

THE SERVICE ECONOMY—SUCCESS IN A MARKET DEMOCRACY

Many of the service economy's problems come from government, says **Craig Emerson**

When I spoke to a CIS gathering last year I posed the question: should we expand opportunity or the welfare state? Unsurprisingly, I came down on the side of opportunity. Ongoing expansion of the welfare state would necessitate ever-higher taxation, crushing the incentive for work, risk taking and entrepreneurship. Passive welfare, I argued, subjugated the people to the state, denying them self-esteem and robbing them of independence and freedom.

Noel Pearson, through the Cape York Institute, has forcefully highlighted the debilitating effects—the poison—of passive welfare. While only partially picked up by the Howard government in its recent intervention in the Northern Territory, at least it's a start. The government should go on to embrace the policy product of Noel's vision—opportunity as the superior alternative to passive welfare.

I want to broaden the argument about extending opportunity to all by championing free markets as the best vehicle for delivering prosperity, enabling some of the proceeds of growth to be deployed in giving every citizen an equal chance in life.

Services as free markets

I am an enthusiastic supporter of the service economy not because Kevin Rudd created and assigned me to this portfolio but because I was already an enthusiastic supporter of the service economy and small business. I am the first federal frontbencher to hold a shadow or government

portfolio explicitly covering the service economy.

My background as a market economist, an adviser to former Prime Minister Bob Hawke on microeconomic reform and as a small business owner made the portfolio of the service economy, small business and independent contractors a natural fit.

Labor in government created the open, competitive economy. And most service industry activities epitomise the open, competitive economy. Restaurants and cafes are the classic case in point.

People buy into restaurants because they feel they can do a better job of running a restaurant than the existing owners. They give it a go and work hard. Some succeed. Some fail. But they never go to government demanding that competition from nearby restaurants be restricted. They don't seek guaranteed market share, they don't seek government handouts. They are free-market entrepreneurs. And the beneficiaries are customers who enjoy a good night out, a beautiful lunch, or coffee and breakfast to start the day.

If the whole economy functioned like the restaurant industry we would be an even more prosperous nation. It is free enterprise at its best.

Craig Emerson is the Shadow Minister for the Service Economy, Small Business and Independent Contractors. This is an edited version of a speech to The Centre for Independent Studies in July 2007.

Service industry businesses—small and large—are unsung heroes. It is said disparagingly of the service industries that they don't make anything. Tell that to our musicians, our artists and our writers who enrich our lives with their creative talent. They make music, they make movies, they make us laugh, they make us cry, they make us think. Tell it to our doctors, nurses, teachers and child care workers who care for us and our families.

Tell it to the financial services industry that has invested more than \$1,000 billion of national superannuation savings, helping to secure for working Australians a good income in retirement.

Service industries and Australia's economic future

There's a lot of talk right now about the significance of the mining boom to Australia's continued prosperity. Australia has had extraordinary good luck with the massive increases in the prices of major commodities like coal, iron ore and copper.

The boom in the mining sector is boosting economic activity not just in Western Australia and Queensland, but across the nation. Indeed its largest impacts are the flow-on effects of higher dividends, high share prices, and the tax cuts made possible by the big increases in corporate profitability.

But commentary about the mining boom often neglects the importance of services businesses—like the businesses that develop and provide exploration technology, specialised mining software, transport logistics and employee training. Indeed, some of Australia's best mining success stories are the mining services businesses that have become world leaders as they have grown alongside our minerals and energy industries, such as asset management and mining software company Mincom.

Specialised services businesses now play a critical role in the competitiveness of our traditional mining, agricultural and manufacturing sectors. Often, these businesses are established by people who worked directly in the traditional sectors before—people who have expertise and want to chance their arm at running their own business, further developing their competitive advantages.

As Australia looks to our economic future, we don't need to choose between the mining sector, agriculture, manufacturing and services. Businesses in any of these sectors can flourish in an open, competitive economy.

Regulation in the service economy

Some parts of the service economy are subject to specific regulation, such as hygiene standards for restaurants and child protection rules for educational businesses. These regulations need to be efficient in their design and enforcement and not unnecessarily hamper investment and employment decisions. A market economy could not function in the absence of enforceable laws to establish and protect property rights.

Markets are places—increasingly in cyberspace—where goods and services are traded. But why buy fruit from a greengrocer when you can steal it? Why offer yourself for employment if you can hack into someone else's bank account and take their money? Why invent anything if someone can come along the next day and copy the invention free of charge?

Those who argue for totally deregulated markets are arguing for anarchy. Regulation is needed to establish property rights and the rules of exchange.

But interventionists and protectionists sometimes latch onto the term market failure to claim its existence even where it is nowhere to be found.

Market failure

Regulation can also be justified when market failure occurs. But interventionists and protectionists sometimes latch onto the term market failure to claim its existence even where it is nowhere to be found. They claim market failure abounds in the real world, since perfect competition exists only in the theoretical world of numerous sellers and buyers behaving atomistically in a world of perfect certainty and perfect information.

Market failure exists only in defined circumstances that include: anti-competitive behaviour, spillovers, unevenly-held information, public goods, and common resources like water and fisheries. I will deal with the first two.

It is a legitimate role of government to protect consumers from anti-competitive behaviour by businesses—large and small. But it is not a legitimate role of government to protect one business against competition from another.

A bigger business that exerts pressure on its suppliers to provide goods or services at low prices is not necessarily behaving anti-competitively. If governments were to intervene on behalf of suppliers and oblige the bigger business to pay suppliers a higher price, the suppliers would win but at the expense of consumers. It is not the size of a business that matters, but whether or not it behaves competitively.

In the open, competitive economy, trade practices legislation should be pro-competition not pro-business, big or small. My colleague, the shadow minister for competition policy, Chris Bowen, and I will be working closely together on the government's proposals for amending section 46 of the *Trade Practices Act*. We will do so from the perspective of protecting competition, not protecting particular businesses.

These long-awaited amendments have been necessitated by the ineffectiveness of section 46 in promoting competition. Consistent with Labor's support for the open, competitive economy, our view is that section 46 needs to be strengthened not as a protectionist measure but as a pro-competition measure.

It's easy for any industry to think its conditions are special and justify government intervention in its favour.

Spillovers

When a business activity produces a benefit or cost that is not fully confined to the business it is said to have produced a spillover. A business undertaking research and development can capture some of the benefits for itself but other benefits spill over onto the broader community. A business that trains an employee benefits from that training, but if the employee leaves and joins another business, some of the benefit accrues to the hiring business. These are examples of positive spillovers.

If left entirely to the market, there will be too little business activity that produces positive spillovers. A role exists for government to support R&D, education and training. Kevin Rudd's call for an education revolution is based on a recognition

that, by raising productivity, education produces positive spillovers for the wider community.

Conversely, there can be too much business activity producing negative spillovers like pollution and noise. A role exists for government to curtail these activities, such as through regulations or better price signals. However, often the best form of government intervention can be the use of market-based mechanisms and initiatives.

It's all too convenient for special interest groups to see regulation as the solution to their problems, and argue that extra government regulation can be justified in circumstances of market failure. So they readily invoke the term whenever they line up for a government handout, a tax concession or an anti-competitive regulation. It's easy for any industry to think its conditions are special and justify government intervention in its favour.

Removing impediments to success

The best way that government can help businesses in the service economy and the wider economy is not through regulation, but through facilitating a competitive, productive environment and removing impediments to business success. Any regulation needs to be clearly in the public interest.

When I worked for Prime Minister Bob Hawke, we set about deregulating the economy so that Australian business could flourish in a fiercely competitive world. This Labor government unshackled business by floating the dollar, deregulating financial markets, phasing down tariffs, removing quotas and introducing enterprise bargaining and National Competition Policy. It removed business impediments.

And business responded by becoming more efficient, ushering in the productivity miracle of the 1990s that laid the platform for the longest period of sustained economic growth in Australia's history.

Today, Australian service industries have taken the open, competitive model to heart. But the service economy faces new challenges: most of them imposed by government. It has been hit by massive increases in regulation since the election of the Howard government. It suffers from skills shortages and labour shortages. Red tape is piling up because of current problems with Commonwealth-State relations. This is why the

April COAG meeting was such a disappointment for those keen to see red-tape reduction.

Kevin Rudd and I have identified the key problem of harmonising and improving regulation across states and territories and we have proposed solutions. Labor will give the Productivity Commission the role of establishing the costs and benefits of various reforms, and there will be a pool of incentive funds from which the Productivity Commission will recommend distribution to states as incentives for reform action.

The Howard government has failed the market

As Australia approaches a federal election it might seem odd that a progressive political party—Labor—is advocating a reduction in business regulation, while a conservative political party—the Liberal-National Coalition—is promising more of the same accumulation of red tape as has already occurred under its stewardship.

Isn't this the Labor Party attacking the Howard government from the Right? Superficially it might seem so. Deeper examination reveals that while the Liberals might legitimately claim to have been the party of private enterprise, in truth they have never been the party of free enterprise.

Under Hawke and Keating, Labor was the party of free enterprise in an open, competitive economy. Labor in government, led by a former head of the ACTU, made the politically hard decisions to dismantle the anti-competitive regulation that had been built up over 32 years of mostly conservative government rule.

Now Labor in opposition is designing a new reform program to dismantle overbearing business regulation and offer genuine reward for effort, risk-taking and entrepreneurship. Rudd Labor's agenda is a modern expression of the philosophy of the previous Labor government.

In June, Tony Blair resigned as Britain's Prime Minister. Many have argued that Rudd Labor should pick up the Blair philosophy. But in so many ways Blair's third way was an adaptation of the Hawke-Keating philosophy. Why export a philosophy and then import it back into Australia with a 'Made in Britain' label on it?

A progressive philosophy of utilising the proceeds of growth in an open, competitive economy for social progress based on mutual

obligation was the beacon guiding the policies of the previous Australian Labor government. The same philosophy inspired a British Labour government.

Support for an open, competitive economy in achieving opportunity for all in a fairer society is Australian Labor's beacon, its light on the hill.

It is not an attack on the Coalition from the Right but a modern expression of all that true progressives yearn for—a prosperous, fair and compassionate society. This is why the service economy and modern Labor philosophy are in harmony.

Support for an open, competitive economy in achieving opportunity for all in a fairer society is Australian Labor's beacon, its light on the hill.

The service economy is modern and forward looking. So is Labor. The service economy wants businesses and their staff to be rewarded for effort, risk-taking and entrepreneurship. So does Labor. (Labor now formally says so in its Platform.) The service economy wants an open, competitive economy. So does Labor. The service economy understands that free enterprise and private enterprise are not the same thing. So does Labor.

In fact, the service economy and modern Labor are soul-mates.

Productivity

Maintaining high productivity growth rates is crucial to a thriving, open, competitive economy. Today's productivity growth is tomorrow's prosperity. Competition provides a powerful spur to productivity growth, since it is through productivity growth that businesses can survive and prosper in tough competitive markets.

After years of Labor arguing the need for a new round of productivity growth, without attracting much popular media attention, Australia's productivity performance leapt into the mainstream of political debate following the release of official statistics showing an improvement in productivity growth over the most recent six-month period. The government seized on these figures to argue that, contrary to Labor claims, its performance in

sustaining productivity growth was good and, beyond *WorkChoices*, the productivity-raising agenda was complete.

The government went so far as to argue that Australia's productivity performance depended on whether we are talking about productivity in the market part of the economy or in the whole economy including the public sector. That's rubbish!

As Table 1 reveals, irrespective of which measure is used, productivity growth has deteriorated during the 2000s from strong growth during the 1990s, and since 2003 it has fallen away further.

Table 1: GDP per hour worked*

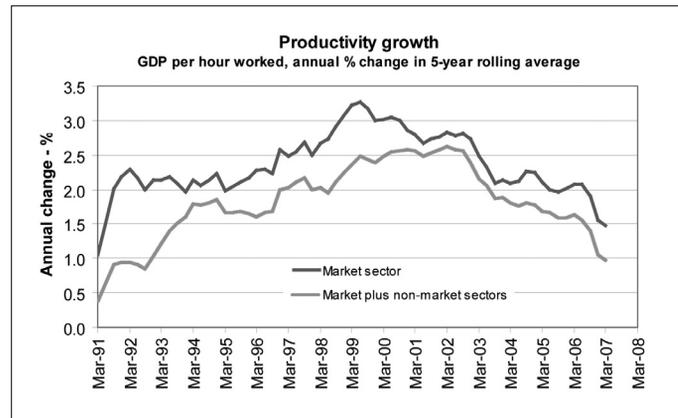
	Annual average increase	
	Market sector %	Whole economy %
December 1989 to December 1999	2.6	2.1
December 1999 to March 2007	2.1	1.6
December 2003 to March 2007	1.2	1.0
March 2006 to March 2007	0.9	1.2

* Chain volume measure (reference year for index is 2004-05=100.0)
Source: ABS, *National Income Expenditure and Product* (Cat. No. 5206.0)

Yet the government has cited market sector labour productivity growth in the six months to March 2007 of 2.1 per cent to 'prove' that productivity growth is strong. It neglected to mention that productivity growth in the previous six months was -1.1 per cent, giving a miserable result for the year of 0.9 per cent.

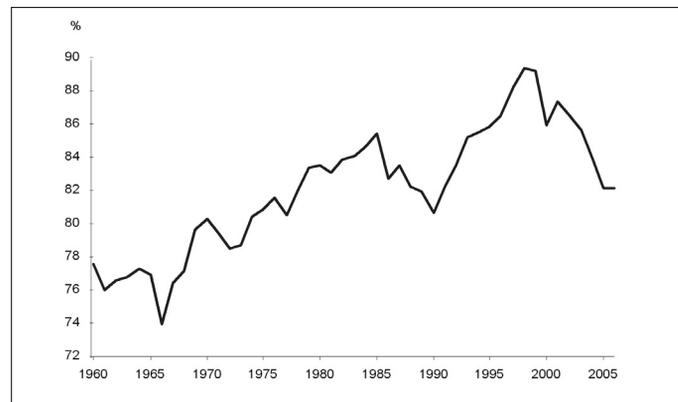
I have taken a leaf out of the book of Craig James of CommSec and reproduced the five-year rolling average of market sector productivity growth, so as to iron out the quarter-by-quarter fluctuations. Chart 1 confirms James' conclusion that 'The ugly aspect of Australia's productivity record has been the performance over

Chart 1: Australian productivity growth



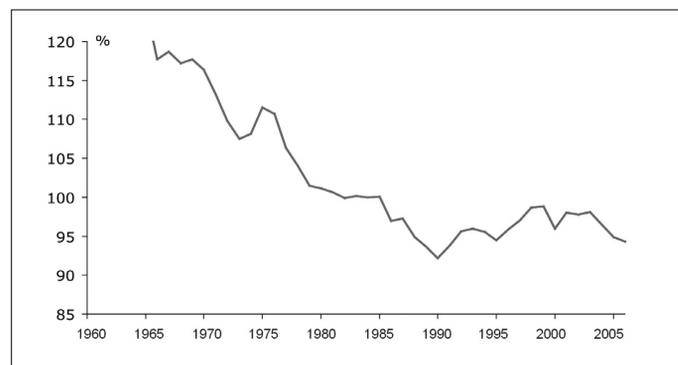
Source: Parliamentary Library using ABS data

Chart 2: Australian labour productivity relative to US



Source: GGDC Total Economy database 2006, (April 2007 version)

Chart 3: Australian labour productivity relative to OECD



Sources: GGDC Total Economy database 2006, (January 2007 version); Economics@ANZ

the past five years, the *weakest average growth in 16 years* [emphasis added].¹

And look what happens when the five-year rolling average productivity growth in the whole economy—market and non-market—is

plotted. This is the lower line. The pattern is identical. The productivity miracle of the 1990s has been squandered and Australia is in its biggest productivity slump in 16 years.

If further proof were needed, it can be obtained by reference to international comparisons of productivity growth using agreed international definitions. Fortunately such an agreed series exists and is updated regularly by the Groningen Growth and Development Centre.

The first comparison is with the United States. Chart 2 reveals that Australia made up strong ground against the United States during the Australian productivity miracle of the 1990s built on Labor reforms, but fell behind during the 2000s to a point where almost all of the gains had been squandered by 2005.

The story is the same for Australia's productivity performance relative to that of the OECD as a whole. Chart 3 confirms that most of the gains Australia made against the OECD during the 1990s have since been lost.

Yet the Treasurer continues to claim that Australia's productivity growth is ahead of the rate achieved during the last productivity cycle.² Try telling that to the Business Council of Australia, which observes in its election-year publication: *Policy that counts—reform standards for the 2007 election* that, 'labour productivity growth averaged around 3% per annum over the period from 1995–99, but has slowed to around 1¾% since 2000.'³

If everything is hunky dory, the BCA wouldn't conclude that:

The creeping re-regulation of business and the introduction of policies that are inconsistent and overlapping across jurisdictions are additional examples of how the benefits of past reform can be quietly eroded over time.⁴

And if productivity growth were truly ahead of the last cycle, why does the BCA advocate that, 'In the near term Australia must seek to lift annual productivity growth to 2½% or more?'⁵

While productivity growth will rise as mine production comes on stream, relying on the mining boom does not constitute a productivity-raising reform agenda. A sustainable resumption of strong productivity growth will require Rudd

Labor's education revolution, a national high-speed broadband network and a new program of cutting back overbearing business regulation to restore and revitalise the open, competitive economy created by the previous Labor government.

Trade in services

Though the service economy contributes 85% of the nation's employment and more than three-quarters of our GDP, it generates only 22% of our exports. These don't have to equalise, since a number of service industries are properly regarded as non-traded. Not too many Australians travel overseas for a haircut. And when we want an ice-cream at the footy, we don't ask what the international competition is offering.

But services that traditionally have been treated as non-traded are increasingly being traded. E-Bay is a global auction site. Australians no longer think automatically of a local real estate agent when wanting to buy or sell a home. Many go on-line and in the future may look beyond our borders for the best websites. Services are going global.

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Yet services remain a low priority in the Howard government's trade policy. Coalition governments have pushed very hard to obtain access to American and European agricultural and manufacturing markets—as have previous Labor governments. As important as access for Australia's agricultural and manufactured exports is, access for services exports needs to be elevated up the trade policy priority list and under a Rudd Labor government it will be.

Why don't our service industries get the same priority as agriculture in our approach to international trade negotiations? They represent the fastest growing global markets with high-paid employees and high value-added output.

Yet when the House of Representatives economics committee produced a bipartisan, landmark report on the future of the service economy recommending

that Australian trade negotiators should not get bogged down on agriculture at the expense of services, the government arranged a 'Dorothy Dixer' question by one of the Liberal committee members to condemn Labor for embracing the report's unanimous recommendation.

The question was answered by the National Party trade minister, which proves the point: National Party trade ministers have neglected our service industries. But this hasn't stopped the Howard government handing trade policy to the Nationals over the last 11 years.

Services would continue to languish in trade policy under the next National Party trade minister if the Howard government were re-elected. But under a Rudd Labor, services, manufacturing and agriculture would have equal standing in trade policy negotiations led by Simon Crean.

At the ALP National Conference I met with representatives of Australia's financial services industries. They were very keen to see Australia establish itself as a regional financial capital to rival the markets in Tokyo and Hong Kong. Fifteen years ago people would have laughed at this possibility. But not now—the chance is there if we grab it.

Australia is an English-speaking nation in the Asian time zone. We are getting closer to the centre of world economic activity. We have some of the best economic and business graduates in the world, and some of the world's best banks and managed funds.

That is why Labor has announced a policy to reduce the withholding tax on foreigners who invest in Australian managed funds from 30% to 15%. This policy was applauded by the financial services sector but attacked by the Howard government.

And Labor will restore the teaching of Asian languages in our schools.

Labor is the architect of superannuation for working Australians which has led to enormous growth in superannuation funds. Labor has also proposed changes in the parliament to the Early Start Venture Capital Limited Partnership, to raise the threshold for forced divestment from \$250 million to \$500 million. This measure would also encourage more local and international funds to flow to Australia for SME start-up businesses. We

should encourage start up venture capital to grow in Australia. And yet again this proposal, too, was rejected by the Howard government.

When Labor was last in government it created Australia's open, competitive economy by removing unnecessary regulation. Over the last 11 years the Howard government, pretending to be a party of free enterprise, has presided over the creeping re-regulation of the Australian economy. It has expanded the welfare state and stifled the incentive for effort, risk-taking and entrepreneurship. It is no coincidence that Australia is in its biggest productivity slump in 16 years.

Fresh thinking is needed for a productivity-raising reform agenda comprising an education revolution, investment in modern infrastructure like high-speed broadband and the removal of overbearing business regulation. The election of a Rudd Labor government will set productivity growth onto a sustained upward path, securing Australia's prosperity beyond the mining boom and enabling the extension of opportunity to all.

Endnotes

- 1 Craig James, 'Productivity: the god, the bad and the ugly', *Economic insights* (CommSec), 26 June 2007.
- 2 Australia, House of Representatives 2006, *Debates*, No 16, 1 November 2006, pp 75–76; Australia, House of Representatives 2007, *Debates*, No 6, 10 May 2007, pp 73–74.
- 3 Business Council of Australia, *Policy that counts—reform standards for the 2007 federal election*, Melbourne (April, 2007), p 8.
- 4 As above, p 5.
- 5 As above, p 9.