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National Competition Policy—15 Years On¹

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In August 1993 the Independent Committee of Inquiry recommended a National Competition Policy³ that was adopted by all Australian governments in 1995. The aims of the policy were clear. Competition was not an end of the policy in and of itself. Rather, the goals of competition policy were to channel the forces of competition to lift productivity and efficiency, and hence improve community welfare.

In reflecting on the policy, its implementation and achievements, two key observations emerge. First, the goal of improving productivity remains as important now as it was in the late 1980s and early 1990s. A number of key reports make this point. For example, in 2004, following a review of economic performance of 13 countries, the McKinsey Global Institute wrote “productivity varies widely around the world and explains virtually all of the differences in GDP per capita”.⁴

¹ This paper was first presented by Professor Frederick Hilmer at the 29 July 2010 ACCC Regulatory Conference under the title of “Learning from Success—Competition Policy and Productivity”.

² The author acknowledges the assistance of Rushmila Alam and Victoria Finlay.

³ National Competition Policy, Report by the Independent Committee of Inquiry (Hilmer Report), AGPS, 1993

⁴ William W Lewis, ‘The Power of Productivity’, *The McKinsey Quarterly*, 2004, No. 2

The Australian Government has reaffirmed the importance of productivity in a number of reports. The *Australia to 2050: future challenges* Intergenerational Report talked of the criticality of the three Ps—productivity, participation and population—with productivity growth the main driver of economic growth and living standards in the future.⁵ In the same year the House of Representatives Inquiry into Productivity found that “achieving multi-factor productivity growth rates above Australia’s long-term average of 1.1% is a critical, long-term national goal”.⁶

Australia’s MFP growth declining since early 2000s

Growth in multifactor productivity; per cent

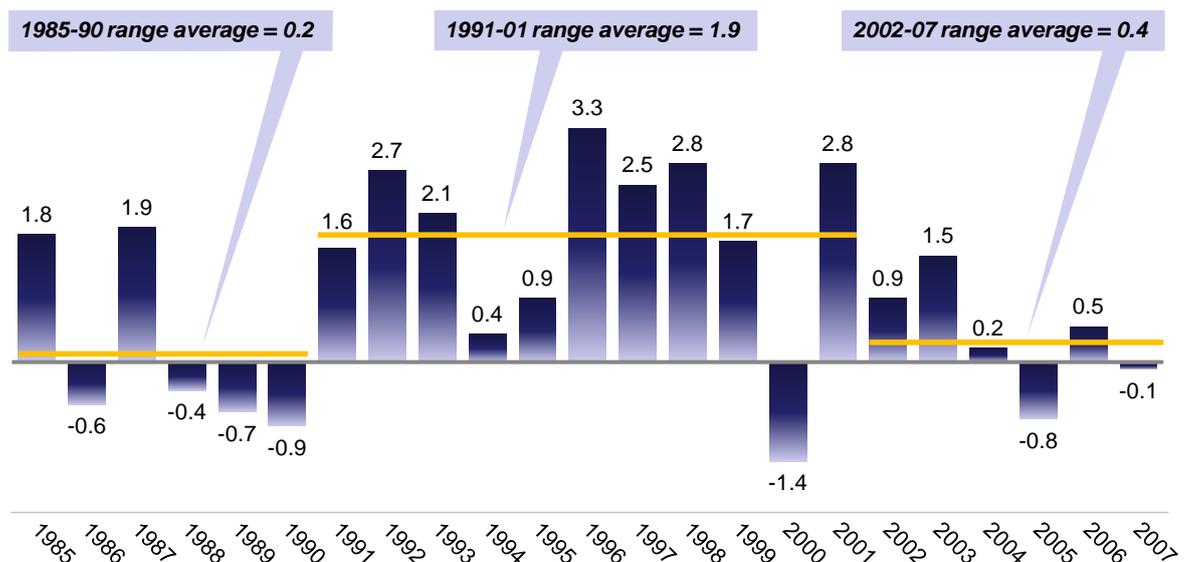


EXHIBIT 1

Second, despite the professed commitment to improving productivity, recent performance is not encouraging. As Exhibit 1 shows, as competition policy and other micro economic

⁵2010 Australian Government Intergenerational Report *Australia to 2050: future challenges*, p 21

⁶ 2010 House of Representatives Inquiry into raising the productivity growth rate in the Australian economy, April 2010, p xix

reforms were rolled out in the late 1980s and early 1990s, multifactor productivity growth lifted sharply from an average of about 0.2% in the late 1980s to close to 2% in the 1990s and early 2000s. However, in the last several years, multifactor productivity growth has again slumped, averaging only 0.4% per annum. If we compare performance against OECD countries (Exhibit 2) the same picture emerges— a decade or so of under-performance through the early 1990s, then over-performance up to about the last 5 years when Australia’s productivity growth stalled both in absolute and relative terms.

Australia versus OECD —real GDP growth

Real GDP growth, 3-year rolling average; per cent

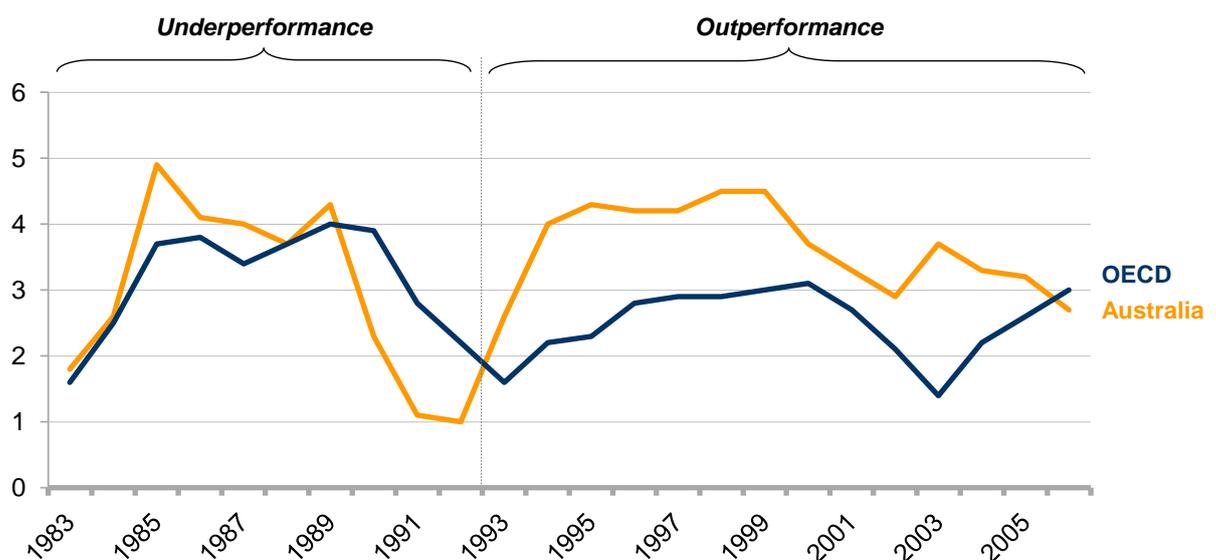


EXHIBIT 2

Why is this the case? Recent reports by the Productivity Commission⁷, the House of Representatives⁸, the Treasury⁹ and the Reserve Bank¹⁰ offer a number of explanations.

⁷ Productivity Commission, *Submission to the House of Representatives Standing Committee on Economics Inquiry into Raising the Level of Productivity Growth in the Australian Economy*, p 26

⁸ *Inquiry into raising the productivity growth rate in the Australian economy*

These include the following:

- Infrastructure and skills inadequacies and bottlenecks: capacity limitations are putting a brake on the nation's ability to continue to increase productivity.
- Lower research and development, as technological innovation in the early part of this century was less rapid than it had been in the 1990s when the information and communication technologies were being implemented and having a significant impact.
- A three-sector problem — productivity in agriculture, mining and utilities accounts for most of the decline in the national average. This is occurring in some cases for good reasons, such as drought in the case of agriculture and the need to invest in assets that will have returns well into the future in the cases of mining and utilities.
- A slowdown in microeconomic reform, particularly once the competition payments that were being made to State governments for implementing reforms in line with the National Competition Policy ended in 2006.

It is this set of reasons that has led to the current response to Australia's low productivity.

That response has at least four elements, as follows:

1. Investing in infrastructure
2. Improving education and skills
3. Cutting red tape, and
4. Encouraging more R&D and innovation.

⁹ 2010 Australian Government Intergenerational Report: *Australia to 2050: future challenges*, p 21

¹⁰ Ian Macfarlane, Reserve Bank Governor, as quoted on The World Today, ABC online, www.abc.net.au, 18 February 2005

As Exhibit 3 shows, there are major policy initiatives in each of these four areas, all with the goal of lifting long-term productivity.

Current response

Initiative	Example
Investing in infrastructure	Infrastructure Australia <i>Planning, funding and implementing the nation's future infrastructure needs . . . advice about gaps that hinder growth . . . identify priorities, policy and regulatory reforms</i>
Improving education and skills	The Education Revolution <i>. . . "most important economic policy issue"</i>
Cutting "red tape"	COAG—March 2008 <i>27 deregulation priorities aimed at cutting red tape, making it easier for businesses to operate across State and Territory lines, and making key industries more competitive</i>
Encouraging R&D/innovation	Innovation Policy Agenda to 2020 <i>"Increasing our capacity to create new knowledge and find new ways of doing business is the key to building a modern economy based on advanced skills and technologies"</i> 2010 House of Representatives Inquiry <i>"When governments intervene to boost . . . productivity the focus should be on . . . technological capacity . . . and technical effectiveness"</i>

EXHIBIT 3

The argument made in this paper is that this current four-pronged approach is unlikely to significantly lift productivity even in the medium term. There are three reasons. First, productivity growth depends on both incentives and enablers. Competition is a prime incentive for firms and individuals to lift productivity but there are others such as taxation rates and structure and corporate governance. The key enablers include the quality and capacity of the workforce, workforce flexibility, technology, R&D, infrastructure and a sound legal and institutional framework.

Second, while it is difficult to find authoritative work on the relative impact of incentives and enablers, cross-industry studies within single economies as well as broader productivity research suggest that incentives are far more important than enablers. Put another way, enablers make it possible for firms and individuals to lift productivity. However, just because firms and individuals can improve productivity does not mean that they will necessarily do so, particularly if there is no incentive for this to occur.

Third, the flaw in the current approach is that it focuses almost exclusively on enablers while incentives are getting weaker and receiving little policy attention. Hence, the current measures in and of themselves are unlikely to significantly lift productivity.

Each of these three points is discussed in turn.

Incentives and enablers

Numerous studies have sought to identify the factors that underpin growth in productivity. The OECD Growth Project identified particular policy and institutional factors including competition, trade exposure, flexibility in labour and product markets, information and communication technologies and innovation, and physical and human capital accumulation.¹¹

The Global Competitiveness Index uses a wide range of factors in defining competitiveness. The Competitiveness Index, a qualitative concept closely related to productivity, recognises that the relative importance of the factors depends on the nature and stage of development of

¹¹ *The Policy Agenda for Growth—An Overview of the Sources of Economic Growth in OECD Countries*, 2003

each economy.¹² It considers the basic requirements to be institutions, infrastructure, macroeconomic stability, and health and primary education. These factors are vital for factor-driven economies. It identifies other factors as efficiency enhancers, which are key for efficiency-driven economies. These include higher education and training, goods market efficiency, labour market efficiency, financial market sophistication, technological readiness, and market size. The final factors are classified as innovation and sophistication factors, which are key for innovation-driven economies, and these are business sophistication and innovation.

A series of studies of the Australian experience confirm that most of these factors were at play in the 1990s and early 2000s in explaining Australia's productivity surge.¹³ Two key factors promoting productivity growth over this period were:¹⁴

- Incentives to be more productive, principally by removing unnecessary barriers to competition and giving government business enterprises more autonomy and exposure to commercial disciplines; and
- Flexibility to adapt to change and to meet the rigours of competition via regulatory labour market reforms.

For the purposes of this paper, the range of factors identified in the cited studies have been grouped into two categories—incentives and enablers (as set out in Exhibit 4).

¹² World Economic Forum, *The Global Competitiveness Report 2009—2010*, 2009.

¹³ See, eg, Dean Parham, 'Productivity Growth in Australia: Are We Enjoying a Miracle?', presented at the Melbourne Institute/The Australian conference, *Towards Opportunity and Prosperity*, Melbourne, April 2002; Charles Bean, 'The Australian Economic Miracle: A View from the North', in D Gruen and S Srestha (eds), *The Australian Economy in the 1990s*, p 73-114.

¹⁴ Parham, above, p 9.

Incentives and enablers

Three key incentives	Multiple enablers
○ Competition	○ Infrastructure
○ Tax	○ Skills
○ Corporate Governance	○ Legal and institutional framework
	○ Labour market flexibility
	○ Technological progress

EXHIBIT 4

Incentives are critical

The importance and effectiveness of incentives has been long recognised in economic thought. Classical economics models situations on the assumption of rational, profit maximising behaviour, with profit the key incentive. Over time, the notion of the incentive has been broadened, to include social and personal factors as well as money. And the limits on human perception and problem solving have been explored and factored into economic modelling by, for example, Kahneman and Tversky. But the basic premise, that incentives are what matter most in understanding actions and outcomes, has been consistently supported. Well-aligned incentives explain good performance in many areas from business

to social policy. And misaligned incentives, or incentives that have not been properly understood and lead to “unintended consequences”, are seen as causes of serious problems. For example, the recent issuance by banks of financial products that failed spectacularly, triggering the first wave of the Global Financial Crisis (GFC), has been attributed to a flawed incentive structure for bank executives.

Incentives are quite different to enablers. Enablers, such as human and physical capacity or a sound legal and institutional framework, open up possibilities for action. Being able to do something may lead to that thing being done, but this is often not the case. Businesses have considerable degrees of freedom in choosing where and how they compete. The choice may be influenced by what is possible (i.e. the enabler) but the choice is actually made by selecting the most desirable return/risk outcome, which depends on the size of the incentive and the probability of the payoff.

Competition

While both incentives and enablers are important, without incentives enablers have a limited impact on productivity. Where the impact of productivity factors has been quantified in empirical studies, incentives and particularly competition have been shown to have greatest impact.¹⁵ The McKinsey Global Institute’s research suggests that factors such as labour and capital (i.e. enablers) explain few differences, if any, in the productivity and economic performance of different countries. For example, poor education systems have not hindered companies such as South Korea’s POSCO, which may have the highest productivity of any integrated steel producer. Similarly, the lack of investment capital is not the main constraint

¹⁵ Dean Parham, *Sources of Australia’s Productivity Revival*, Productivity Commission, December 2003, pp 23-24

to growth in developing economies. Instead, companies can increase productivity without additional capital investment by reorganising the businesses and management. The paper concludes that the nature of competition in product markets is key in explaining productivity differences.

These findings are reaffirmed in the OECD growth project,¹⁶ which identifies many factors behind economic growth but points out that the key drivers are “unified and highly-competitive service and product markets” coupled with flexible labour markets.¹⁷

Further evidence of the critical importance of incentives is provided by looking at the performance of different industries in a single economy.

There are two types of case study that can be examined:

1. The comparative performance of industries in an economy with high-quality enablers.
2. The comparative performance of industries in an economy with low-quality enablers.

The first type of case is illustrated by the performance of two kinds of industries in Japan, as described by Porter and Sakakibara¹⁸ (Exhibit 5).

¹⁶ *The Policy Agenda for Growth — An Overview of the Sources of Economic Growth in OECD Countries*, 2003, p 15, <http://www.oecd.org/dataoecd/47/4/2505752.pdf>

¹⁷ *The Policy Agenda for Growth*, p 13

¹⁸ Michael E Porter and Mariko Sakakibara, *Competition in Japan*, *Journal of Economic Perspectives*, Vol 18, No. 1, Winter 2004, pp 27-50

Case study: Japan

	<i>Type 1</i>	<i>Type 2</i>	
<ul style="list-style-type: none"> Examples 	Globally competitive <i>(Automotive, consumer electronics, robotics)</i>	Examples <i>(Chemicals, retail transport)</i>	
<ul style="list-style-type: none"> Supporting infrastructure 	Good	Good	} Enablers same
<ul style="list-style-type: none"> Education and training 	Excellent	Excellent	
<ul style="list-style-type: none"> Competition 	High	Low	} Incentives different
<ul style="list-style-type: none"> Intervention 	Low	High	
<ul style="list-style-type: none"> Productivity 	High	Low	} Result different

EXHIBIT 5

Porter and Sakakibara compared the performance of what they called the Japanese globally competitive industries including automotive, consumer, electronics and robotics with the performance of what they called uncompetitive industries which included chemicals, retail and transport. In each case the enablers were the same. Japanese supporting infrastructure was good, education and training were excellent, and the institutional environment was identical and excellent. However, in the case of the globally competitive industries, competition was high and intervention was low. In the case of the uncompetitive industries, competition was low and intervention was high. The results are well known. The industries in the competitive markets had high productivity growth while the industries in the uncompetitive markets had low or declining productivity. This illustrates the critical importance of incentives over enablers.

A similar situation can be seen by looking at countries where the enablers are far weaker, for example, India and, at least in previous decades, South Korea. In each case, a number of industries were thrust into global competition. For example, in India¹⁹ the automotive industry was deregulated and opened to competition while textiles remained highly regulated and relatively uncompetitive. The performance of the automotive industry in India rose to the point where a world-competitive product was made by Tata Motors, while textiles remained uncompetitive and characterised by low productivity. In each case, the enablers, the skills of the workforce and the institutional framework were the same but the outcomes were very different because the incentives were different. A similar example can be seen in South Korea comparing steel versus service industries.²⁰

Another example is the wide variance in productivity growth across the European countries. As the OECD pointed out in its paper *The Policy Agenda for Growth* in 2003, “weak competition in service and product markets may help explain why productivity growth and ICT diffusion have remained disappointing in many European countries”.²¹

In summary, competition remains a key incentive and is well supported by both case study research and broader microeconomic analysis. The data with respect to the importance of the other incentives is less compelling but nevertheless interesting. The incentives that have been studied include tax structure and rates, as well as corporate governance.

¹⁹ K Kundu, ‘Productivity—the Key to India’s Growth’, *Asia Times Online*, 4 January 2005

²⁰ William W Lewis, ‘The Power of Productivity’, *The McKinsey Quarterly*, 2004, No. 2

²¹ *The Policy Agenda for Growth—An Overview of the Sources of Economic Growth in OECD Countries*, 2003, p 7, <http://www.oecd.org/dataoecd/47/4/2505752.pdf>

Taxes

Taxes affect productivity by distorting incentives through three specific channels:²²

- Affecting incentives to become an entrepreneur by reducing the expected post-tax return;
- Distorting relative factor prices and the efficient allocation of resources, and
- Encouraging or discouraging investment in research and development by affecting the after-tax cost of the investment.

Using industry-level data on 13 OECD countries, Vartia (2008)²³ finds evidence that corporate taxes have an adverse affect on total factor productivity, particularly for firms in industries that are on average more profitable. Similarly, there is a negative relationship between the top marginal personal income tax rates and the long-run level of total factor productivity.

Two other studies suggest a direct link between corporate taxes and economic growth.

The study by Lee and Gordon²⁴ suggests that significant corporate tax cuts of about 10 percentage points would lift economic growth by 1-2 percentage points. The OECD growth project found a similar relationship between tax and growth rates. They estimated that a tax increase of about 1 percentage point would have a 0.3 percent negative effect on households

²² Laura Vartia, 'How Do Taxes Affect Investment and Productivity? An Industry-Level Analysis of OECD Countries', Economics Department Working Papers No 656, OECD (2008), p 17.

²³ Laura Vartia, 'How Do Taxes Affect Investment and Productivity? An Investment-Level Analysis of OECD Countries', Economics Department Working Papers No 656, OECD (2008).

²⁴ Young Lee and Roger H Gordon, *Tax structure and economic growth*, Journal of Public Economics 89 (2005), pp 1027-1043

per capita.²⁵ Much has also been written on the incentive effects of lower versus higher marginal tax rates, but this research is still in its infancy.

Governance

The structure of internal corporate governance also influences the productivity of the firm. Using data from a sample of Australian companies between 2000—2005, Tian and Twite (2010)²⁶ find that better governance positively affects productivity, particularly in non-competitive industries, although in competitive industries, tougher product market competition serves as a substitute for effective governance. The authors conclude that productivity can be improved by mandating better corporate governance through more non-executive directors, smaller boards and stock-based executive compensation.

In its submission to the House of Representatives Inquiry into raising the level of productivity growth in Australia, the Productivity Commission stated that while factors such as expenditure on infrastructure, education and training, and research and development, are important in the long run, they are unlikely to have had an immediate and direct role in Australia's decline in productivity. The Commission concluded that to raise the rate of productivity growth, reforms are needed to remove the impediments to the efficient allocation of resources, and to heighten the incentives for firms to perform.²⁷

So, in summary, productivity is affected by incentives, in particular competition, tax and governance and by enablers, including the quality of education and skills, infrastructure,

²⁵ *The Policy Agenda for Growth—An Overview of the Sources of Economic Growth in OECD Countries*, 2003, p 8, www.oecd.org/dataoecd/47/4/2505752.pdf

²⁶ G Tian and G Twite, 'Corporate Governance, External Market Discipline and Firm Productivity', available at <http://ssrn.com/abstract=1539118> (2010).

²⁷ Productivity Commission, *Submission to the House of Representatives Standing Committee on Economics Inquiry into Raising the Level of Productivity Growth in the Australian Economy*, p VI

technology, and the legal and institutional environment, including labour market flexibility. Of these two sets of factors, the first, incentives, is by far the most important.

When incentives are lacking, enablers in and of themselves will not cause a lift in productivity. This leads to the third plank of the argument: that the current approach to productivity improvement is unlikely to work because the approach pays inadequate attention to incentives and focuses almost exclusively on enablers.

Current approach needs revising

In the 1990s, Australia experienced the coincidence of the implementation of a comprehensive national competition policy, tariff reductions, and financial and labour market deregulation, all within the context of a relatively stable and conservative fiscal and monetary policy.

However, this approach has begun to weaken. In 2000, competition payments to State governments were halved, decreasing the incentive for these governments to persist with pro-competitive policies, with payment stopping in 2006. Responsibility for competition policy—initially a priority of the Prime Minister—was moved to less senior cabinet members and is now the responsibility of a minister who is not a cabinet member.

Between 2003 and 2008, Australia tightened aggregate product market regulation. This was in contrast to the period from 1998 to 2003 where Australia deregulated, as measured by the product market regulation indicator developed by the OECD. This indicator measures the overall regulatory environment, in terms of government policies, classifying them into state control, such as public control and price controls; barriers to entrepreneurship, that is legal and administrative barriers to entry; and barriers to trade and investment. In 1998, Australia

had an index of 1.52, which decreased to 1.16 in 2003. However, by 2008, the index had risen to 1.23, indicating increasing anti-competitive regulation²⁸, as shown in Exhibit 6.

Current approach

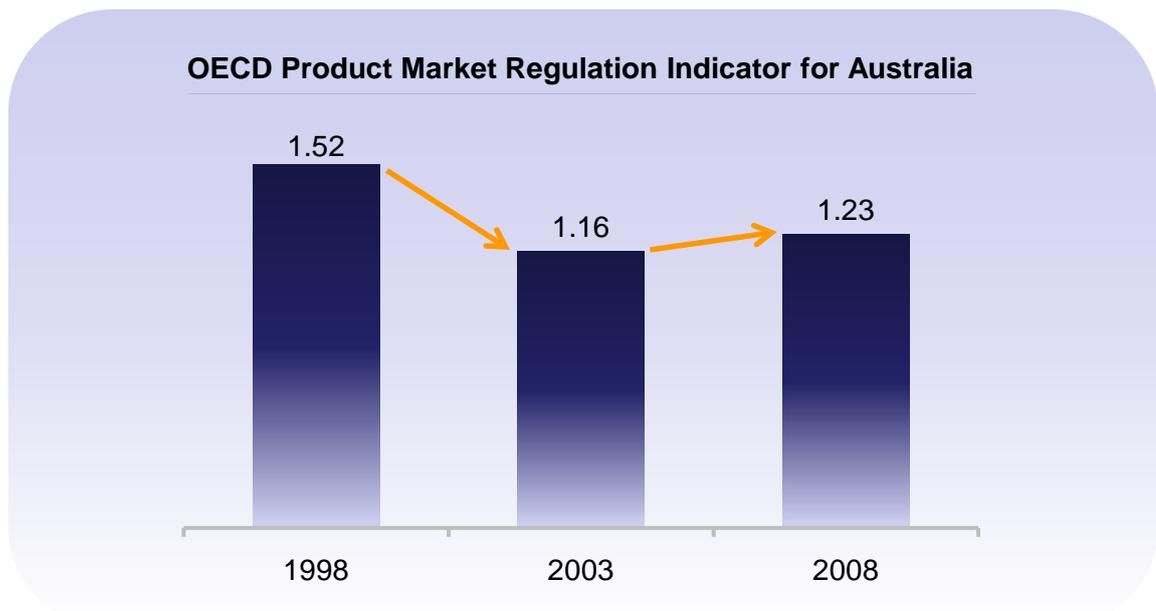


EXHIBIT 6

There are a number of examples of regulation being introduced that appear to continue this trend of increasing anti-competitive regulation which include:

- Prohibiting financial planning trailing commissions versus simply requiring full disclosure;
- Unwillingness to let economics determine energy and conservation choices;
- Unwillingness to allow a market solution for the provision of broadband;
- Restricting overseas ownership of housing; and

²⁸ A Wolfi, I Wanner, T Kozluk and G Nicoletti, 'Ten Years of Product Market Reform in OECD Countries—Insights from a Revised MPR Indicator', Economics Department Working Papers, No 695, OECD (2009)

- Reducing the degrees of freedom available to universities when competing for students and funding.

In addition, the corporate governance agenda has switched its emphases to compliance and conformance rather than performance. Tax policy has encouraged productivity growth through the major cuts to the corporate rate in the 1990s—falling from 46 per cent to 30 per cent over the period 1985-2004. However in the last several years no further corporate tax reductions have been implemented²⁹.

These changes are a reversal of policies of the 1990s, as Exhibit 7 shows.

Comparing eras

	1990s	2000s
• Competition	↑	↓
• Product market regulation	↓	↑
• Taxation	↓	=
• Government focus	<i>Performance</i>	<i>Compliance</i>
• Labour flexibility	↑	↓

EXHIBIT 7

²⁹ J Kelly and R Graziani, 'International trends in company tax rates—implications for Australia's company income tax' (2004), *Economic Roundup*, Australian Treasury, Spring, p 24

At the same time, the reform agenda is emphasising enablers specifically infrastructure, education and removing red tape. The COAG reform agenda focuses on education in terms of early childhood, schooling and skills and workforce development. Education reforms will have an impact on the workforce in the long term. In the short-to-medium term however, these reforms will not address the productivity decline. COAG has also endorsed microeconomic regulatory reforms, such as harmonising occupational health and safety laws. Other reforms include trade measurement, environmental assessment and approval processes, rail safety regulation, product safety, trade licensing, further payroll tax harmonisation and institutional lending arrangements. While these reforms are intended to enhance productivity, they have little or no incentive effect.

Conclusion

Improving enablers is clearly worthwhile, often, as in the case of education, for social as well as economic reasons. However, focusing on enablers while going backwards on incentives is unlikely to generate the productivity improvements needed, especially at a time when the population is both increasing and ageing.

Why has emphasis on competition policy diminished since Australia made good progress during the latter 1990s through to the early part of the 21st century? Competition lost its place in the productivity agenda for largely political reasons, not because it is not effective.

In 1995, Prime Minister Keating put in place a solid process with both review and reward mechanisms to drive the implementation of policy for the next decade. This process was well underway by late 1996 when John Howard became Prime Minister. For most of Prime Minister Howard's term competition policy did not need extra attention or focus as the

mechanisms were in place to drive it via the National Competition Council and competition payments to States. However these payments ceased in 2006 and leadership and election issues drowned out the need for continued support and revitalisation of competition policy.

In 2007 Prime Minister Rudd was elected. That year, however, saw the onset of the GFC which set back progress on competition policy in two ways. First, the government's attention focussed on the crisis. Financial system stability, employment and macroeconomic performance were all-consuming issues. Second, market systems and neoclassical economics, areas central to competition policy, were seen as causes of the GFC, with Prime Minister Rudd an active proponent of these views³⁰. The possibilities for regulatory and implementation failures as a result of government action and regulation were largely ignored. Consequently, competition reform fell off the agenda.

Some specific proposals that could give competition policy a more critical role in the reform processes include:

- Revitalising the National Competition Council,
- Assigning responsibility to a more senior minister,
- Reviewing areas where progress has stalled.

Revitalising the National Competition Council (NCC)

The objective of the National Competition Policy Committee in recommending the establishment of the Council was for it to provide high-level, independent analytical and policy advice in which all governments would have confidence. Because some governments

³⁰ Kevin Rudd, 'The Global Financial Crisis', The Monthly Essays, February 2009, No. 42

were concerned that a broad mandate might surface politically difficult issues, the NCC was established with a more limited mandate, focusing on monitoring implementation and recommending competition payments accordingly. This role disappeared in 2006, and the role of the NCC was recently redefined to recommending regulation of third party access to services provided by a monopoly infrastructure. As a result, there is now a gap in the provision of advice on policy that could apply judgement to integrate the findings of the ACCC, the Productivity Commission, Reserve Bank and other expert bodies. Our Committee recommended against the ACCC having this role, believing it inappropriate for a single body to be adjudicator, administrator and key policy advisor on competition policy.

Improving the voice and visibility of competition policy in cabinet

Since implementation of the policy in 1995, responsibility has moved steadily further and further from the centre of government. The 1992 report and its implementation were driven by Prime Minister Keating. Under the Howard Government, responsibility passed to the Treasurer. More recently, responsibility moved from Cabinet Minister Bowen (Minister Assisting the Treasurer) to Minister Emerson³¹, not currently a member of cabinet. Given the centrality of Competition Policy to productivity and economic performance, it is argued that the responsibility should rest with a senior minister, preferably the Treasurer.

Reviewing areas of slippage

There is a strong case for a further fundamental review of policy, given the 15 years and changed circumstances since the national policy was implemented. Why has the OECD

³¹ In June 2009, see <http://minister.innovation.gov.au/emerson/Pages/ministerialresponsibilities.aspx>

indicator of Product Market Regulation turned upward? Why does progress with respect to competition policy in some key areas, particularly energy and infrastructure, appear to be stalled? The focus of the review should be on incentives, particularly competition. It should also cover international competition policy and regulation, which has become more important since the 1993 Inquiry was completed.

Competition policy is an area where Australia is widely recognised as a leader. Our policy framework forms the basis of reforms in economies as diverse as Canada, India and Mexico. Learning from our success by revitalising the policy and the institutional framework that supports it provides the best opportunity to again achieve high productivity growth.

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OECD database, growth in multi-factor productivity

OECD Stat Gross Domestic Product (output approach), volume index

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