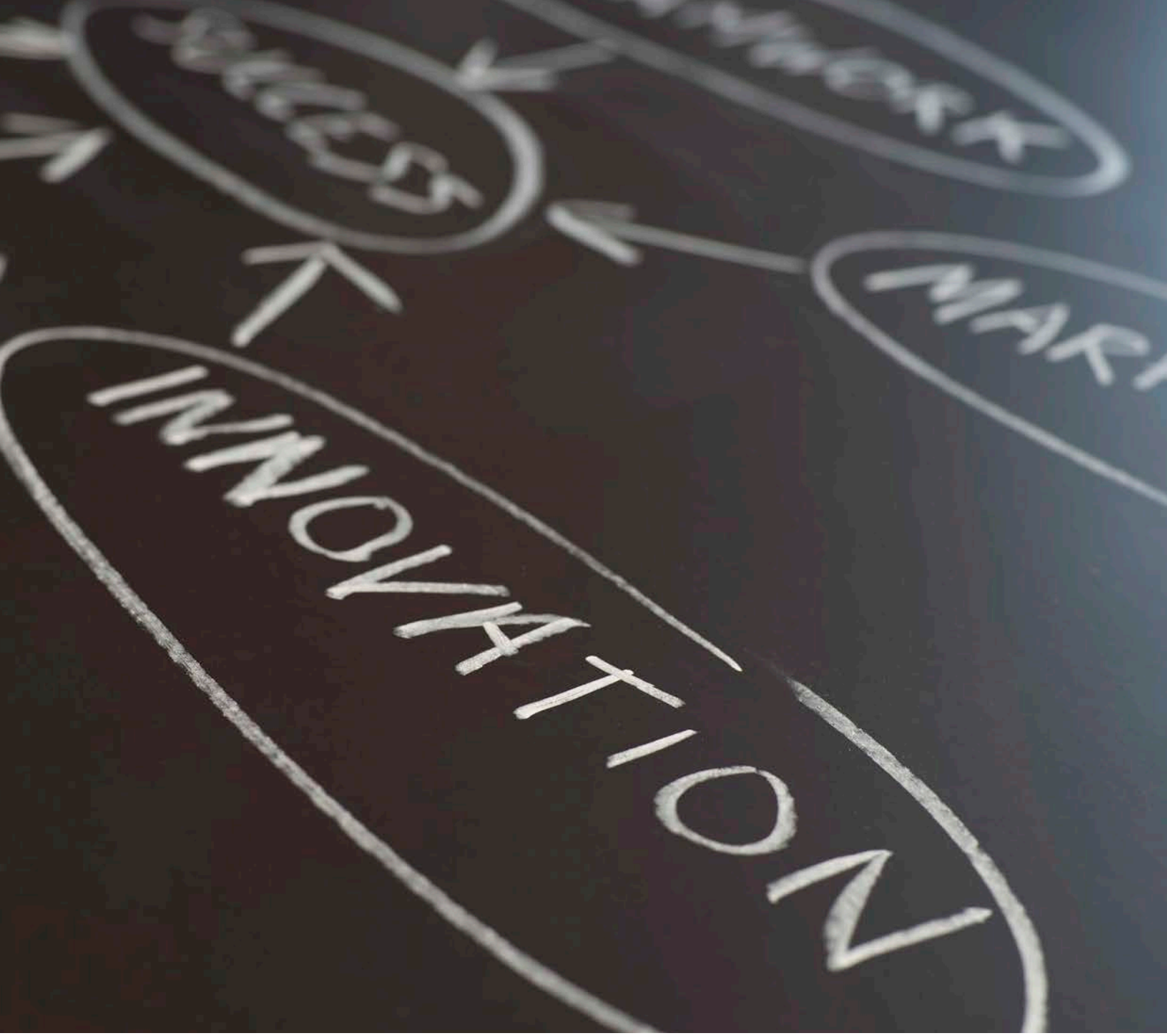

Innovation strangled by red tape

Submission to the Productivity Commission Inquiry into business set-up, transfer and closure

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Executive Summary

- Recent IPA research has demonstrated that business entry rates in Australia have been in steady decline for the previous decade to June 2014.[1] This falling business turnover signals a decline in Australian dynamism and entrepreneurship.
- It is precautionary government regulation instigating this decline. The current culture of red tape threatens to prevent the next Facebook or Google launching on Australian shores by over-valuing certainty, and under-valuing flexibility.
- The process of the free market is the only true business selection mechanism; expanding productive and innovative businesses while replacing unproductive dead wood.
- This process is irreplaceable, but it may certainly be hindered. Many regulations, while framed in terms of 'public interest', more accurately act as friction in the free market process; their costs are often ignored.
- These frictions prevent the market from facilitating learning and experimentation with new ideas, technologies and businesses.
- The market cannot select what is worthy and what is not if technologies are continually restricted before we even know how they are best used.
- Rather than as a nation of rules, regulations and road-blocks, Australia must position itself as a nation of experimentation, testing and exploration for entrepreneurial talent.
- Much of this friction is due to the 'precautionary principle', where governments over-value hypothetical harms, and undervalue the capacity of the market to test, experiment and evolve.
- Industry-specific regulation and red tape must be critically avoided. This includes occupational licensing, quotas, subsidies and suchlike. These apply artificial rigidity in what are constantly evolving industry boundaries and the development of innovative new sectors.

[1] Talimanidis, Dom. *Where have all the entrepreneurs gone?* Institute of Public Affairs Occasional Paper, December 2014. http://ipa.org.au/publications/2299/where-have-all-the-entrepreneurs-gone/pg/4

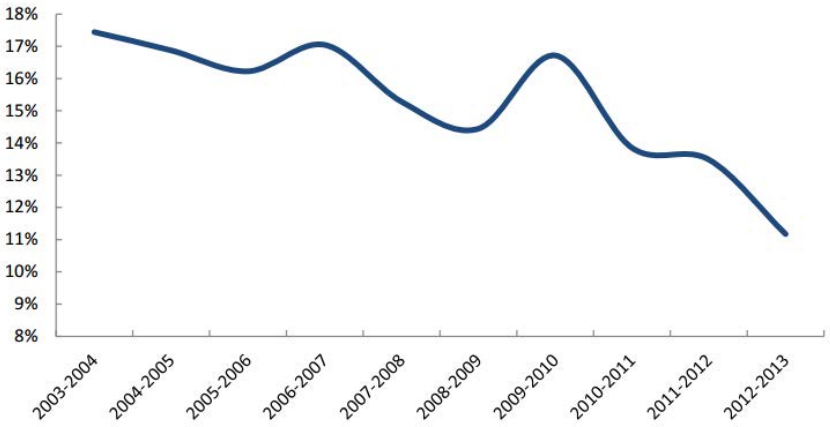
Declining business entry

It is a widely held fallacy of aggregation that economic growth of, say, three per cent is achieved when all the businesses in the economy grow by three per cent. In reality, there are large variations in the productivity and growth of individual firms within an industry.[2] This is due to firm differentiation in the adoption of new technologies, new management and work practices, superior business models, and a raft of other factors that impact on the productivity of firms in different ways. Economic growth occurs as the outcome of a selective process: high productivity firms expand, and the low productivity firms exit.

Therefore high levels of entry and exit within an industry are a necessary condition for economic growth. Note of course that the exit of low productivity firms frees up resources that enables the higher productivity firms to expand. Regulations that slow the exit process also slow the new entry process. This inhibits the growth process that is what ultimately creates new jobs and higher living standards for Australian workers and consumers.

Worryingly, Australia's business entry rates are in steady decline. A recent Institute of Public Affairs research report found a worrying decade-long trend in new firm entry rates (depicted in Figure 1 below). [3] While in 2003-04 there were 325,935 new businesses in Australia, by 2012-13 that number had fallen to 239,229 entries. This drop is not confined to one sector of the Australian economy; it constitutes a broader economy-wide decline.

Figure 1: Australia's new firm entry rate



Source: Australian Bureau of Statistics Cat. No. 8165.0

It must be made emphatically clear that business entry and exit are phenomena to be praised. They represent a dynamic and entrepreneurial economy. Unfortunately, the turbulence and uncertainty of business turnover are often feared.

The free market passes entrepreneurs, businesses and ideas through a selection process. A fundamental tenet of a free society is that the productive, innovative and efficient businesses will

[2] Nicholas Bloom, Raffaella Sadun and John Van Reenen. "Americans Do IT Better: US Multinationals and the Productivity Miracle," 2012, American Economic Review, 102(1), 167-201.

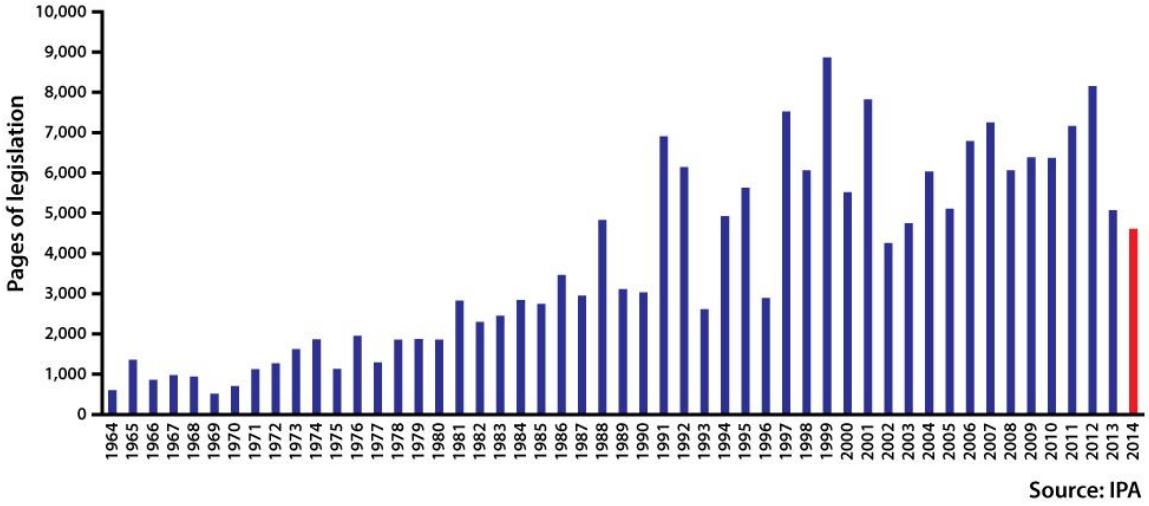
[3] Dom Talimanidis. *Where have all the entrepreneurs gone?* Institute of Public Affairs Occasional Paper: December 2014. http://ipa.org.au/publications/2299/where-have-all-the-entrepreneurs-gone/pg/4

enter markets, expand, and prosper, while their unproductive counterparts will shrink, fail and exit. This process needs to occur continuously in all industries. It is only through free markets, clear property rights and strong rule of law that this evolving process can take place. The outcome is higher productivity, economic growth, and improved living standards.

Australia's trend signifies increasing friction in this process. Of course, a slowing of business entry and exit could signify a lack of ideas or of entrepreneurial imagination. But this is highly unlikely to be the case. A more probable explanation is that the cost of entrepreneurial activity is higher because of the increased burden of government red tape.

In recent Institute of Public Affairs research, it was shown that there were 4607 pages of Commonwealth legislation passed in 2014. While the number of pages passed annually has declined for two consecutive years, Australian entrepreneurs must not only wade through the legislation passed this year, but all of the years before. The figure below shows the pages of Commonwealth legislation passed annually:

Figure 2: Pages of Commonwealth legislation passed annually



The current high-cost institutional environment means entrepreneurs must now wade through the pools of red tape protecting existing industry. Tales of business entrants having long and public legal battles with incumbents have regrettably become a sign of the times. Battles resembling Uber and Airbnb are not a new problem; it is just that they are being exacerbated by sets of out-dated and overly-precautionary regulators and regulations. Further, they are only being recognised because they are putting up a fight.

It is clear that the skill of the entrepreneur is no longer confined to having an idea, plus the costs of obtaining an ABN and a factory and suchlike. The fact that entrepreneurs must also gauge political uncertainty is a worrying sign for Australia's future.

Obviously some government institutions are necessary for the continual and efficient entry and exit of business. Private property rights allow entrepreneurs to make long term investments, or to sell or close their business. Further, an impartial and predictable court system encourages contract-enforcement and the resolution of disputes.

These basic institutions are the necessary roles of government. Propping up incumbent industries, imposing industry quotas and licenses, and prohibiting nascent technologies are not. These must be market decisions.

Governments have long outgrown their basic function. Businesses (both existing and potential) sit in an institutional context that does not solely promote their free dealings, but rather adds friction to what should be an organic process.

Analysing complex layered regulations is an intellectually tough task. While each individual policy may appear reasonable in isolation, much of the problem is the cumulative effect this has on entrepreneurial decisions and the Australian economy more broadly.

We can ask two main questions about business entry and exit in Australia. Firstly, what is the regulatory culture that has created such a convoluted red tape environment for entrepreneurs? Secondly, how has industry-specific regulation impacted on the dynamism of markets?

Regulatory responses to technology

There are four general regulatory responses to nascent new technologies or businesses. When governments and regulators face change, they may either:

- prohibit the technology or business;
- enforce precautionary safeguards;
- address the risk through resiliency (education, awareness building and suchlike); and
- allow society to adapt by learning to live with the risk through trial-and error and experimentation.[4]

The attitudes towards these options can be grouped into three broad policy conceptions or cultures. These are complex relationships between regulators, incumbents and entrants. Governments and regulators may either adopt a culture of:

- permissionless innovation – regulators leaving entrepreneurs free to experiment;
- permissioned innovation – entrepreneurs have freedom to experiment until innovation may later be restricted by regulators; or
- precautionary principle – where new innovations are disallowed by regulators until the innovators prove the safety of the technology.[5]

Australia, and much of the developed world, are moving towards the latter. This is because regulators tend to over-weight future harms, and simultaneously under-weight the benefits of

[4] Adam Thierer. 'Technopanics, Threat Inflation, and the Danger of an Information Technology Precautionary Principle.' Minnesota Journal of Law, Science & Technology 14, no. 1 (2013): 12-09.
[5] Adam Thierer. 'Who really believes in 'permissionless innovation'?' The Technology Liberation Front, http://techliberation.com/2013/03/04/who-really-believes-in-permissionless-innovation/ accessed February 3 2015.

industry flexibility. Australia is applying Thierer's *precautionary principle* to new technologies and businesses.[6]

Precautionary regulation leads to slowing business entry and exit. Fewer businesses enter the market for fear of being regulated against; while incumbents sit idle behind barriers of regulations.

There are a number of reasons why this precautionary principle may continually creep into public policy. When incumbents fear they may be out-competed on the market, their lobbying efforts begin. Their demands – largely based around hypothetical harms, or maintaining the status quo – generate more political pull than the potential benefits of small new business entries. It is intuitively easier to justify the 'someone might get hurt' argument over the 'this might be an important business or technology in the future'. That is, a hypothetical harm has more persuasive effect than a hypothetical benefit. The result is what US economist Mancur Olson[7] long-ago identified as the cause of cycles of growth (because of new technologies) leading to slow-down and decline, as regulations and incumbent vested interests pile up.

To move away from this harmful precautionary principle, Australian regulators must adopt the powerful policy concept of *permissionless innovation.* Permissionless innovation advocates implementing **bottom-up self-regulation as the default policy mechanism**, and only applying top-down government control if it is later required. Adam Thierer of George Mason University's Mercatus Centre explains:

> 'It [permissionless innovation] refers to the notion that experimentation with new technologies and business models should generally be permitted by default. Unless a compelling case can be made that a new invention will bring serious harm to society, innovation should be allowed to continue unabated and problems, if they develop at all, can be addressed later.'[8]

Unfortunately, precautionary regulation has had a long history in Australia. For example, while FM radio was developed throughout the 1930s in the United States, it remained effectively banned until 1947. A similar tale occurred around pay television, which took over a decade to be implemented following recommendation of its introduction by the Australian Broadcasting Tribunal in 1982.[9] More recently we have seen tensions around online marketplaces such as eBay and camera phones. Currently, the battles are around technologies such as 3D printers and the 'sharing economy'.[10]

The running theme here is that when technologies are first developed there is general misunderstanding of future potential uses. Regulators assume they understand the proper function and use of the technology, when it is clear that no one does. When a technology is first developed, it is unclear exactly what specific uses to which they might profitably be put, both in terms of private benefits and for the social good. No one can know this in advance, and regulators have no special

[6] Adam Thierer. *Permissionless Innovation: The Continuing Case for Comprehensive Technological Freedom.* Mercatus Centre, George Mason University: 2014.
[7] Mancur Olson. *The Rise and Decline of Nations*. Yale University Press: 1982.
[8] Ibid. vii.
[9] Richard Allsop. 'How Government Holds Back Technological Change,' IPA Review, Vol. 66 No. 2 (2014), 14.
[10] Darcy Allen and Chris Berg. *The sharing economy: how over-regulation could destroy an economic revolution*. Institute of Public Affairs Occasional Paper: December 2014.

insight into the possible commercial applications that might be realised. That is the role of entrepreneurial experimentation.

But the issue is that technologies fast become over-regulated, especially for any entrepreneur looking to make commercial gain. Regulators deem when, where and how technologies may be used. The tangible outcome of this is fewer business entries and therefore reduced prospect of gains to firms, workers and consumers due to reduced entrepreneurial experimentation and discovery.

Shutting down a technology in this way renders mute many of the potential benefits. Who is to say that a technology that looks insignificant when first developed may not begin revolutionary change? One thing is for certain, as long as there are regulations defining what nascent technologies can do, entrepreneurs are unable to test and trial their potential uses.

What this means is lower entry rates, lower exit rates, and an economy that is less entrepreneurial and dynamic. This is bad for everyone except the incumbents.

Permissionless innovation is critical because it allows market trial-and-error, learning and experimentation. Regulators must understand is that no one knows the future of technology, or what it must be used for. What is historically evident is that this can be determined by the free market.

Without allowing entrepreneurs with new technologies and businesses to enter into markets and test their ideas, governments are stifling innovation:

> "… this is about ensuring that individuals as both citizens and consumers continue to enjoy the myriad benefits that accompany an open, innovative information ecosystem. More profoundly, this general freedom to innovate is essential for powering the next great wave of industrial innovation and rejuvenating our dynamic, high-growth economy. Even more profoundly, this is about preserving social and economic freedom more generally while rejecting the central-planning mentality and methods that throughout history have stifled human progress and prosperity."[11]

Avoid industry-specific regulation

Thierer is talking about the United States. We must discuss Australia in the same way. It is widely recognised that Australia is nation of red tape. In the most recent World Economic Forum Global Competitiveness Report, Australia ranked 124th of 144 countries on the burden of government regulation. [12] This is not surprising once the pool of licenses, permits, approvals, subsidies and suchlike are compiled.

Many of these are industry-specific regulations. Much of the discussion over business entry and exit focuses solely on the tangible costs of entering a market. These are things such as the number of days to start a business, the cost to register an ABN, or the rate of tax. These tangible costs have

[11] Ibid: x.
[12] World Economic Forum. *The Global Competitiveness Report 2014–2015: Full Data Edition*.

been a focus of recent Coalition government reforms – including the current *Regulation Impact Analysis (RIA)* process and the *Regulation Impact Statements (RIS)*.

These are, of course, genuine issues in the decision-making of entrepreneurs. But they are not the whole picture. Let us focus on two particular questions in the issues paper of this inquiry:

> *'… Are there industry specific regulations that act as a disincentive to set-up or acquire an existing business? What is the right balance between regulatory certainty and flexibility in this area?' page 8 of Issues Paper*

We argue here that industry-specific regulations are troublesome by nature. A large proportion of industry-specific regulation acts as a disincentive to set-up or acquire an existing business. The problem is that these regulations, by nature, define industry structure. Regulators must ask questions like 'what is a taxi?', 'what does a teacher look like?', and 'what's the difference between a hotel and a home?'

This is not an issue in a static world where industry boundaries are unchanging. But all of the regulatory problems are created in a dynamic world of change and flux. As Joseph Schumpeter famously explained: "As a matter of fact, capitalist economy is not and cannot be stationary. Nor is it merely expanding in a steady manner. It is incessantly being revolutionized from within by new enterprise, i.e., by the intrusion of new commodities or new methods of production or new commercial opportunities ..."[13]

What changes through this process is the structure of the industry: who's producing; who's producing what; and how they're doing it. But regulatory frameworks tend to inhibit this change. Industry-specific regulation locks in existing industry boundaries. But new growth tends to happen at the intersection of existing industries (bio-informatics, for instance).

The reason these industry specific regulations are implemented is because of calls for greater certainty. As the question cited above suggests, there is some trade-off between certainty and flexibility. It must be clearly and explicitly understood that the trade-off for industry-specific certainty is a reduction in *innovation*.

This can be described in terms of the 'technology-neutral' regulation debates. There is a relative consensus between regulators over the need for 'technology neutral' regulation.[14] For instance, in the recent Financial Systems Inquiry, recommendation 39 focused on the need for technology neutral regulation which is "…principles-based and functional in design, focusing on outcomes rather than prescribing the method by which it should be achieved."[15] Further,

> "Some regulation assumes or requires the use of certain forms of technology. For example, regulation may specify certain delivery mechanisms for products, or use terminology that assumes a paper-based environment… These circumstances can impede innovation and efficiency by preventing the uptake of new technologies that could provide better outcomes

[13] Joseph Schumpeter. 1942. 'Capitalism, Socialism and Democracy', Part I, Chapter 3: 31.
[14] Of course, there remain a few dissenters.
[15] Financial System Inquiry – Final Report: 270.

> for users, businesses and government. They can also prevent government and regulators from managing risks appropriately." [16]

The underlying principle here is a much broader than technology. The principle behind technology neutrality is for governments to craft legislation in such a way that specific technologies are neither recognised nor advantaged. These debates, as the above quotation indicates, suggest regulators 'focus on the effects' and ignore the process by which these services are delivered.

What we suggest here is that the lessons from technology-neutrality must extend to industry-specific regulations. The recent furore over Uber, for example, is much less defined in terms of technology neutrality, and much more in terms of industry competition.

[16] Financial System Inquiry – Final Report: 269.