inflation in Australia



Source: RBA Bulletin

The Howard Government also introduced a Charter of Budget Honesty in 1998. This is legally binding. The Charter of Budget Honesty provides a framework for the conduct of fiscal policy by the Federal Government. It requires the Government to table an economic and fiscal outlook each year in the Budget and provide mid-year updated forecasts of these outlooks. Before each election, the Government is required to provide an economic and fiscal outlook report as well as full costings of all election commitments by major political parties.

The Howard Government is also committed to maintain at least budget balance (if not budget surplus) over the medium term. This parallels the medium-term framework of monetary policy.

3. The Process of Reform

The process of reform in Australia has been incremental, self-reinforcing and driven more by pragmatism than ideology.

Incrementalism, Self-Reinforcement and Pragmatism

Reform has been incremental in the sense that few of the reforms have been completed in one step. Rather, they have mostly occurred in many steps. This reflects the confluence of four factors.

First, the Australian political system diversifies power across a range of players. Australia is a federation, with constitutional power lying with the Commonwealth Government and the six State Governments. Many areas which have been subject to reform (like tax, the scope of competition policy, and labour laws) are spread across these jurisdictions and hence they require a common vision, negotiation and compromise to be made into law. The Federal Parliament also consists of two Houses, a House of Representatives and a Senate. For many decades, it has been the case that the Government has had a majority in the House of Representatives but not in the Senate. This means further compromise, either between both major political parties or between the Government party and the small or minor parties which hold the balance of power in the Senate. Governments in Australia can rarely implement their full policy agenda.

Second, the need for, and scope of, reform in a particular sector sometimes only becomes apparent after a period of time. One example is the financial sector. In the early 1980s, the key requirement of reform seemed to be the removal of controls and regulations. After rapid credit growth in the late 1980s and the build up and collapse of asset price bubbles in property and stocks, the perception shifted to the need for effective supervisory systems. This led over time to a radical overhaul of the system of financial supervision and regulation in the late 1990s. This has been reinforced recently by the collapse of a major insurance company (HIH Limited) due to corporate malfeasance: the prudential and regulatory system established in 1998 was not sufficiently well equipped to deal with these problems in the insurance sector. More reforms are likely.

Third, the willingness of governments to engage in reform has also depended on their own constituencies. The Hawke Government was the initial and primary agent of reform over the past two decades. It initiated the watershed major financial and tariff reforms. But, because it was a Labor Government with close ties to the industrial labour movement, it was also constrained in the way it approached labour market reform and the extent to which it could pursue such reform. The Howard Government was not constrained in this way, which explains why labour market reform came relatively late in the scheme of things.

Finally, structural change often goes to the core of economic and commercial activities. Sometimes reform needs to be sequenced. It cannot all be done at once but has to occur in a series of steps. An example is the industrial structural and tariff reform in a range of manufacturing sectors in the 1980s such as motor vehicles and TCF. Removing tariffs without first implementing deep some other changes (including investment in new technology) may lead merely to the collapse of sectors rather than their reform.

Reform has been self-reinforcing over time. Reform has tended to build on itself over time. Successes in reform, such as in industrial and tariff reform in the 1990s made policymakers more confident. And it increased general social acceptance of reform.

Reform has also generally been pragmatic rather than ideological. The system was reformed because it was demonstrably not working. Policymakers saw that protection created rent seeking, insularity and a third-rate corporate culture. The Australian dollar was floated and capital controls removed because of the problems associated with the pegged exchange rate. Policymakers were nervous about the changes they made but they persuaded the electorate that there was little choice. This is not to say that the process was not influenced by the radical pro-market thought of writers like Hayek or Milton Friedman. There were strains of this thinking but it was not dominant. Nor was the reform process in Australia ever the ideological exercise it was in the United Kingdom under Margaret Thatcher or in the United States under Ronald Reagan.

Building Coalitions of Support for Reform

The process of reform has also been largely successful because of the creation of coalitions of support and ownership of reform.

Thus is most evident in the creation of institutions to support reform. In Australia, three sets of institutions have been important to the reform process: what is now called the Productivity Commission,[7] university academics (especially from the Australian National University), and senior officers of the Treasury and Reserve Bank. What now exists as the Productivity Commission (PC) was first set up in 1921 as the Tariff Board (TB) to extend and administer Australia's system of external tariffs and quotas. It was restructured as the Industries Assistance Commission (IAC) in 1973 and again as the Industry Commission (IC) in 1989. The name changes are instructive: they reflect a fundamental shift in the function of the institution from being the guardian of protection from its formation until

[7] The Productivity Commission was established in April 1998, drawing together the Industry Commission, Bureau of Industry Economics and Economic Planning Advisory Agency. It is headed by a Chairperson and between 4 and 11 other Commissioners appointed by the Government. Its staff are Australian Government public servants.

the mid 1960s to being the primary public advocate for structural reform in Australia. The shift in the role of the Tariff Board was led by particular individuals, notably its last Chairman and the first Chairman of the IAC, Alf Rattigan, as well seminal ANU thinkers of the time like John Crawford, Heinz Arndt, Max Corden and Fred Gruen, and politicians like Bert Kelly.[8] (Later, it was the influence of people like Ross Garnaut, Stuart Harris, Richard Snape and Peter Drysdale.)

Rattigan was a public servant who was not regarded as pro-free market before his appointment. He developed his thinking in office through exposure to the special pleading by industry and the ideas of reform (including measures of the effective rates of protection). Rattigan used his position in a practical and constructive manner, initially using the Board's annual report as a device to explain in public the national consequences of protection. This started the tradition of the TB, IAC, IC and PC putting their reports on the public record, an outcome with momentous political impact since it affected the political debate and gave an agenda to political entrepreneurs. Rattigan also developed constructive and ongoing working relationships with influential 'fellow travellers' in the Government and Opposition political parties, bureaucracy (notably Treasury), academia and the media.

One of the fundamental difficulties in the reform process is the fact that the people who lose from reform better represent their interests than those who gain from reform. Those who lose from reform are usually concentrated in a sector and location, have developed powerful political connections and are vocal. Those who gain from reform are spread across many sectors or else are consumers whose interests are more diffuse. The losers from reform take collective action to protect their interests; the gainers typically do not. The gains are also sometimes not as immediately apparent as the losses from reform. Reducing tariffs, for example, affects an industry. The output and job losses are immediately evident. But the gains from lower prices are less evident; they are spread among other sectors and consumers and they may take time to become apparent. People well understand the immediate static one-off losses from reform. It is much harder to see the dynamic across the board gains that come from a more efficient allocation of resources.

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[8] See http://www.aph.gov.au/library/pubs/rp/1999-2000/2000rp07.htm and John Hyde's http://www.ipa.org.au/pubs/special/hydelong/word/longChapter6.doc (also in http://ipa.org.au/pubs/special/hydelong/Hydebooklong.html) for accounts of the history of the Productivity Commission and key players. Snape et al. (1998) provide an account of the recent history of Australian trade policy. The following assessment is based on these sources.

Over the past four decades, the Productivity Commission and its successor institutions have played an important intellectual and social role in using economic analysis to demonstrate the deadweight losses from protection and the dynamic gains from reform (Productivity Commission 2001: 9). The many reports that have been issued by this institution have been valuable in looking at what economists call the counterfactual – what would have happened if a different policy had been in place from the one that was implemented.

The Productivity Commission (2001: x) argues that

> good policy outcomes require robust evaluation processes. These should involve explicit consideration of the likely benefits, costs and distributional effects of reform proposals – not just for particular groups, but across the wider community. … Reforms are proposed because of the considerable benefits they can bring to the community. But reform usually involves adjustment and other costs. Assessment of whether the expected benefits of a policy change exceed its costs need to be made … [as well as] a need to assess the scope for reducing these costs.'

One important element in Australia has been the use of public reports to influence and guide the public debate on reform. Most major changes in policy have often been preceded by a public report. For example, reduction in tariffs was preceded by the Vernon Report (1965), financial deregulation was preceded by the Campbell Report (1981) and Martin Report (1985), further reduction in tariffs to take advantage of growth and development in North East Asia was preceded by the Garnaut Report (1989), reform of competition and corporate law was preceded by the Hilmer Report (1993), and reform of the financial prudential and regulatory system was preceded by the Wallis Report (1997).

The process of building coalitions of support has not been a smooth one. There have been setbacks and backlashes. The rise of small counter-reform counter-culture political parties has been one avenue for the expression of backlash. On the left side of politics, there was the rise of the Greens. On the right side of politics, there was the rise of One Nation and its various offshoots. These have had some influence on the formation of policies of both the Liberal-National Government and Labor Opposition. One Nation has now failed as a political force in its own right because of deep schisms and a shift to the right of the Howard Government in its social policies. The Greens remain a significant influence.

One impact of these counter-culture movements on the left and right of politics has been to slow the reform process, or at least make it more difficult to pursue in full. For example, the Australian Democrats agreed to pass the Howard Government's proposed GST Bill so long as it excluded food from the GST. This reduced the efficiency of that particular tax reform. In response to these pressures, the Productivity Commission has also extended its policy evaluation framework and implementation strategies to look at ways to use the social security net as a basis for supporting adjustment.

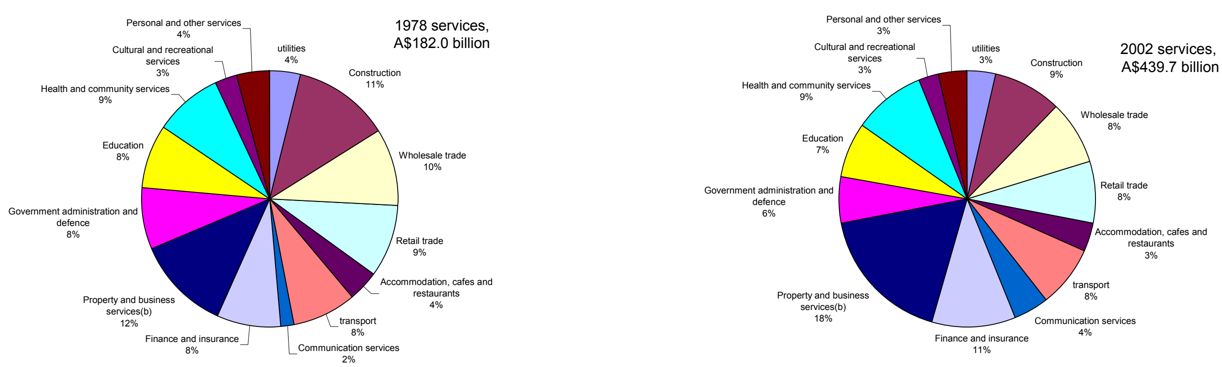
4. The Effects of Reform on Economic Growth and Performance

Structural change had a deep and substantive effect on the Australian economy and on the living standards of Australians.

In the first instance, it created a more diverse economy. Figure 7 shows a snapshot of the economy in 1978 and in 2002. The industrial base of the economy is now wider across industries. A more diverse economy is an economy which is better able to deal with the various shocks that inevitably occur, lowering the risk of 'putting your eggs all in one basket'. This was shown in the East Asian crisis and, more recently, the global slowdown.

Figure 7: Industrial Sectors in Australia

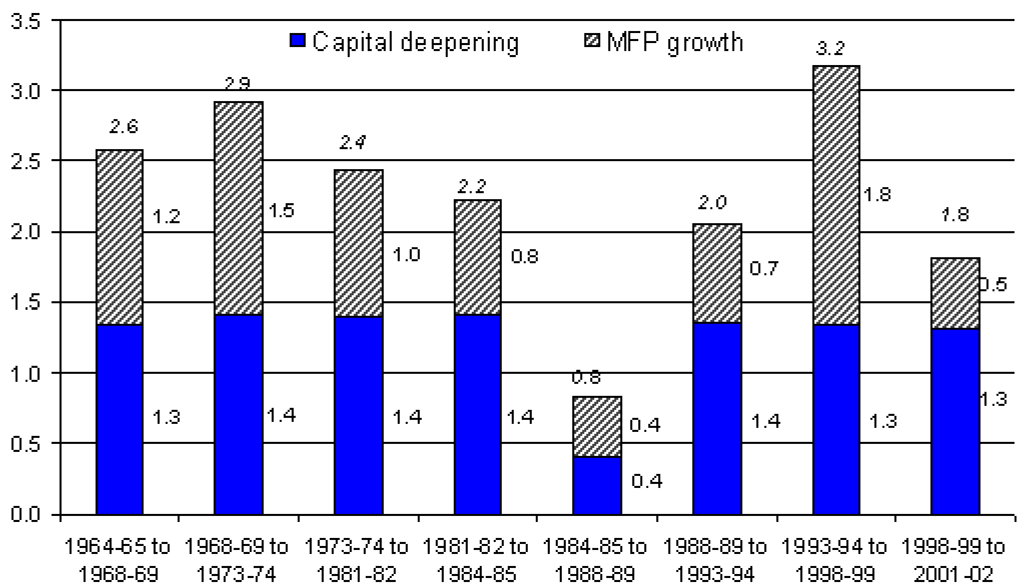
Panel A: 1978 Panel B: 2002



The economy is also a much bigger one than it was 25 years ago. Australia has been fortunate to enjoy strong and steady growth. It is an economy which has been growing faster over time. Economic growth can be decomposed into two elements: growth in the number of people working and growth in the output of each person working, which is otherwise called labour productivity growth. Labour productivity growth can come from two sources: more capital (called capital deepening) and better use of the existing capital stock for each person employed, which is called multifactor productivity growth. Multifactor productivity growth is an indicator of efficiency in the economy.

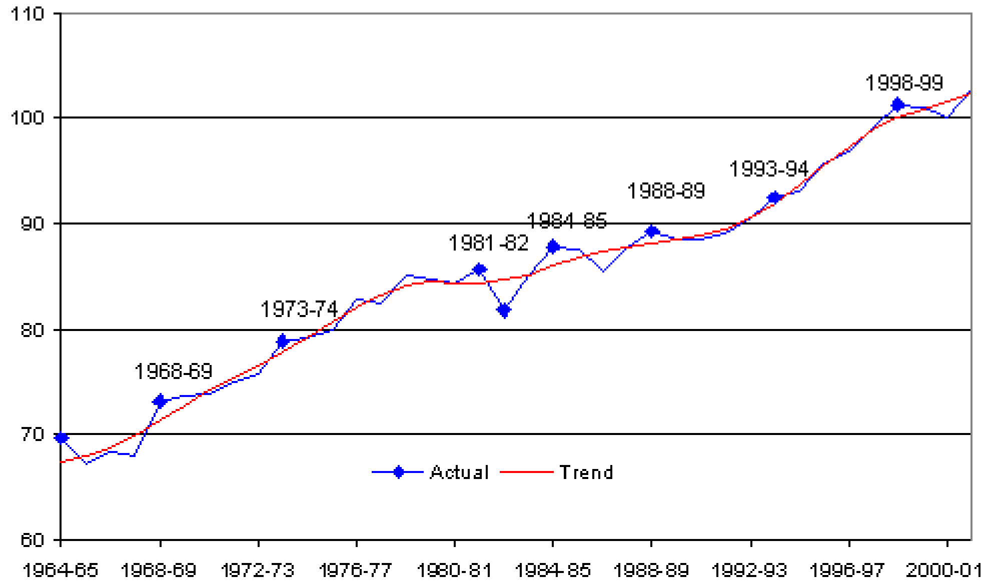
Figure 8 shows underlying labour productivity growth in Australia, decomposed into capital deepening and multifactor productivity growth over productivity cycles of the past four decades. The light part of the bar is multifactor productivity growth and the black part of the bar is capital deepening. The point to note is that multifactor productivity growth started to slow in the 1980s but picked up sharply in the mid 1990s. Most of the increase in labour productivity growth in the 1990s was due to increased efficiency. It has slowed in the past couple of years at a time of temporary slowdown but is expected to rise as growth picks up from the slowdown of 2001. Figure 9 traces out the level of multifactor productivity over this time.

Figure 8: Growth in Labour Productivity and Multifactor Productivity



Source: Productivity Commission (based on ABS Catalogue No. 5204.0)

Figure 9: Australia's Multifactor Productivity Over Four Decades



Source: Productivity Commission (based on ABS Catalogue No. 5204.0)[9]

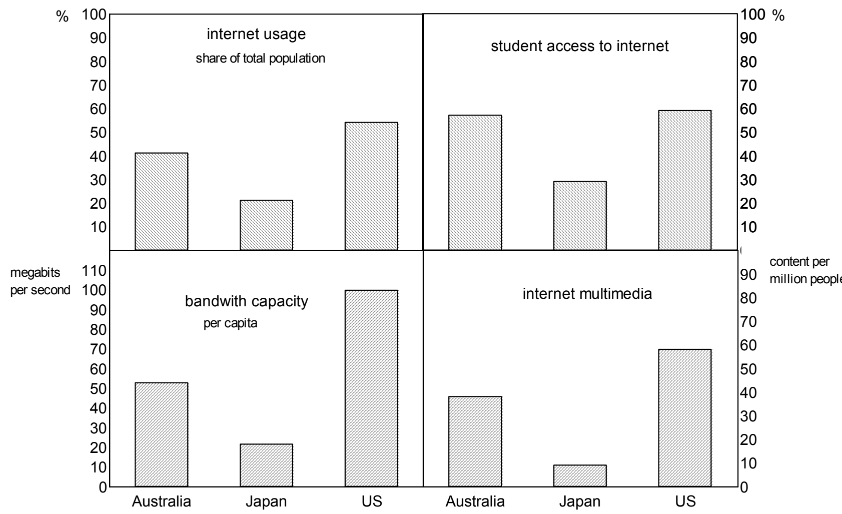
The rise in multifactor productivity growth in the 1990s has not occurred evenly across industries. The acceleration in productivity growth has come from wholesale trade, construction, finance and insurance, transport and storage, accommodation, the retail sector, and communications. It declined in agriculture, utilities and manufacturing.

The adoption of new information and communications technology (ICT) has been an important element in labour productivity growth over the past decade. Australia is not a big producer of ICT but it is, relatively speaking, one of the biggest users of ICT in the world. Australia is ranked as the third biggest user of ICT in the OECD.[10] Figure 10 shows some indicators of ICT use. Capital deepening in ICT has been of particular importance. Parham (2002) reports that capital deepening in ICT was positive over the 1990s (and made a bigger relative contribution in Australia than in the United States) but that it occurred at the expense of other forms of capital (similar also to what happened in the United States). He estimates that at most only a third of the rise in multifactor productivity growth is attributable to the effects of ICT: the bulk of the rise in multifactor productivity growth in the 1990s is, by implication, due to the reform processes that have taken place.

9 See http://www.pc.gov.au/work/productivity/marketsector.html.

10 See OECD (2001).

Figure 10: Use of ICT in Australia and Japan



Source: OECD (2000)

These improvements in productivity in the Australian economy are quite impressive but they have only served to restore Australia's relative global position in terms of productivity and output per person to where they were in the 1950s. Table 2 shows output per person and productivity (output per hour worked) for Australia, Canada, France, Japan and the United States over the past 50 years. Australia's solid productivity growth in the 1990s contrasts to the relatively poor performance of Europe and Japan over this period.

Table 2: Output Per Person and Productivity

	Relative level US=100 1950	1973	1980	2001	Growth 1950-2001	Average growth 1950-73	1973-90	1990-01
GDP per person								
United States	100	100	100	100	193%	2.5%	2.0%	1.7%
Canada	79	84	83	81	200%	2.7%	1.9%	1.5%
Australia	**78**	**76**	**73**	**78**	**192%**	**2.3%**	**1.7%**	**2.3%**
France	54	77	76	73	300%	4.0%	1.9%	1.4%
Japan	20	69	82	75	987%	8.1%	3.0%	1.0%
Productivity								
United States	*100*	*100*	*100*	*100*	*189%*	*3.0%*	*1.3%*	*1.4%*
Canada	*91*	*87*	*84*	*85*	*170%*	*2.9%*	*1.0%*	*1.6%*
Australia	***81***	***73***	***76***	***82***	***194%***	***2.6%***	***1.5%***	***2.2%***
France	*50*	*80*	*108*	*110*	*527%*	*5.1%*	*3.1%*	*1.6%*
Japan	*22*	*55*	*71*	*75*	*897%*	*7.3%*	*2.9%*	*1.9%*

Source: Treasury (2003). Note: GDP is measured in 1999 dollars using purchasing power parities.

A remaining issue of controversy and importance in Australia is the effect of structural change on income distribution and inequality. This is not a clear cut story but there are three broad points to make.[11] The first is that the lowest income earners are not worse off in absolute terms, so long as taxes and government benefits are taken into account in estimating income. The second point is the lowest income earners are relatively less well off compared to the highest income earners, since incomes of high earners have risen faster than that of low income earners. (Gini coefficients, which measure income inequality, have risen over the past two decades.) Third, there is substantial uncertainty about the accuracy of income inequality measures. There is less controversy about consumption inequality measures and these indicate that expenditure inequality increased in the 1980s but decreased in the 1990s. This may reflect changes in the composition of low income groups towards retired people. Whatever the case, the changes in income inequality have been small.

5. Conclusion: The Remaining Agenda

Despite improving productivity performance and rising per capita incomes, there is still substantial scope for doing better. And despite more than two decades of reform, it is also clear that the reform is not yet over. Reform is still required in areas such as education, health, welfare and community services (including making incentives under welfare and tax systems compatible), legal and professional services, the environment, water, electricity and transport.[12] Moreover, reform has to be ongoing because the world is always changing.

This paper has sought to make three points about the reform process in Australia. First, it has been wide-ranging and covered almost all areas of the economy. Second, it has been a difficult process, requiring vision, constant work and action. This has been facilitated by having independent and credible institutions which have set out the benefits of reform and provided a platform for advocacy. Third, it has had demonstrable benefits in terms of increasing incomes, helping the economy and society deal with the adverse shocks and disturbances that inevitably occur, and reducing some of the

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[11] See, for example, Harding and Greenwell (2002) and Department of Foreign Affairs and Trade (2003).

[12] As Treasury (2003) points out, one element in the need for further reform is dealing with expected future demographic change. As Australia ages, it is necessary to institute incentives which encourage stronger participation in the labour market. This will include changes in the tax system to remove incentives for older Australians to retire early and create incentives for professionals overseas (including the 5 per cent of mostly professional Australians who live overseas) to work in Australia. See 'Treasury Puts Tax on Reform Agenda', *Australian Financial Review*, 21 May 2003 and Statement Number 4 of the Budget Papers, http://www.budget.gov.au/2003-04/bp1/html/bst4.htm.

shocks that have hurt the economy in the past (especially in the domestic labour market). Australia's reform is a success story. What is clear looking forward is that we have to work to keep it that way. There is no inevitability about a country's economic success. Continuing engagement and sharing experience with its partners in the region and beyond are important in helping Australia build on its past success.

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