Taking competitive neutrality seriously:

A submission to the Productivity Commission inquiry into Competition in the Australian Financial System

By Nicholas Gruen

Introduction

Economic reform grew through the 1980s into an increasingly comprehensive program which, from then until the early 2000s affected almost every aspect of economic policy. To simplify somewhat, the mental model behind it operated by a series of presumptions which were, at least in principle, rebuttable. One of the principle ideas was that markets could be expected to work well in the absence of 'market failure' and that where there was market failure, policy should look to how it might correct this, rather than assume a larger role for governments.

This was often a useful corrective to the economic institutions existing at the time, representing as they did the collected detritus of decades and decades of *ad hoc* political favouritism. On the other hand the record now shows that we underplayed the profundity and complexity of market failure in many sectors. As the dust has settled from our period of reform, it's remarkable how constrained our clear successes have been to 'stroke of the pen' reform – where we swept away the old as we did with the two airline policy, the regulation of shopping hours and tariffs. We also have some positive victories where a singular idea could be implemented using existing systems from the commanding heights of the policy apparatus – as we did by running income contingent loans and child support through the tax system.

In infrastructure and utilities on the other hand, where monopoly and asymmetric information problems abound, regulation remains inevitable and new rent seeking political pathologies lie in wait for those unpicking the old ones. Here our reform efforts brought forth excessively priced energy, toll-ways, airports, desalination plants and financial tricks many of which saw governments paying more for what they already had, as occurred with the sale and lease-back of government offices. To this day in energy, infrastructure and telecommunications are mired in political short-termism, dysfunction and crisis.

Then there is finance which in many ways is a special case. Warming to his theme that the financial system is a "pyramid of promises", here is Martin Wolf:

> [T]he purchasers of promises will know that the sellers normally know much more than they do about their prospects. The name for this is "asymmetric information." They will also know that those who have no intention of keeping their word will always make more attractive promises than those who do. This is "adverse selection." They will know that even those who are inclined to be honest may be tempted . . . not to keep their promises. The source of this is "moral hazard." The answer to adverse selection and moral hazard . . . is to collect more information. But this too has a drawback: "free-riding". . . [T]hose who have made no investment

> in collecting [information] can benefit from the costly efforts of those who have . . . . That will, in turn, reduce the incentive to invest in such information, thereby making markets subject to the vagaries of "rational ignorance." If the ignorant follow those they deem to be better informed, there will be "herding." Finally, where uncertainty is pervasive and inescapable – who, for example, knows the chances of nuclear terrorism or the economic impact of the internet? – the herds are likely both to blow and ultimately to burst "bubbles".

This brief *tour de force* continues with a new paragraph beginning "Finance is a jungle inhabited by wild beasts. How then are they to be made at least tolerably tame?" [1]

We are still searching for answers to that question. In such circumstances it seems reasonable to be sceptical of any quest to answer this question that is overly tendentious or dogmatic, or which makes too easy or inflexible use of presumptions in favour of the relative efficiency of more, as opposed to less market based solutions. It seems more reasonable to assume that the best we can do will be some mix of competition and collaboration – between actors in markets and institutions tasked with improving their efficiency and effectiveness.

In such circumstances this submission proposes a new approach to competitive neutrality. The old approach to economic reform sought to refashion our institutions to make them as market oriented as might be possible and desirable in the presence of, and whilst seeking to mitigate market failures. As outlined below this produced competitive neutrality as a shield to protect business from unfair government competition. In the section below we argue that such a notion can be subsumed into a broader notion of competitive neutrality. This is one in which both markets and governments and other collaborative institutions are taken to define a repertoire of possible manoeuvres by which we might 'tame' the wild beasts of finance. Our task is to evolve institutions of the mixed economy in which the public and private, the competitive and the collaborative, play to their strengths and bolster the others' weaknesses as best they can.

Competitive neutrality

It is not surprising that Australia gave the world the expression "competitive neutrality".[2] We coined the expression in the mid 1990s when we were global leaders in economic reform – alone amongst the more aggressive Anglophone liberalisers – in the UK, the US and New Zealand – in reforming our economy without promoting economic inequality. Alas that leadership has been

[1] Wolf, M., 2008. *Fixing Global Finance,* The Johns Hopkins University Press, pp 13-4.

[2] OECD Working Party on State Ownership and Privatisation Practices, 2013. "Competitive Neutrality: National Practices in Partner and Accession Countries", OECD, Paris. Accessed on 25th Sept 2017 at http://www.oecd.org/officialdocuments/publicdisplaydocumentpdf/?cote=DAF/CA/SOPP(2013)1/FINAL&docLanguage=En.

relinquished since the early years of this century. This inquiry provides an opportunity for renewal.

Hitherto, competitive neutrality has typically been pursued as a shield for business against unfair competition from government owned entities. Thus for instance the 'founding document' of competitive neutrality as a government policy in Australia, the Commonwealth Competitive Neutrality Policy Statement, 1996 outlines the purpose of the policy thus:

> The implementation of competitive neutrality policy arrangements is intended to remove resource allocation distortions arising out of public ownership of significant business activities and to improve competitive processes.

Yet the process by which this is to take place is asymmetrical. The statement just quoted argues that:

> Competitive neutrality requires that government business activities should not enjoy net competitive advantages over their private sector competitors simply by virtue of public sector ownership.

This seems entirely reasonable where government agencies are, by virtue of institutional history exempt from various constraints on the private sector such as taxation or planning regimes and restrictions.

However, as we are increasingly realising, private for profit firms come with certain disadvantages at least in the presence of market imperfections and government agencies exist partly to address these issues. For this reason the principle of competitive neutrality offers promise not just as a shield for firms within markets from unfair competition, but also as a sword, as a mechanism to improve competition, efficiency and effectiveness in addressing users needs where government agencies can provide services as well as or better than private firms.

In this regard, in this submission, government agencies competing with private for profit firms is 'fair' and presumptively efficiency enhancing when they compete at prices that reflect the underlying resource costs of public provision. Moreover it stands to reason that government agencies may be able to provide services at lower resource cost and/or higher quality in some areas, particularly finance.

Particular advantages that may be enjoyed by government agencies in finance include:

- The directness of their relationship with the fundamental architecture of the monetary and financial system.[3] Thus for instance central bank notes offer lower transactions costs and risks on users than private bank notes.
- The public's trust in the integrity of services provided by government including the lower extent to which senior executives in publicly owned

[3] The entire financial structure of a modern economy is built on government provided architecture from the specification of the monetary unit, the provision of central banking, the setting of monetary policy and the financing of government, including through the selling of bonds.

organisations have been able to exploit their positions as insiders to extract rents from users.

- The tendency for government backed firms to be substantial players in their markets and so the access this gives them to scale economies.[4]

Banking

In the case of banking, an entire industry has been built on a fundamental competitive non-neutrality which the advent of the internet has now rendered largely obsolete. Firstly and most fundamentally, citizens do not enjoy competitive neutrality with commercial banks because commercial banks receive basic banking services from the central bank which citizens cannot access.

Secondly the commercial banks – who 'retail' and upsell to their customers the basic banking services of payments and savings initially 'wholesaled' by the central bank – are themselves advantaged against other businesses which cannot themselves directly access those basic central banking services.

And yet, since at least the advent of the internet, it has been technically possible to cost effectively end this non-neutrality by allowing all comers access to central bank services – that is to allow them to save money in central bank accounts, be rewarded at the overnight cash rate and use those accounts to pay others.

Indeed central banks have 'retailed' their services to the general public since the English Bank Charter Act of 1844 legislated the Bank of England's dominance in the public issue of paper bank notes. Remarkably, there's been no hint of something analogous in the world of digital banking.

Quite obviously, getting our central bank to provide retail digital services would have far-reaching consequences for banking, given the extent to which banking has hitherto been built around commercial banks exclusive access to central banking services.

Of course this would be disruptive but it would be disruptive in precisely the way that competitive neutrality was disruptive when Australia led the world in introducing it as a shield for business against unfair competition from government agencies. Used in this way it was instrumental in moving our economy towards a division of labour between publicly and privately provided services that played better to the respective strengths and weaknesses of each sector.

Competitive neutrality used as a sword against uncompetitive businesses would do the same in one of the sectors that has bedevilled policy since the rise of modern finance in the nineteenth and twentieth century – finance.

As I've outlined in a number of publications,[5] allowing central banks to provide basic banking services to all who qualify and can pay the full costs of doing so

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[4] Moreover where scale economies are substantial they may also compromise the vigour of competition in the private sector.

would generate large gains. Since my initial publication in this area, Bank of England research has argued that, coupled with the issuance of digital currency, the kind of access proposed here could generate economic gains of three percent of GDP a remarkably large number in comparison with most micro-economic reforms.[6]

Much of this gain comes from the proceeds to government of money creation, something which is generated in my model with central bank lending against super-collateralised assets.

Superannuation and funds management

The principle of competitive neutrality would also offer a useful means by which the excessive margins in the provision of superannuation services could be tackled. Given the resources governments invest in account and funds management to support public servants' defined contribution superannuation, as a matter of right and to promote economic efficiency the same services should be made available to any Australian wishing to avail themselves of that service.

Naturally Australians' right to elect to have others managing their money should be preserved, but the fact is that all the evidence suggests that the public sector is a more competent a manager of superannuation than most other alternatives available to Australians.

As the Grattan Institute's Jim Minifie observed in 2015, "public sector funds as a group have achieved the highest average net returns over the 14 years to 2013". Their average annual returns exceeded those of the entire APRA-regulated superannuation industry by 1.1 percentage points, industry funds by 0.6 percentage points, and retail funds by 2.2 percentage points per year over that period.[7]

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5 Gruen, N, 2014. "Central banking for all: a modest proposal for radical reform", Nesta, accessed on 25th Sept at http://www.nesta.org.uk/publications/central-banking-all-modest-case-radical-reform

Gruen, N. 2016. "Why Central Banks Should Offer Bank Accounts to Everyone: Central banking disrupted for the 21st century", Evonomics, December, accessed on 25th Sept at http://evonomics.com/central-banks-for-everyone-nicholas-gruen/.

Gruen, N. 2017. "Making the reserve a people's bank" *The Saturday Paper,* April 15 – 21, Edition No. 152, accessed on 25th Sept on https://www.thesaturdaypaper.com.au/opinion/topic/2017/04/15/making-the-reserve-bank-peoples-bank/14921784004504.

6 John Barrdear and Michael Kumhof, 2016. "The macroeconomics of central bank issued digital currencies", *Staff Working Paper* No. 605, Bank of England accessed on 25th Sept at http://www.bankofengland.co.uk/research/Documents/workingpapers/2016/swp605.pdf.

7 Minifie, J. 2015. "Super savings", Grattan Institute, Melbourne, April accessed on 25th Sept at https://grattan.edu.au/wp-content/uploads/2015/04/821-super-savings2.pdf. The latest numbers from APRA suggest that this record remains in tact see APRA, 2017. *Quarterly Superannuation Performance* June 2017 (Issued 22 August 2017) accessed on 25th Sept at http://www.apra.gov.au/Super/Publications/Documents/2017QSP201706.pdf.

New principles of competitive neutrality

In short, what is being proposed here would:

- Use existing infrastructure.
- Achieve its objective simply by enabling government agencies to compete in the marketplace on their own merits rather than by preventing or impeding competing private service providers.
- Involve no subsidies.
- Respect the important principle that government agencies' commercial dealings should be at arm's length from the government of the day.

In the upshot, the use of the principle of competitive neutrality as a sword to promote market efficiency could generate large gains for the Australian economy and improve the wellbeing and peace of mind of many Australians who lack either the ability or the desire to make a well-informed choice between highly complex and sophisticated products and wish instead to access products that they can reasonably expect to be professionally managed with their interests in mind.