Submission to Productivity Commission Inquiry on "Cost Recovery"

by

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Introduction

1. This Inquiry is a welcome review of the issue of "cost recovery" in Australia. The serious economic consequences of the unbridled embrace in the 1980s of "cost recovery" by governments in Australia was first highlighted by the Business Council of Australia in its two publications: *A Tax Relief System for Australian exports: A study of the cascading of business taxes and 'user charges' on Australian exports and the design of a tax relief system* by T M Dwyer and J T Larkin, Business Council of Australia, Melbourne, December 1993, ISBN 0 909865 56 6, and *Refocusing Microeconomic Reform* by J T Larkin and T M Dwyer, Business Council of Australia, Melbourne, August 1995, ISBN 0 909865 57 4.

2. These research publications, while directed more specifically at "cost recovery" and "user charges" for infrastructure, bear directly on issues being addressed in the current Inquiry.

3. More recently these earlier Business Council of Australia publications have been further developed in the Rural Industries Research and Development Corporation (RIRDC) publication *Infrastructure Pricing, Provision and Process: Implications for Rural Australia* by Bob Lim & Company Pty Ltd and T M Dwyer, October 1999, ISBN 0 642 58011 1.

Empirical Evidence

4. It seems clear that during the 1980s Australian public finance witnessed a profound change - with the rise of "user charges" and, more generally, full cost recovery for government services. The publications abovementioned demonstrate both in theoretical and practical terms how this "cost recovery/user charges" revolution was nothing more than disguised taxation. While it is understandable that diligent Treasury and Finance Departments (both State and Federal) will wish to uncover and exploit new and novel forms of taxation, the economic consequences for the Australian economy of such charges cascading into the cost base of business is significant. The GST now provides an additional tax on these taxes for which there is no cascade relief (BCA 1993).

5. The PC *Issues Paper* quite rightly concedes that a taxation, or revenue raising, motivation unlies the growth of "cost recovery" in Australia. Indeed it is significant, as the *Issues Paper* notes, that much of the implementation of cost recovery has, perforce, to be given effect by way of formal taxation legislation.

6. The BCA and RIRDC publications cited above provide empirical evidence of the growth in user charges for infrastructure since the 1980s. For example RIRDC 1999 states: *"…That this new form of indirect tax has grown at a truly meteoric rate can be gauged from the fact that income transferred to governments from all public trading enterprises in Australia (other than banks) jumped from $0.4 billion in 1987-88 to $6.8 billion in 1996-97 an increase of 1,700 per cent! Over 40% of the annual revenue of public trading enterprises in Australia is now transferred to governments compared with only 9% seven years ago. The new "tax milch cow" status of public trading enterprises as revenue generators for governments can be seen from the following chart (Chart 6). This shows that while their gross fixed capital expenditure is shrinking public trading enterprise revenues are being siphoned off to governments at a rapidly increasing rate. In 1990-91 "dividends" stripped from public trading enterprises were $1.4 billion while their gross fixed capital expenditure was $11.1 billion. By 1996-97 dividends had jumped to $6.8 billion at the expense of capital expenditure which had dropped to $9 billion."*

7. This PC Inquiry should:

   (i) Quantify and publish how "cost recovery/user charges" have increased in Australia since the mid 1980s to date;

   (ii) Model the cascade effect on business costs of these imposts;

   (iii) Quantify their "contribution" to departmental and agency recurrent spending over the above period.

Deadweight Costs

8. It is axiomatic that the "cost recovery/user charges" form of revenue raising and (disguised) taxation imposes deadweight costs on the economy. This is because the existing system of general taxation and revenue raising remains in place while new (and obviously costly) bureaucratic structures have to be put in place in departments and agencies to administer "cost recovery".

9. As the USDA observes *"…User fees generate administrative costs for tracking detailed program costs, managing revenue flows, and adjusting fees over time. Fees also create policy issues, and managers frequently devote considerable time to fee issues as they are raised by Congress and by fee payers. The process of collecting fees also creates compliance costs for direct users, as each must now make, record, and review payment. Compliance and administrative costs will substantially exceed any administrative savings realised through reduced support from general revenues because the system for administering and paying for general revenues remains in place. Administrative and compliance costs will be larger the more complex is the regulatory environment and the more diverse are the regulated entities."* (USDA/ERS Report No 775)

10. This PC Inquiry should:

(iv) Quantify and assess the deadweight costs of departmental and agency compliance of "cost recovery and user charges" and estimate the net contribution of revenue generated.

Marginal Cost Pricing the Norm

11. The BCA and RIRDC publications cited above establish most comprehensively in theoretical terms that marginal cost is the only valid basis for pricing of government services. The extensive theoretical discussion of this matter in those publications will not be repeated here. It should nevertheless be noted that the deficiencies of Ramsey pricing, which might best describe some current practices of "cost recovery", are also reviewed in those publications. As RIRDC 1999 states: *"…Strictly speaking, any price above marginal cost is a tax, even if that price is below average cost. Thus a cost accountant may denounce as a "subsidy" a price which an economist would regard as already in excess of marginal cost – and thus a tax."* (RIRDC 1999, p43)

12. It appears that Finance Department instructions to departments and agencies have triggered, and continue to drive, Australia's cost recovery phenomenon. But as the PC *Issues Paper* notes the key Finance Department manuals or instructions are not available for public examination. Casual empiricism suggests that **full** cost recovery (emphasis added) appears to be a the norm in departments and agencies nowadays. Such an approach seems to be characterised by the discipline of accounting rather than economics. As noted in the publications cited above the dangers for Australia's economic efficiency of embracing an accountant's view of the world (much as it may maximise revenue) can be serious indeed for the economy.

13. This PC Inquiry should:

(v) Affirm marginal cost pricing as the guiding principle for departmental and agency services;

(vi) Establish and promulgate a marginal cost pricing methodology which departments and agencies should follow;

(vii) Estimate the existing implicit taxation involved in departmental and agency cost recovery revenues.

Existing pricing regimes and Gold Plating

14. In examining a selection of government publications (and services) it seems most doubtful that they are priced other than on a Ramsey, or monopoly, pricing regime. The most notable and welcome exception to this appears to be the Reserve Bank of Australia who apparently is alone in observing marginal cost pricing for its *Monthly Statistical Bulletin*. In stark contrast is the pricing substantially above marginal cost of many government publications. BCA 1993, p32, reports the AGPS pricing additional print runs at six times marginal cost!

15. The apparent unvirtuous circle of (unpublished and uncontested) Finance Department directives seeking ever increasing full cost recovery from departments and agencies combined with the monopoly power of those agencies in administering Ramsey, or monopoly, prices on users clearly impairs the economic efficiency of the Australian economy. Such a questionable framework of public finance must also detract from a proper zero based budget review of government functions and doubtless it retards appropriate contestability and privatisation. Gold plating of government publications seems to be one outcome of the present system of full cost recovery. Indeed, it should be asked is "full" an invitation to gold plating? Misallocation of resources in terms of staff, conditions and equipment must also arise given the deadweight costs inherent in the current full cost recovery framework.

16. This PC Inquiry should:

(viii) Develop and promulgate (undesirable) gold plating indicators;

(ix) Communicate and recommend to departments and agencies the apparent (commendable) attachment of the Reserve Bank to marginal cost pricing.

Contestability & Privatisation

17. As already noted the current system appears to retard contestability and there is no mechanism for independent regulatory review of pricing. This PC Inquiry should:

(x) Examine and recommend, as far as practicable, contestability and privatisation of the areas and functions under review;

(xi) Ensure that a process of annual price review and determination by independent arms-length regulators is established (such as IPART or other comparable Regulator-Generals). Such a process should be open to business and consumers to contest and ensure transparency and justification of department and agency pricing practices – and the (non-transparent) Finance Department directives which drive them.

Conclusion

18. The Productivity Commission has over the years been notable for its fearless pursuit of economic efficiency through advocacy of unilateral tariff reduction - stressing that tariffs are disguised taxes and, hence, a cost on the economy as a whole. It is similarly important that the Productivity Commission pursue this present Inquiry into disguised taxes with equal vigour having regard to the over-riding need for economic efficiency and international competitiveness in the Australian economy.

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