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### STATEMENT 3 — STRUCTURAL CHANGE: RECENT DEVELOPMENTS, BENEFITS AND THE ROLE OF POLICY

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# **STATEMENT 3 — STRUCTURAL CHANGE: RECENT DEVELOPMENTS, BENEFITS AND THE ROLE OF POLICY**

## **INTRODUCTION**

Changes in the Australian economy over recent decades have been profound. Australia has become increasingly open to international trade and investment with reduced levels of protection, free capital flows and a floating exchange rate. Exports and imports as a proportion of production have grown dramatically over this time and the composition of exports has changed markedly. The services sector has become increasingly important in terms of both output and employment. Workplace arrangements have been changing with greater focus on wage-setting at the firm level. Female participation in the workforce has increased and skilled workers are a much larger proportion of total employment.

The world economy has undergone major structural change over the last quarter century. There have been significant and continual changes in the capacity of different countries to supply goods and services as a result of technological change, the opening up of trade, the discovery and harnessing of natural resources and the development of human skills. At the same time, rising incomes and demographic change have influenced the pattern of demand for different goods and services.

Governments around the world have responded differently to structural change at different times, sometimes attempting to restrict trade and to insulate selected activities from that change. Other countries — including Australia — have introduced microeconomic reforms aimed at facilitating structural change. Some of the reforms undertaken include deregulation of financial markets, freeing up aviation and telecommunications markets, taxation reform, making government enterprises more commercial and reductions in border protection such as tariffs and quotas. In recent years, particular attention has been given to reform of public utilities and making labour markets more competitive.

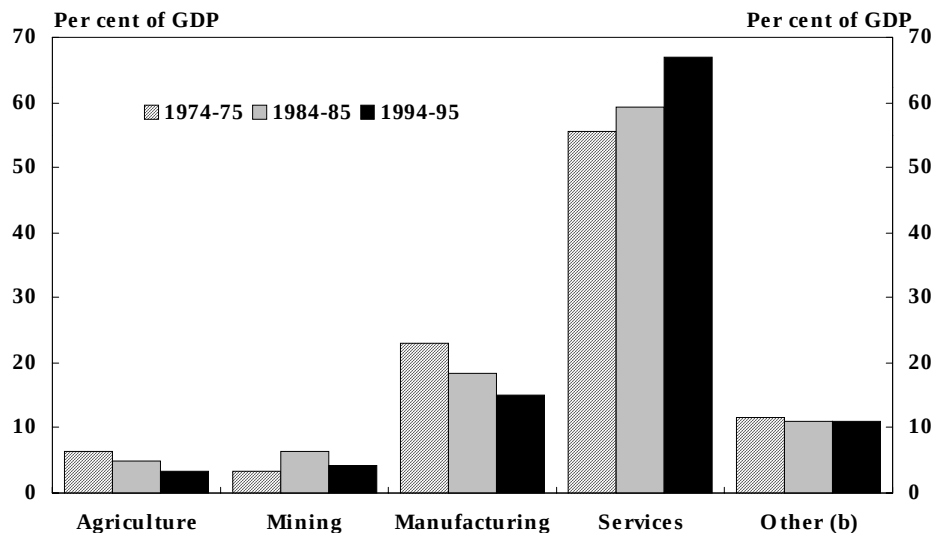
The freeing up of financial markets and rapid advances in communication technology have resulted in speedier and larger international movements of investment funds in response to changing financial conditions. This development has placed more discipline on the conduct of macroeconomic policies, which must now have regard for well-informed and influential market sentiment.

This Statement examines the nature of structural change and the benefits of facilitating change through microeconomic reform in terms of increased productivity, increased economic flexibility, lower prices for consumers and increased employment opportunities. The Statement then considers whether Australia's macroeconomic and microeconomic policies are meeting the demands of structural change and the possible need for further policy change. Consideration of what is an appropriate industry policy is also included in the Statement.

## STRUCTURAL CHANGE IN THE AUSTRALIAN ECONOMY

Structural change is continual. The advent of steamships and railways were as revolutionary in their day as satellite communications and microchips are today. The continued urbanisation of society, greater international integration and increased trade flows, more specialised means of production and an expanding array of new products are some of the more obvious features of structural change. One consequence of the collective effect of such change is continual adjustment in industry composition; for example, a common feature of economic development around the world has been a shift in the share of output from manufacturing to the services sector, a trend clearly evident in Australia in recent decades (Chart 1)<sup>1</sup> and in industrial countries generally (Chart 2).

**Chart 1: Sectoral Shares of Output — Australia<sup>(a)</sup>**



(a) Current price data — six year average ending in the year shown.

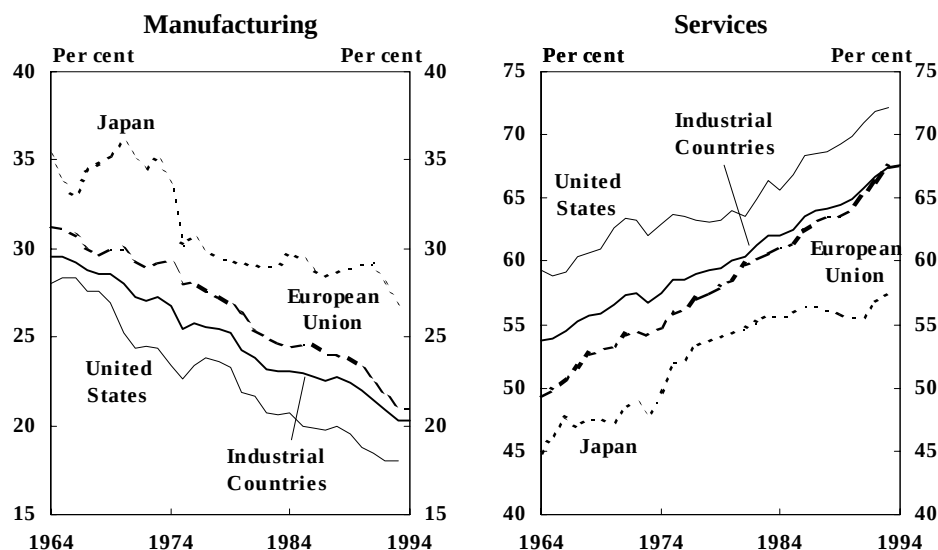
(b) 'Other' includes electricity, gas & water and construction.

Source: Reserve Bank of Australia, *Australian Economic Statistics: 1949-50 to 1994-95*, 1996 and Treasury estimates.

The causes and consequences of structural change are complex and inter-related. Technological advances impact by changing the costs of production, by increasing international trade and by increasing the demand for skilled labour. Increased international integration encourages greater trade and international investment, helps to stimulate innovation and can affect consumption patterns; recent developments in East Asia have been of particular relevance to Australia. Demographic factors influence work preferences and labour force participation, and affect the types of goods and services purchased. And changes in one area of the economy can have wider effects by inducing the transfer of resources from other (less profitable) areas.

<sup>1</sup> The increased relative importance of the services sector has occurred despite increases in output in each of the major sectors.

**Chart 2: Sectoral Shares of Value Added — Industrial Countries<sup>(a)</sup>**



(a) Current price data.

Source: IMF, *World Economic Outlook*, April 1997.

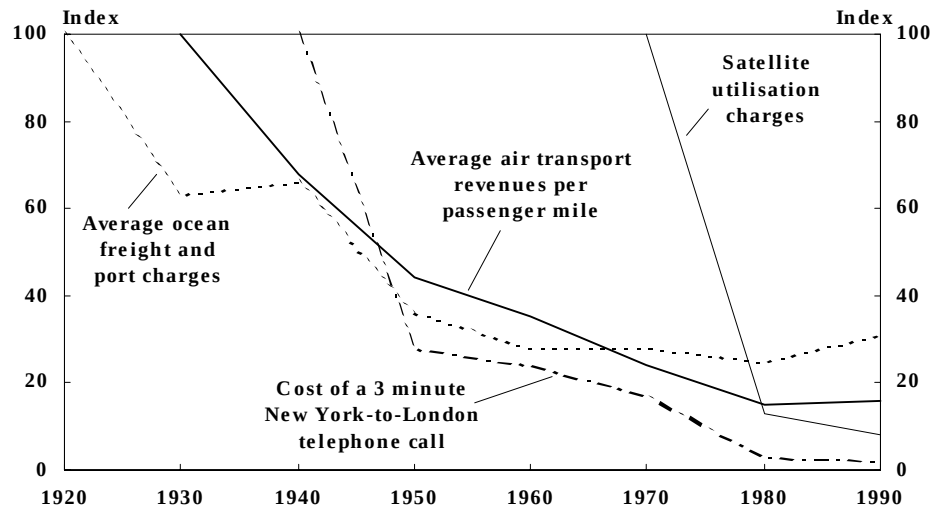
### Technological Change

The impact of technological change is primarily felt through the development of new products and new methods of producing existing products or providing services. For example, expansion of Australia's mining industry in the mid-1960s partly reflected the development of new technology for extracting and transporting large volumes of minerals at world competitive prices. More generally, with the pace of technological change differing across industries both locally and overseas, there are likely to be constant changes in relative prices, inducing shifts in the structure of production, consumption and employment.

Advances in transport and communications have been important catalysts for change. Lower costs of international transactions (Chart 3) have helped to enhance the efficiency of international markets, reduce consumer prices and increase international competition. Increased exposure to goods of foreign origin has helped to stimulate greater innovation in order to meet that international competition and has served as a conduit for faster diffusion of technological progress and organisational change.

Changes in information technology have spawned the creation of computer hardware and software industries. Increases in computing power have allowed information to be processed in greater quantities and with more speed, increasing demand for information services and underpinning advances in communication which have assisted the process of increased international integration. Enhanced information processing has also assisted in accelerating the spread of knowledge, potentially advancing the rate of technological progress in a wide range of areas. These influences accelerate changes in the types of goods and services purchased and how and where they are produced.

**Chart 3: International Transport and Communication Costs<sup>(a)</sup>**



(a) Real price index = 100 in the first year of data for each category.  
Source: World Bank, *World Development Report*, 1995.

### Increasing International Integration

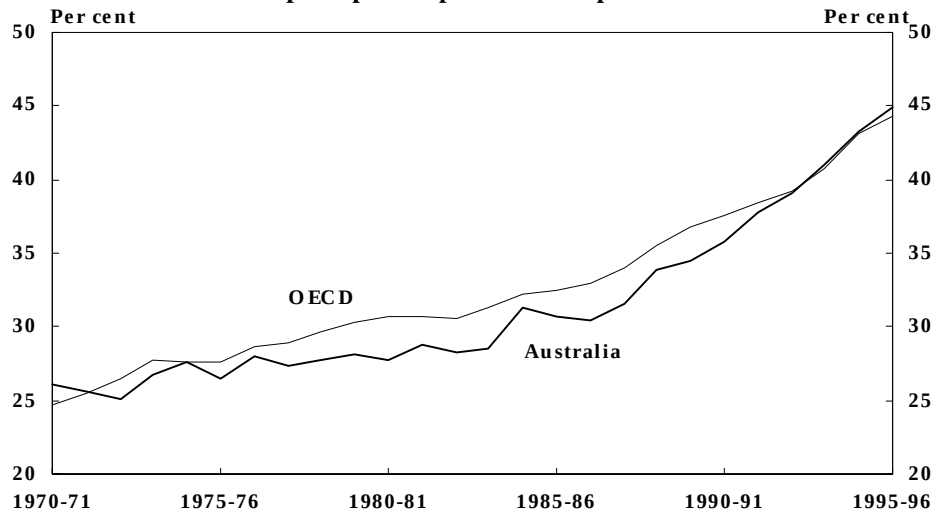
Over recent decades, an increasing proportion of Australia's production has been exported and imports have increased as a share of spending. The overall trade share as a proportion of total domestic output has risen from an average of about 25 per cent in the 1960s to over 40 per cent in recent years. This increase in trade intensity is in keeping with international trends (Chart 4). Substantial changes have also been apparent in the composition of exports, with commodities becoming relatively less significant while manufactures and services have commensurately increased in importance.

Increased trade intensity is partly the result of technological advances in transport and communications. Also important are the reductions that have occurred in trade barriers around the world, flowing from a recognition of the inherent economic costs of such protection. Some of these reductions reflect GATT negotiations, but unilateral initiatives have also been important. More than 70 countries, including Australia, independently reduced their trade barriers between 1986 and 1993.<sup>2</sup>

Capital has also become increasingly mobile, with advances in computing and communications allowing capital markets to respond rapidly to developments throughout the world. Such technological developments have complemented financial deregulation and the easing of restrictions on foreign exchange transactions, often associated with more flexible exchange rate regimes.

<sup>2</sup> GATT, *International Trade and the Trading System*, 1993.

**Chart 4: Exports plus Imports as a Proportion of GDP<sup>(a)</sup>**



(a) Constant price data (1989-90 prices for Australia, 1990 prices and exchange rates for the OECD).  
Source: ABS Cat. Nos. 5302.0, 5206.0 and OECD, *National Accounts: Main Aggregates*, Vol. 1, 1997.

World capital flows have risen significantly in recent decades. Australia's capital flows have also increased considerably, particularly since the early 1980s. The stock of foreign investment in Australia has risen from around 32 per cent of GDP in the early 1980s to around 90 per cent by the end of 1995-96 (the bulk of this investment is in the form of debt rather than foreign ownership). This sharp rise in foreign investment in Australia has reflected: a shift down in domestic saving relative to overall investment; the breadth of investment opportunities; the stability of our economic and political framework; financial deregulation here and abroad; and the proximity of overseas markets with potential for rapid growth. There has also been a sharp increase in the stock of Australian investment abroad, from around 11 per cent of GDP in the early 1980s to 31 per cent at the end of 1995-96. An important component of this has been direct investment, reflecting a desire of Australian firms to invest in productive capacity in export markets in which they have established a presence and to become insiders in foreign markets by locating some functions abroad.

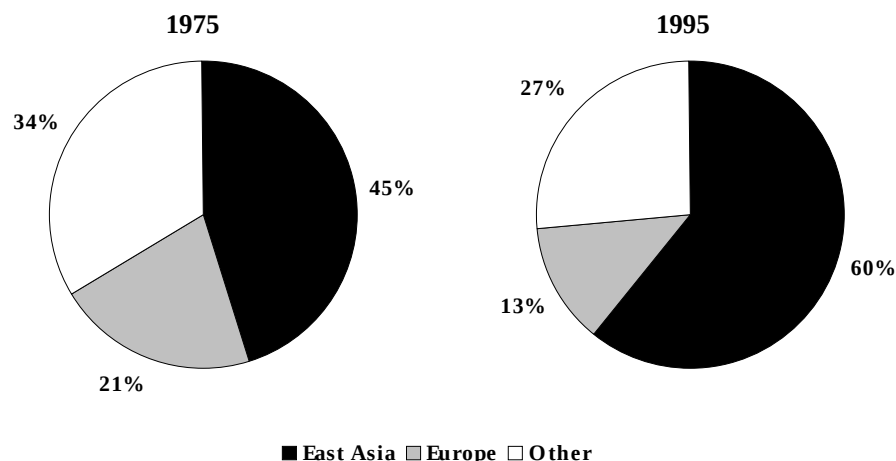
Overall, developments overseas create significant pressures for structural change in the Australian economy. Opportunities for expansion in trade provide the basis for greater specialisation in areas of relative economic strength — a prescription for higher living standards through the opportunity to make the best use of available resources.

### **The Growth of East Asia**

Whereas historically Australia's main markets were distant and grew relatively slowly, the proximity of fast-growing East Asia, combined with lower transport and communication costs, has in recent decades offered opportunities for faster growth in Australia. Australian businesses have taken advantage of these opportunities, and exports to East Asia constitute a growing proportion of Australia's total exports (Chart 5). Not only is East Asia an important destination for Australia's traditional commodity exports, it is also an increasingly important source of demand for manufactures and

such services as tourism and education. Changes in the direction, and composition, of exports will continue to have an impact on the composition of Australia's production.

**Chart 5: Direction of Australia's Exports**



Source: Department of Foreign Affairs and Trade, *Direction of Trade Time Series: 1975-1995*, May 1996.

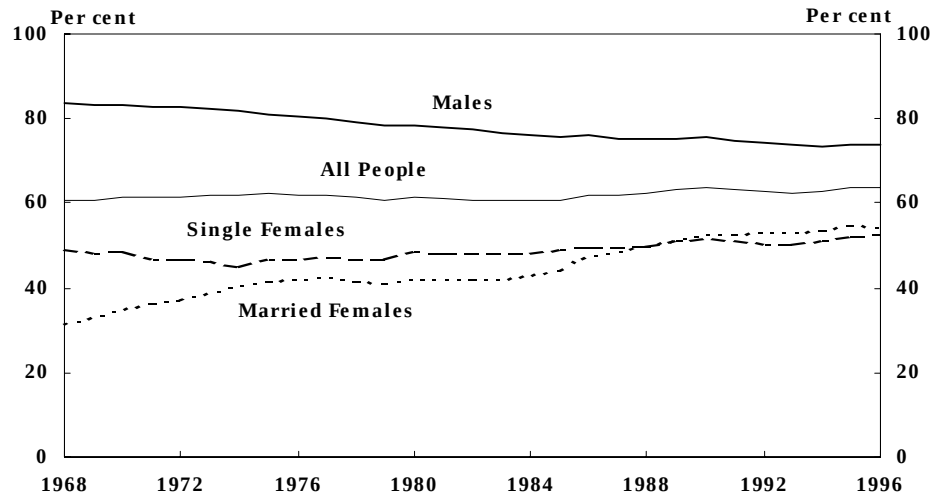
### Changing Composition and Organisation of the Labour Force

Demographic influences are a factor in the responsiveness of an economy to change and are also a source of change. Changes in the size and location of industries have been associated with considerable mobility of the work force between industries, occupations and regions. On average over the past twenty years, around 16 per cent of workers changed jobs (employers) in the preceding year. With the addition of workers who did not work in the previous 12 months — reflecting inflows either from unemployment or from outside the labour force, such as school leavers — almost 23 per cent of workers on average over this period had been in their jobs for less than one year. This high turnover of labour provides the opportunity for expanding industries to more readily take up employment losses in declining industries.

Demographic factors and changes in social preferences have resulted in changes in the composition of the work force, particularly in relation to participation and hours worked. Increasing participation by married women in the labour force has underpinned an increase in the past 30 years in the proportion of the population either employed or looking for work (Chart 6). Over the same period, average weekly hours worked have declined from around 39 hours in the second half of the 1960s to around 36 hours in the first half of the 1990s. Notwithstanding that aggregate decline, the proportion of males working more than 49 hours rose from 20 per cent in 1981 to 29 per cent in 1996, while the proportion of employed females working such hours rose from 6 per cent to 9 per cent<sup>3</sup>.

<sup>3</sup> ABS, *Labour Force Australia*, Cat. Nos. 6204.0 and 6203.0.

**Chart 6: Labour Force Participation**



Source: ABS Cat. Nos. 6203.0 and 6204.0.

These changes have coincided with increased availability of part-time and casual work. The reasons lie both in increased supply and demand for such forms of work, including the increasing importance of the services sector. For example, many people seek flexibility in working hours to manage family or study commitments and deregulation of shopping hours has increased demand for workers outside traditional working hours. Greater flexibility in the terms and conditions of part-time and casual work has also meant employers have been more willing to take on such workers. The combined effect of longer working hours for some and increased part-time and casual work for others is that a smaller proportion of workers is now working a conventional working week compared to twenty years ago.

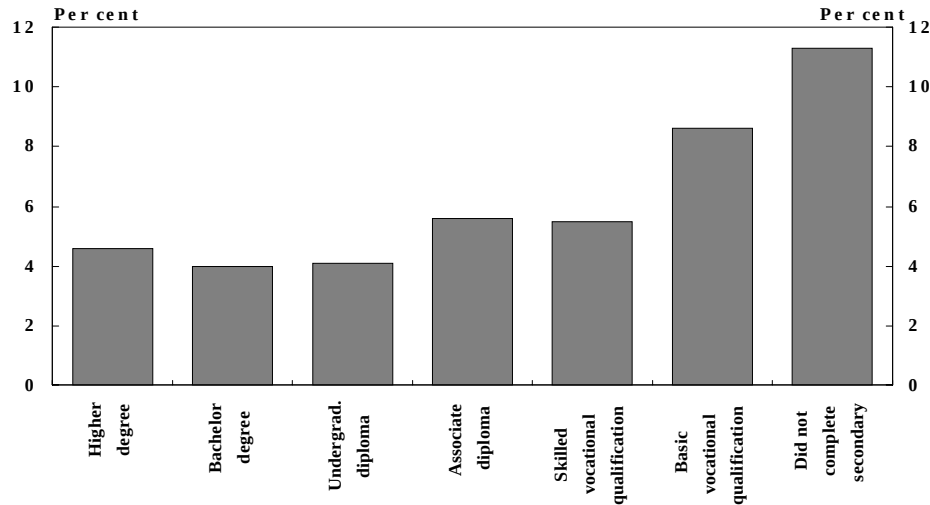
Changes in the composition of the work force have been accompanied by declining trade union membership. Membership fell from 51 per cent of employees in 1976 to 31 per cent in 1996.<sup>4</sup>

Skilled workers who are able to take advantage of new technology and are more adaptable to new work arrangements are becoming more highly valued. In both the 1970s and the 1980s employment growth was weakest for the generally less skilled occupations — labourers and related workers — and strongest for the more skilled occupations — professionals and para-professionals. This trend has continued in the 1990s, with the highest incidence of unemployment occurring among those with the lowest levels of educational attainment (Chart 7).

<sup>4</sup> ABS, *Trade Union Members*, Cat. No. 6325.0.



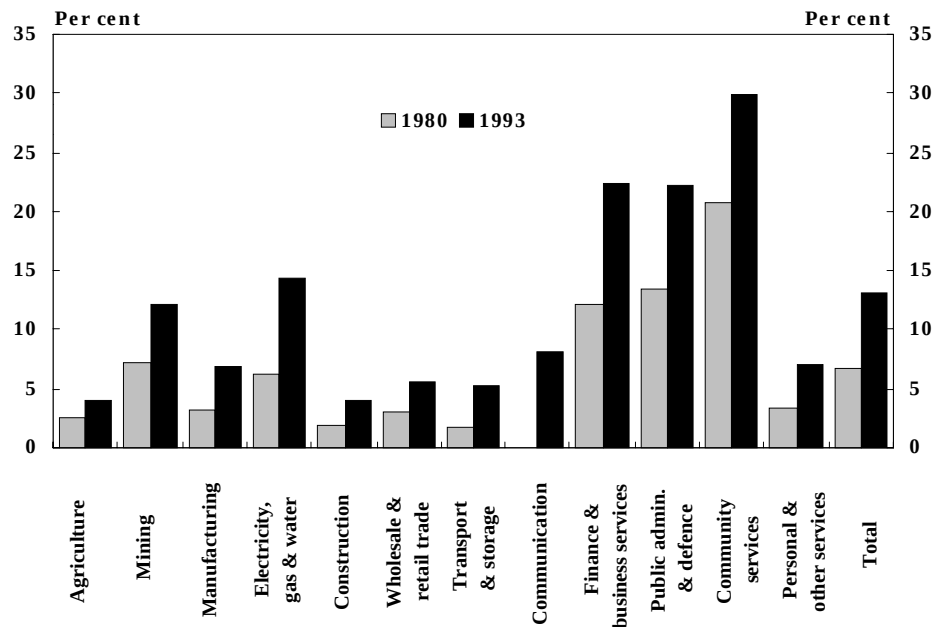
**Chart 7: Unemployment Rate by Educational Attainment (May 1996)**



Source: ABS Cat. No. 6227.0.

An increase in education levels is apparent in all industries (Chart 8). The overall proportion of employees with post-secondary qualifications rose from 38 per cent in 1980 to 52 per cent in 1993.<sup>5</sup>

**Chart 8: Proportion of Industry Employees with a Degree<sup>(a)</sup>**



(a) Data are not available for communication sector in 1980.

Source: ABS Cat. No. 6235.0.

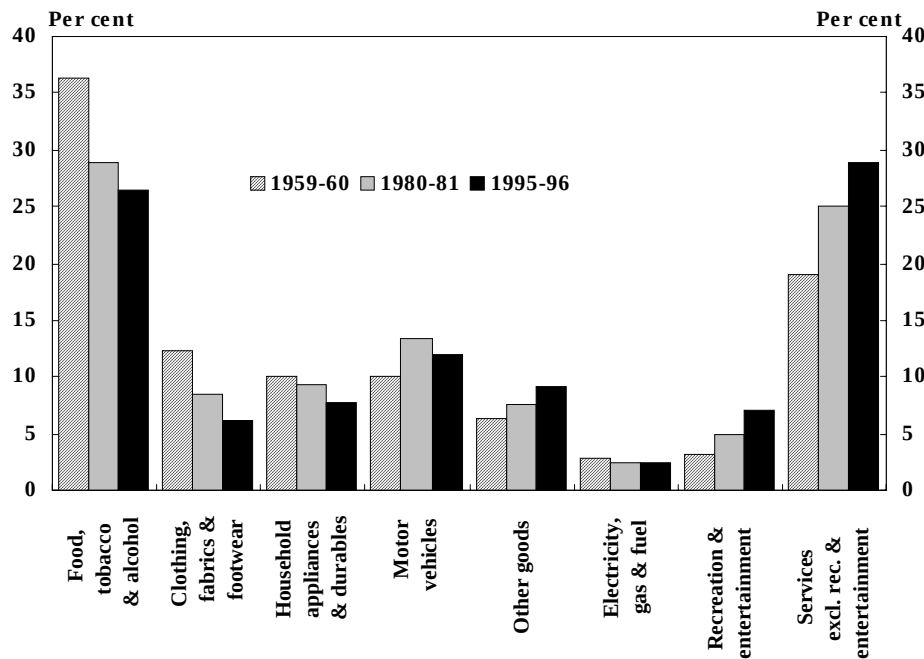
<sup>5</sup> ABS, *Labour Force Status and Educational Attainment, Australia*, Cat. No. 6235.0 (February 1980 and February 1994).

## Changing Consumption Patterns

In the past thirty years or so there have been notable shifts in the composition of consumer spending. In particular, food, clothing and related items now account for almost one-third of consumer spending compared with almost one-half 35 years ago, while consumption of services has increased in relative importance (Chart 9).

Such changes in composition may reflect a response to changes in relative prices and incomes as well as changes in tastes. Changes in relative prices may occur because of, say, the development of new or cheaper products embodying new technology or because of reductions in protection or changes in rates of taxation applying to particular goods and services. Falling relative prices of particular items may result in a higher or lower proportion of income being spent on them, depending on the price and income elasticities of demand. In addition, increasing incomes influence consumption patterns as those on higher incomes tend to spend proportionately less of their incomes on food and more on recreation and entertainment.<sup>6</sup> Other demographic changes, such as increased female participation in the work force, may also result in changed spending patterns.

**Chart 9: Shares of Consumption Spending as a Proportion of Total Consumption<sup>(a)</sup>**



(a) Total consumption excludes expenditure on dwelling rent. Current price data are used.  
Source: ABS Cat. No. 5206.0.

<sup>6</sup> For measurement purposes, spending at restaurants is divided between a food component and a service component which appears in Chart 9 under 'services excluding recreation and entertainment'.

## THE BENEFITS OF MICROECONOMIC REFORM

The preceding section illustrates the widespread and continuous process of structural change occurring domestically and internationally. In broad terms, the spectrum of choice facing governments in relation to structural change ranges from resistance to facilitation. Australia has been actively pursuing microeconomic reform across a number of areas to make the economy more responsive to change.

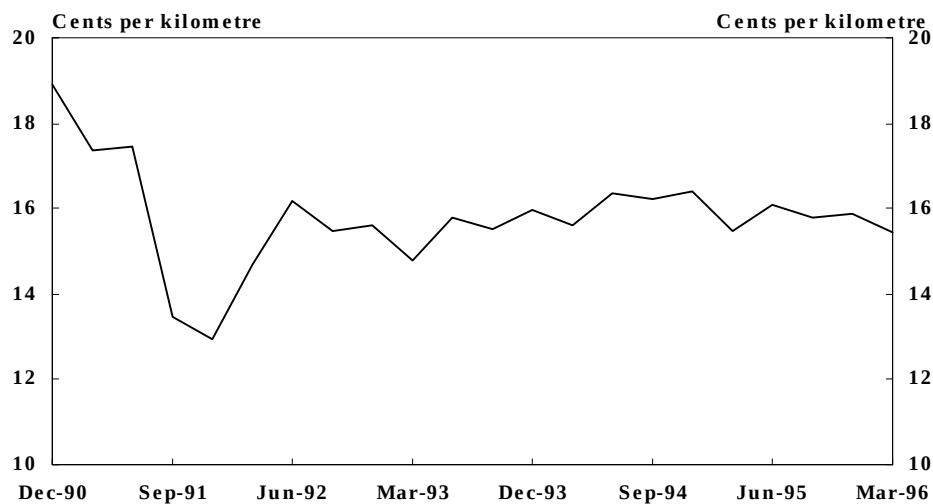
Consistent with the experience of a number of other industrial economies, the overall benefits from the reforms undertaken are becoming evident — particularly in the industries directly affected but also at the economy-wide level.

### Benefits of Competition and Commercialisation

A prime focus of reform has been to subject the private sector in Australia to more competition from both domestic and international sources and to improve the performance of public utilities. The direct benefits of these reforms are lower prices and increased productivity which, in turn, reduce input costs for other industries and increase aggregate employment opportunities. Aside from lowering the cost structure of downstream businesses, such price falls also exert downward pressure on overall inflation and inflation expectations.

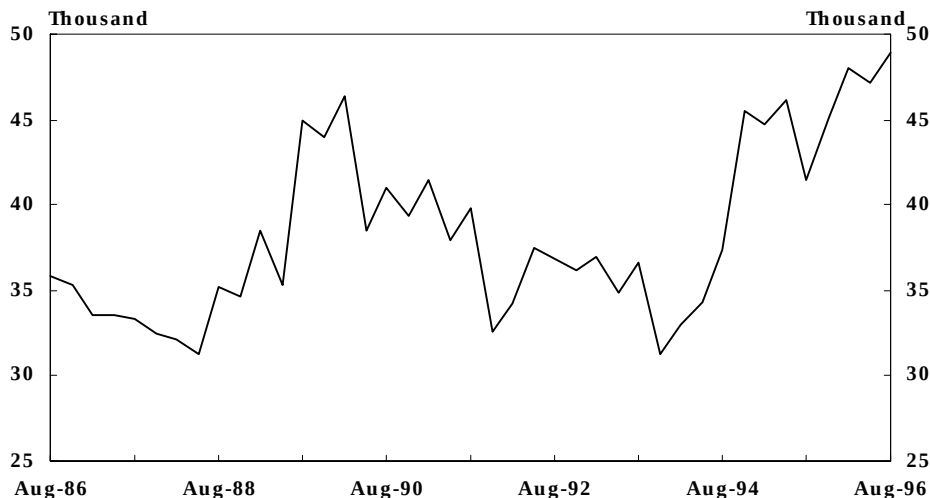
**Domestic aviation** provides a good example of the benefits of increased competition. Prices fell with the end of the 'two airline policy' in October 1990 (Chart 10) and, with lower prices, passenger numbers have increased by around 75 per cent. Employment in August 1996 was 19 per cent above the August 1990 level and also in excess of the temporary peak reached in the late 1980s (Chart 11).

**Chart 10: Average Airfares (1989-90 dollars)**



Source: Australian Competition and Consumer Commission, *Movement in Average Airfares Quarterly Update*, March 1996.

**Chart 11: Employment in Aviation**

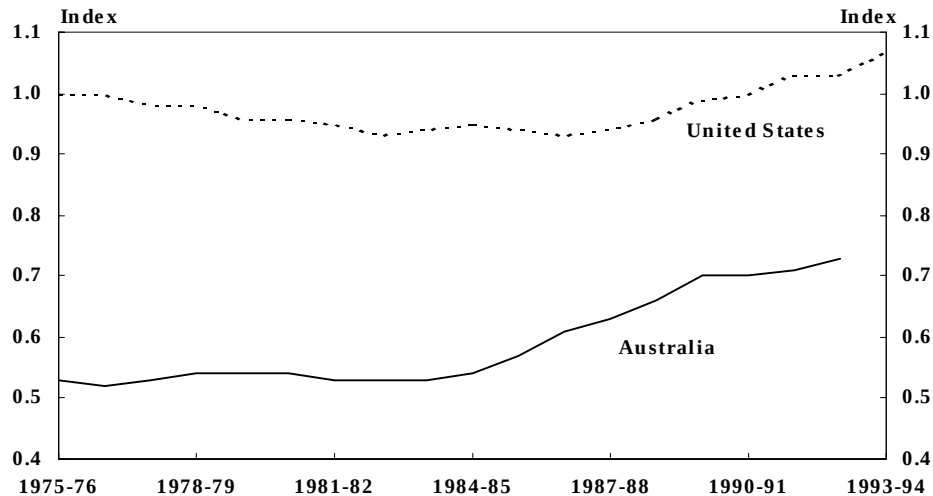


Source: ABS Cat. No. 6204.0.

In the **communication services** industry, measures to improve the commercial focus of Telstra and Australia Post include the introduction of managed competition in the telecommunications sector from 1992 and the reduction in 1994 in Australia Post's monopoly over some previously reserved postal services. A fall in Telstra's employment over the 1990s has been offset by increased employment elsewhere within the industry, including the new carriers (Optus and Vodafone) and the service providers that have emerged since the removal of Telstra's monopoly over many activities. Similarly, a reduction in employment in Australia Post over the 1990s has been offset by increased employment amongst private couriers and mail handlers. Overall employment in the communication industry (postal, courier and telecommunication services) has increased from around 150,000 at the end of 1989 to around 170,000 at the end of 1996. The improved efficiencies stemming from these reforms are illustrated by the marked reductions in the price of Telstra's services during the 1990s accompanied by significant rises in profitability (reflected in higher dividends and corporate tax payments) and by improved quality and responsiveness of service. Similarly, Australia Post's profitability has risen significantly since 1992 even though the price of standard stamps has remained unchanged, and therefore fallen in real terms, over this period.

Corporatisation and privatisation of **electricity** businesses have also fostered a more commercial focus and helped to deliver substantial improvements in productivity in recent years, although productivity remains below international best practice (Chart 12). Some losses in employment in the industry itself have been partly offset by an increase in contracted labour supplying services to the electricity industry. Average prices have fallen by six per cent (in constant dollar terms) between 1989-90 and 1994-95.

Chart 12: Total Factor Productivity Levels in Electricity<sup>(a)</sup>



(a) Total factor productivity accounts for output increases beyond those explained by increases in inputs of capital, labour, fuel and other materials and services (eg contract maintenance).

Source: Bureau of Industry Economics, *Electricity 1996: International Benchmarking*, September 1996.

Significant economy-wide benefits — in the form of increased output and employment — can flow from price reductions of significant inputs supplied to other business activities. Electricity is an area of considerable importance to downstream industries, and the Industry Commission (1996) calculated that implementation of a range of reforms in this industry could deliver an eventual gain in GDP of up to 1.3 per cent. The commencement of inter-State competition on the National Grid should help to realise those benefits and lift productivity performance towards international best practice. Benefits of increased competition in electricity have already been seen in Victoria where 78 per cent of firms surveyed by the Australian Chamber of Manufactures consider that they have been able to negotiate better prices as a result of recent reforms and only 10 per cent consider that they are worse off.<sup>7</sup>

Overall, reforms to **government business enterprises** have resulted in lower costs for services provided, with surveyed prices for 58 major Commonwealth, State and Territory enterprises falling by around 10 per cent in the first half of the 1990s (Chart 13).

<sup>7</sup> Australian Chamber of Manufactures, *Customer feedback on Victoria's competitive electricity market*, 1996.

**Chart 13: Government Trading Enterprises — Average Real Prices<sup>(a)</sup>**

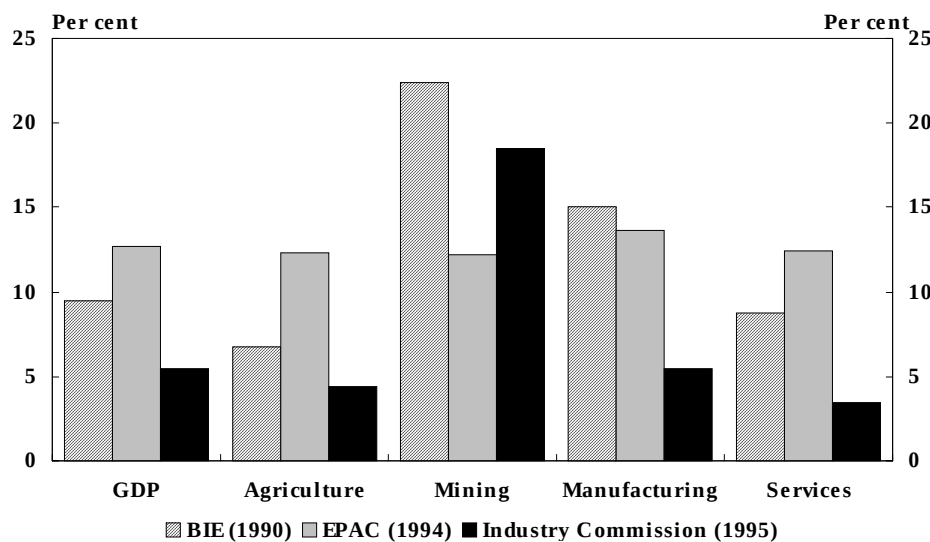


(a) Index (1989-90 = 100). Prices of examined enterprises are deflated by consumer price index changes. The decline in the index indicates that average government trading enterprise prices have risen at a slower rate than general inflation.

Source: Steering Committee on National Performance Monitoring of Government Trading Enterprises, *Government Trading Enterprises Performance Indicators*, various editions.

Potential benefits from wide-ranging microeconomic reform have been further emphasised in a number of studies (Chart 14). For example, the Industry Commission estimates that a range of reforms associated with the implementation of the National Competition Policy could boost GDP by around 5.5 per cent.

**Chart 14: Projected Benefits of Microeconomic Reform<sup>(a)</sup>**



(a) Benefits measured in terms of aggregate GDP and sectoral output.

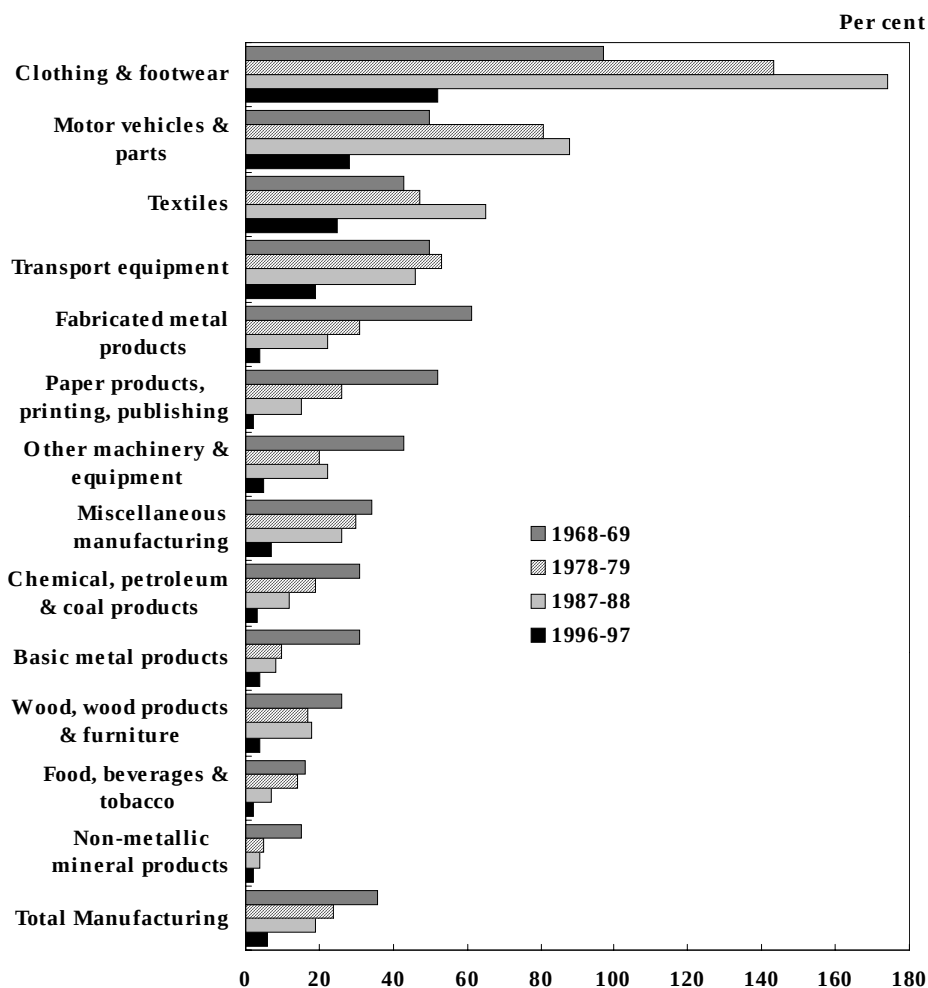
Source: Results reported in Bureau of Industry Economics, *Setting the Scene: Micro Reform — Impact on Firms*, 1996. The results are derived from different studies, each involving wide-ranging, but different, reforms: Bureau of Industry Economics, *Microeconomic Reform and the Structure of Industry*, 1990; Economic Planning and Advisory Council (authors R. Filmer and D. Dao), *Economic Effects of Microeconomic Reform*, 1994; and Industry Commission, *The Growth and Revenue Implications of Hilmer and Related Reforms*, 1995.

## Industry Assistance

Industry assistance in the form of tariffs and quotas imposes economic costs by distorting the patterns of production and consumption and results in lower aggregate output. The effects of such assistance include higher consumer prices for some goods and higher input and production costs for other producers.

The removal or reduction of such assistance is a spur to reduced costs, improved productivity and a pattern of production that reflects commercial realities. Chart 15

**Chart 15: Effective Rates of Assistance in Manufacturing**



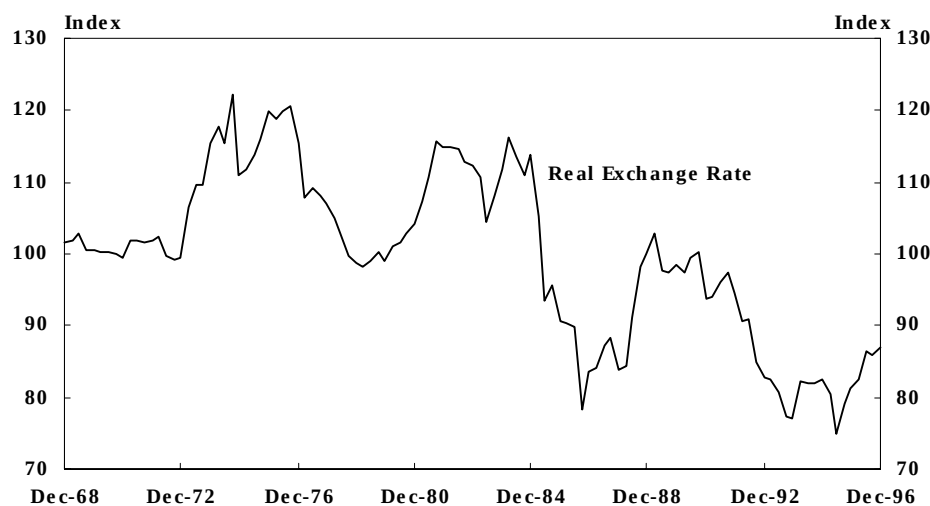
Source: Industry Commission, *Assistance to Agriculture and Manufacturing Industries*, Information Paper, March 1995 and Industry Commission, *Annual Report 1995-96*, September 1996.

shows that effective rates of assistance<sup>8</sup> for manufacturing industries as a whole have been reduced significantly in recent decades, particularly during the 1980s and 1990s. While considerable variation in rates of assistance remains across industries, there is much greater uniformity than was the case 20, or even 10, years ago.

The impact of such changes cannot be viewed in isolation from movements in the real exchange rate — ie movements in the nominal exchange rate adjusted for relative rates of inflation at home and abroad. As indicated in Chart 16, the real exchange rate has fallen considerably since the early 1980s; despite some more recent increases, the real exchange rate is currently about 25 per cent lower than it was in the early 1980s.

A lower real exchange rate will tend to moderate the effects of reductions in protection on import competing industry and provide a relative stimulus for export industry. In Australia, while manufacturing's share of overall production has continued to decline as in other industrial countries, the share of some manufacturing activities has expanded — and some manufactured exports have increased considerably.

**Chart 16: Real Exchange Rate<sup>(a)</sup>**



(a) The real exchange rate is calculated as the trade weighted index of the Australian dollar exchange rate multiplied by the domestic output deflator divided by a trade weighted foreign output price deflator.

Sources: ABS Cat. No. 1364.0.

## Labour Market Reforms

In recent years, Australia has moved away from a centralised wage fixing system towards an enterprise-based bargaining system in which wages should increasingly reflect the circumstances of individual businesses and their employees. The process was accelerated by the *Workplace Relations Act 1996*. These reforms have the objective of reducing unemployment and increasing labour market responsiveness to structural and

<sup>8</sup> If the value added by a firm is low and if the tariffs on the firm's input costs are low relative to the nominal rate of tariff on its output, the effective rate of tariff assistance can be much higher than the nominal rate.



cyclical shifts in product markets. Increases in productivity should also be bolstered, including by removal of inappropriate workplace restrictions.

Overseas experience indicates that a greater focus on enterprise bargaining and increased wage flexibility across sectors and occupations helps to deliver better employment outcomes. The European Union, with relatively inflexible product and labour markets, had unemployment levels of around 10 per cent during the 1980s, and unemployment rates in Germany, France and Italy have risen to around 12 per cent over the past year. In contrast, in the United Kingdom — a European country that has instituted significant structural labour market reform — unemployment has fallen from around 10 per cent in the mid 1980s to around 6½ per cent today. The United States, with generally more flexible markets, averaged around 6½ per cent unemployment in the 1980s, much lower than in Europe, and unemployment has since fallen below 5½ per cent. In New Zealand, after a decade of major structural reforms, including reforms to the labour market, unemployment has fallen rapidly to just under six per cent from a peak of almost 11 per cent in 1991 (although New Zealand's GDP growth over that period has been less than Australia's).

### **Effect on Aggregate Productivity**

An important objective of structural reform is an improvement in productivity performance, which is the main source of continued rises in living standards. At an individual industry level, such improvements are readily discernible; indications of significant gains in productivity have, for example, been mentioned above for the aviation and electricity sectors. The extent of reforms introduced and the indications of improvements evident at a sectoral level give rise to an expectation that an improved productivity performance should also be apparent at an economy-wide level.

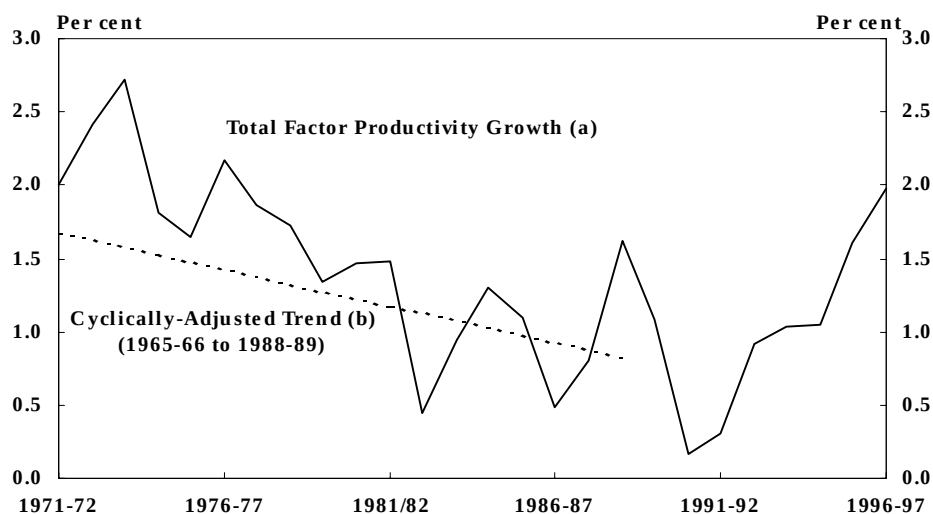
A number of factors, however, complicate analysis of trends in aggregate productivity performance. Cyclical factors obscure recognition of structural improvements; for example, in the early stages of economic recovery, factor inputs may be used more intensively, resulting in increases in output and productivity. Moreover, productivity improvements are generally only incremental and so may only become apparent in aggregate data after a considerable period has elapsed.

Productivity measurement, too, is difficult, particularly in the increasingly important service industries. For example, deregulation of trading hours may have increased efficiency in wholesale and retail trade, one of the largest sectors in the economy. Yet extended shopping hours have actually decreased measured productivity on an hours worked basis as, in the absence of other indicators, measured output is indexed to sales (in effect there is no measurement at all of the improvement in service). Similarly, output in the financial sector is measured in terms of labour inputs and hence labour productivity is by definition unchanged, despite industry reports of large increases in

output per worker in this sector partly as a result of deregulation.<sup>9</sup> These considerations suggest that the aggregate data may underestimate the true benefits of reform.

Despite the above difficulties, there are some indications that the improved productivity performance observed for particular industries is also becoming apparent at more aggregated levels. Movements in total factor productivity for the non-farm market sector since the early 1970s are shown in Chart 17. As expected, cyclical influences are apparent, even though the data have been expressed in terms of rolling averages. Nevertheless, even allowing for such influences in the first half of the 1990s, recent outcomes give support to the likelihood of a structural improvement in aggregate productivity performance over the 1990s. In particular, outcomes during the 1990s contrast with the general downward trend in productivity growth evident to the end of the 1980s, even though average productivity growth in the 1990s is not significantly above the 1980s experience. A very significant contributor to the improvement in aggregate outcomes over the 1990s appears to have been developments in the public enterprise sector, related to the substantial reforms of government business enterprises mentioned above. Since 1990, labour productivity levels in the public enterprise sector, which accounts for about 11 per cent of total output, have risen by around two-thirds.

**Chart 17: Total Factor Productivity Growth — Non-Farm Market Sector**



(a) Rolling average growth rates — six years to the year shown.

(b) The cyclically-adjusted trend has been derived by regressing annual total factor productivity growth for the period shown against a cyclical indicator and a time trend.

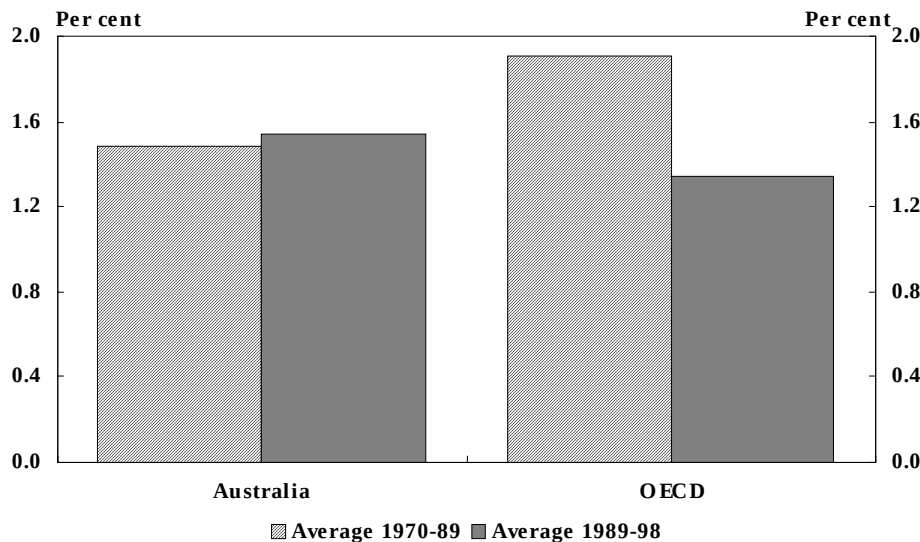
Source: ABS Cat. Nos. 5206.0, 5234.0 and Treasury estimates.

International comparisons also suggest positive productivity developments in Australia. Differences in national accounting conventions create problems in compiling and comparing capital stock estimates, making comparisons of total factor productivity particularly difficult. Concentrating on labour productivity growth, therefore, data from

<sup>9</sup> Oster A. and Antioch L., 'Measuring Productivity in the Australian Banking Sector' in RBA Conference Volume, *Productivity and Growth*, 1995.

the latest OECD Economic Outlook (including forecasts through 1998) indicate that recent and expected performance in Australia compares favourably with the rest of the OECD. As indicated in Chart 18, average labour productivity growth in Australia in the 1990s is expected to be marginally above that in the 1970s and 1980s, an outcome broadly consistent with the outcomes for total factor productivity noted above. Nevertheless, what is most striking is that Australian experience contrasts sharply with the deceleration evident for the OECD as a whole in the 1990s relative to its earlier experience, highlighting the importance of microeconomic reforms in Australia in enabling these broader trends to be avoided.

**Chart 18: Labour Productivity Growth: Australia and the OECD**



Source: Treasury estimates based on data from OECD, *Economic Outlook*, December 1996, including OECD forecasts to 1998.

Despite Australia's better recent productivity growth performance (compared with the OECD as a whole), Australia's productivity **level** remains relatively low. An international comparison undertaken by the OECD<sup>10</sup> indicates that Australia's labour productivity level in manufacturing in the mid-1990s was the lowest of the 11 OECD countries analysed. For a limited range of service industries analysed, the same study concluded that Australia's productivity levels were high only in construction and air transport. Similarly, the BIE has estimated that Australian industry lags significantly behind world best practice levels of labour and capital productivity in industries such as electricity, telecommunications, rail freight, waterfront container movement, aviation, gas supply, coastal shipping and road freight<sup>11</sup>. These international comparisons of Australian productivity performance highlight the need for continued pursuit of reforms to enable ongoing efficiencies to be introduced, both to bridge the existing gap and to match further advances in world best practice.

<sup>10</sup> Pilat D., *Labour Productivity Levels in OECD Countries: Estimates for Manufacturing and Selected Service Sectors*, OECD Working Paper No. 169, 1996.

<sup>11</sup> Bureau of Industry Economics, *International Benchmarking — Overview*, Report 95/20.

## THE ROLE OF POLICY

Structural change offers the opportunity of higher living standards and faster employment growth, but the extent to which these potential rewards are realised will depend on the capacity of the economy to adapt and harness the benefits in prospect.

The depth, diversity and ever-changing nature of structural change mean that attempts by governments to dictate the shape of industry are inevitably frustrated. Attempting to delay adjustment to structural change through regulatory means is likely to increase the degree of dislocation ultimately involved. Governments, both in Australia and overseas, have increasingly recognised the economic costs of trying to stand in the way of structural change. The benefits are recognised of policies which do not constrain employers, employees, consumers and producers from judging themselves how to respond to change so as to maintain or improve their own well-being — and thereby add to living standards overall. Much microeconomic reform both here and overseas since the early 1980s has been directed to that end: the reduction or removal of unnecessary government regulation that impedes the translation of structural change into changed commercial opportunities.

The overriding aim of microeconomic policy must be to provide a flexible economic structure capable of taking advantage of emerging opportunities by facilitating the movement of resources between and within industries. Macroeconomic policy has a supportive and complementary role in providing a stable economic environment conducive to sound investment decisions by business and to encouraging workers to invest in upgrading their skills to take advantage of new employment opportunities. The interactions and synergies between these two areas of policy have long been emphasised by the IMF and OECD in reporting on the observable factors that contribute to economic success, viz: ‘Experience in recent years has confirmed that economic success requires sustained efforts at both structural reform and macroeconomic stabilization and that efforts over a broad range of policies are mutually reinforcing. It has become particularly apparent that a failure to tackle serious weaknesses in some areas may increase the short-term costs, and delay the positive effects, of those policies that go in the right direction. More comprehensive and better balanced policy approaches are necessary if a greater number of countries are to realize their full growth potential.’<sup>12</sup>

Sound macroeconomic and microeconomic policies thus provide a policy environment conducive to flexible adjustment by industry to ongoing structural change. The conjunction of sound microeconomic and macroeconomic policies provides a general framework for industry which offers the potential of higher medium term growth for the economy overall. Industry policy involves the combination of macroeconomic policies that provide a stable environment in which businesses and workers can plan for adjustment to change and microeconomic policies which allow business, employee and consumer alike to respond to new opportunities presented by structural change. Despite the important complementarities between macroeconomic and microeconomic policies, each of these policies has a separate contribution to make.

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<sup>12</sup> IMF, *World Economic Outlook*, October 1996.

## **Macroeconomic Policy**

The maintenance of stable economic conditions in Australia has proven to be a challenging task, with the emergence of unwanted inflation and external current account pressures. Policy action to address these pressures has frequently contributed to a short-term downturn and, inevitably, constrained the sustainable pace of economic growth. The source of the problem, however, is the policy failure which permitted the pressures to emerge. Either way, the resultant sudden changes in the economic outlook affect the confidence of businesses and consumers and their willingness to engage in the process of structural change. In addition, fiscal imbalances and uncertainty about inflation prospects can lead to higher real interest rates, discouraging investment and distorting investment patterns.

In recent years substantial progress has been made in addressing inflation and to a lesser extent current account deficit constraints. The current cycle has been characterised by low inflation, with monetary policy being conducted on a more forward looking basis within the framework of keeping underlying inflation consistent with the RBA's target range of 2 to 3 per cent, on average, over the cycle. Last year the Government introduced a new framework for the conduct of policy, clearly recognising the Reserve Bank's role and endorsing its inflation objective. The clarification of policy responsibilities, and recognition of their observance in practice over time, together with an accumulating record of low inflation, are likely to have a continuing positive impact on lowering inflation expectations and creating confidence in a sound investment environment.

Australia's large structural current account deficit reflects both inadequate national saving and inadequate investment returns overall. On the saving side, the principal cause is a deficiency in public saving especially at the Commonwealth level. The Government through its fiscal consolidation programme, is addressing this problem and has put in place a policy framework that will maintain the adequacy of the Commonwealth contribution to public saving. Statements 1 and 2 spell out in detail the fiscal strategy, including improved transparency and accountability practices, and implementation of the strategy in the years ahead. The benefit of a more soundly based fiscal policy is likely to be seen over time in the capacity of the economy to sustain faster rates of growth than would otherwise be the case. While it is too early to be able to point to any concrete results with confidence, the 1997-98 economic outlook presented in Statement 2 suggests that higher saving in prospect next financial year will help to constrain the current account deficit.

## **Microeconomic Policy**

The central role of microeconomic policy is to improve the return on investments overall by enhancing the flexibility of the economy and increasing its supply potential by allowing product, labour and financial markets to work more efficiently. The pursuit of efficiency — of productivity improvements — is often seen as running contrary to the goal of reducing unemployment yet if an enterprise (or the nation) cannot compete then it stands to lose in a permanent sense. If competitiveness is achieved and maintained, employment growth is limited only by market size — which, for an increasing number of products and services, means the world market. The key to

employment growth and reducing unemployment is through policies and practices which control, or reduce, unit costs.<sup>13</sup>

The importance of unit costs is not set aside by innovation. As discussed earlier, ongoing technological change and innovation are significant drivers of change — with innovation often resulting from the desire to obtain a competitive edge. Unit costs remain a crucial consideration as the products arising from innovation are made and sold: substitute products, for example, are an ever-present threat and the competitive advantage from innovation is usually of limited duration as others seek to share in the advantage.

Controlling unit costs requires restraining the costs of all inputs, be they material, labour, capital or taxes. That there is frequently a focus on labour or taxes reflects no more than that, historically, they have proven to be least amenable to control. Controlling unit labour costs does not require lowering wages: it requires that the combination of labour costs (wages and non-wage labour costs) and labour productivity yield competitive outcomes.

The central role of microeconomic policy assisting that process lies in minimising the constraints faced by enterprises and industries, ie in fostering adjustments including by minimising governments' contribution to unit costs by way of taxes and regulation.

The Government is addressing some of these sorts of issues on a number of fronts including reducing regulation, labour market reform, competition policy, training, small business deregulation, financial system regulation and transport.

Government intervention and regulation is a normal feature of modern market economies and recognises that markets do not necessarily operate with optimal efficiency and that there is a wider role for government in pursuing community and social objectives. A good example is the desirability of regulation, such as the *Trade Practices Act 1974*, to secure competitive outcomes (including where unregulated markets deliver inefficient outcomes) and to protect consumers. Despite there being such legitimate reasons for well-targeted regulation, experience in Australia and abroad shows that regulation, introduced with good intent and often as a temporary measure, has a tendency to become entrenched over time and accepted as part of the economic landscape. It follows that an important policy priority is to keep such regulatory practices under review and ensure they are achieving their intended and legitimate purpose.

Consistent with this, the Government has announced that it will place much greater reliance on competition to keep price increases in check and much less reliance on direct regulation of prices through the *Prices Surveillance Act 1983*. The price declarations under the Act of a number of products such as beer and cigarettes have been rescinded and in the future prices surveillance will only be applied in those markets where competitive pressures are not sufficient to achieve efficient prices and

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<sup>13</sup> Unit cost is the cost of producing one unit of output. For given input prices, unit costs decline as total factor productivity increases.

protect against excessive price increases. The Commonwealth has also announced that it will review by the year 2000 all existing Commonwealth legislation that restricts competition. All together some 90 reviews have been scheduled with the aims being to:

- clarify the objectives of the legislation;
- identify the nature of restrictions on competition;
- analyse the likely effects of the restrictions on competition and the economy generally;
- assess the costs and benefits of the restrictions; and
- consider alternative means of achieving the same results including non-legislative approaches.

Each State and Territory has equivalent review processes established. This systematic review of legislation has the potential to continually re-orient and update the regulatory framework so that it complements competition rather than impedes it.

A key labour market reform is embodied in the *Workplace Relations Act 1996* which came into operation earlier this year. It encourages labour market flexibility by promoting enterprise-level wage bargaining, by providing greater choice in the way enterprise bargaining agreements are negotiated and by limiting the award system to a safety net of fair minimum wages and working conditions. The success and effectiveness of the new arrangements in achieving more flexible work practices and remuneration will be critical to the task of reducing unemployment.

An important objective of Government education policy is increasing the skills of the work force at the entry level, to enhance workers' abilities to move between jobs and to increase their productivity. A new regime of entry level training incentives designed to encourage employers to take on trainees and apprentices and to promote training at higher levels is introduced in this Budget.

The Government also gives high priority to reducing the regulatory burden on small business. In March, in response to the Bell Taskforce, the Prime Minister announced a range of measures aimed at cutting red tape faced by small businesses. Among the measures is an exemption for businesses with 15 or fewer employees from Federal unfair dismissal provisions in respect of new employees until they have been continuously employed for 12 months. Other measures are designed to lower compliance costs in the areas of fringe benefits and capital gains tax, lower regulatory burdens through a single registration for various government authorities, and increase small business' access to finance.

The Wallis Inquiry into the financial system made a large number of recommendations to improve the regulatory framework, and therefore the efficiency, of the financial system, noting that even a 10 per cent improvement in efficiency in the financial sector would translate into cost savings for the economy in excess of \$4 billion per year. The Government will consider these recommendations over the coming months, assessing

how best to adapt the regulatory regime to the changes produced by globalisation, technology advances and consumer preferences.

Transport is a key sector of the Australian economy. Transport provides the link between major cities and forms a critical lifeline throughout regional Australia and between it and the major centres. It provides a key input into many industries, in particular export industries. While there have been recent improvements in productivity in parts of the sector, elements of Australia's transport sector operate at below world's best practice (as evidenced by the international benchmarking studies conducted recently by the Bureau of Industry Economics). To improve the efficiency of the transport sector, a range of reforms have been introduced or are being examined, including:

- privatisation of Federal airports, the Australian National Line, Australian National Railways and the Commonwealth's share in National Rail;
- structural reform of interstate rail services;
- the review of impediments to competition in the aviation sector, including the liberalisation of the domestic aviation market, the establishment of the Single Aviation Market with New Zealand and the proposed review of international air service agreements;
- reform of the road transport sector; and
- a commitment to pursue a broad reform agenda in the maritime sector.

By its very nature, structural change affects individuals and businesses and may impose short-term disruption despite wider community benefits. Adjustment assistance to support individuals directly affected may therefore be warranted, especially in cases of hardship and where significant occupational change is involved. Linking such assistance to training to develop new skills is likely to be the most effective approach in the longer term.

### **International Experience**

There has been heightened interest in recent years in the experience of different countries pursuing economic reform programmes in the context of shaping strategic responses to the key policy challenge of reducing structural unemployment in many industrial countries. Over the past two years the OECD has undertaken detailed country studies, examining the impact of reform programmes which have varied considerably across member countries in the extent and range of reforms involved. Some important policy lessons have been drawn from this work:

- Countries pursuing comprehensive reform programs — such as, the United Kingdom and New Zealand — achieved the best outcomes. This includes sound macroeconomic policies, as well as microeconomic reforms.



- Relatively small areas of reform can be significant to the success of reform as a whole and should not, therefore, be overlooked.
- Reforms take time to work. This suggests that reforms must be sustained over time and that, given the synergies between policies, the benefits of reform are likely to materialise more quickly under a comprehensive approach.
- Effective communication with the public is necessary to explain the need for reform and its benefits.

## CONCLUSION

Structural change is a long-standing and continuous process. At the end of the twentieth century, globalisation and rapid advances in information technology are key (related) influences.

Structural change presents both opportunities and challenges: opportunities to achieve higher real wages, increased employment and higher living standards; and the challenges of creating the right environment to take advantage of the opportunities available to the fullest extent possible.

The role of policy is to facilitate the process of change by providing a stable macroeconomic environment and a flexible and responsive microeconomic structure. International experience suggests that a comprehensive strategy with macroeconomic and microeconomic policies directed towards this end is likely to yield the best results. This provides a conceptually sound and tested general policy framework for industry.

There is evidence to suggest that reform in Australia is delivering results. Improvements in productivity growth, service improvement and lower prices are clearly evident in some key sectors such as transport, electricity and communications. For the economy as a whole, the trend decline in productivity growth in the 1970s and 1980s appears to have been reversed so far in the 1990s. Australia's recent performance also appears to have been relatively better than for industrial countries as a whole. These are encouraging developments.

Despite the progress made, there is a need to exploit to the fullest extent possible the reform of structural policy. While Australia's relative performance has improved, productivity levels in many industries remain low compared with international standards. The challenge for policy and for Australian businesses and workers will be to continue moving forward at a faster pace than other countries, laying foundations for more jobs and higher living standards.