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BUSINESS COUNCIL OF AUSTRALIA

Preliminary Submission to the Productivity Commission
on the
Review of National Competition Policy Arrangements

25 June 2004

BCA Preliminary Submission to Productivity Commission Review of National Competition Policy Arrangements

Introduction

The performance of the Australian economy over the last decade has been impressive, even by international standards. Strong productivity growth, large employment gains, rising real wages, and low and stable inflation and interest rates have greatly improved the living standards of Australians. Microeconomic reforms (including national competition policy) have played an important role in achieving these economic gains. Yet now is not the time rest on our laurels. The small, open Australian economy is constantly facing challenges which require the drive for economic efficiency to continue. External challenges such as international competition and mobile global capital, and domestic pressures such as the ageing of the population, mean that the ability of the Australian economy to remain competitive, flexible and innovative will determine how well Australians continue to improve their lot in life. There is a need to re-invigorate and broaden the reform agenda. Not doing so spells danger for the Australian economy and our quality of life.

It is with these considerations in mind that the Business Council of Australia (BCA) welcomes the Productivity Commission's Review of National Competition Policy (NCP) Arrangements. This review provides an opportunity to reflect on the goals of NCP, assess its performance and determine future areas for reform.

The BCA's submission will firstly evaluate Australia's recent economic performance and microeconomic reform's role in this growth. The dangers associated with reform complacency and counter-reform will then be discussed. Finally, when considering the need to re-invigorate the NCP agenda, the submission will highlight the need to focus effectively on what the ultimate goals of NCP should be. This is an important consideration, as a clear understanding of the goals of NCP will ensure the policy works to achieve the correct outcomes and will determine the nature of policy instruments used and the priority areas for further reform.

Australian Economic Achievements and Economic Reforms

Measures of Economic Success

The Australian economy has performed strongly over the last decade. From 1996 to 2003, the Australian economy has grown at an average annual rate of 3.8 per cent. This growth performance compares favourably with that of the EU, which only grew at an average of 2.2 per cent over the period, and even outperforms the strong US economy, which grew at an average of 3.3 per cent.

This continued expansion of the economy has substantially increased the living standards of Australians. Over the decade 1993 to 2003, the economy produced around 1.9 million jobs, resulting in a fall in the unemployment rate from

10.6 per cent to below 6 per cent. GDP per capita from 1996 to 2003 rose annually by around 2.5 per cent, compared with rates of growth in the US and the EU of 2.2 per cent and 1.9 per cent, respectively. Australia's international ranking in GDP per capita within the OECD has risen from its low point of 15th in 1990 to 8th in 2002.

Even more impressive has been the sustainability of this performance through major international shocks such as the Asian financial crisis in the late 1990s and the tech-bust induced global slowdown in the early 2000s. For example, throughout 1997 and 1998, while the economies of major trading partners such as Japan and Korea faltered (Korea's economy shrunk on average by 1.1 per cent over the two years, while Japan's economy grew by only 0.3 per cent on average), the Australian economy continued to grow by an average of 4.6 per cent.

Australia's productivity growth has been the foundation for this strong economic performance. In Australia from 1995 to 2002, GDP per hour worked grew at an average annual rate of 2.4 per cent, well above the respective growth rates of 2.1 per cent, 1.8 per cent and 1.5 per cent in Japan, the US and the EU.

The Role of Reform

The timing of this productivity and growth surge has coincided with the implementation of a broad agenda of microeconomic and macroeconomic reforms within the Australian economy. Microeconomic reforms since the mid-1980s have encompassed changes to industry assistance (including tariff reform), capital markets, taxation and regulatory systems, labour markets and industrial relations, government enterprises, and competition policy. Their aim has been to improve efficiency and flexibility within the economy by removing distortions and opening markets up to competition from domestic as well as overseas sources.

These reforms have significantly altered the structure of the Australian economy. For example, trade and financial market reforms have dramatically increased trade intensity, international investment flows and the size and importance of the finance sector within the economy. However, it is yet another step to claim that they are responsible for Australia's impressive performance in economic and productivity growth.

A number of recent studies do, however, suggest that the implementation of economic reforms has been an important determinant of the strong productivity growth of the last decade. The Productivity Commission (1999) concludes that evidence from aggregate, industry and case study levels suggests a strong relationship between economic reforms and improved productivity¹. Similarly, the Productivity Commission (2004) notes strong linkages between the productivity performance of individual utility sectors over time and earlier microeconomic reforms². Furthermore, Parham (2002) estimates that while the uptake of information and communications technologies, as well as improved education and skills, may have played an important but relatively modest role in the productivity

¹ Productivity Commission (1999) 'Microeconomic Reforms and Australian Productivity: Exploring the Links', Commission Research Paper.

² Productivity Commission (2004) 'Annual Report 2002-03', Productivity Commission Annual Report Series.

upsurge of the 1990s, the major explanation for the strong productivity performance appears to be the implementation of microeconomic reforms³.

These studies note that it is important not to assume that the recent productivity growth performance of the economy can be solely explained by the implementation of economic reforms. However, they do suggest that reforms are an important factor behind the growth and argue that other factors that have been raised, such as recovery from the 1990s recession, a world-wide productivity boom and increased work intensity, do not provide an adequate explanation.

In addition to supporting the direct link between economic reforms and improved productivity, a number of studies provide further evidence of how economic reforms have improved the performance of the Australian economy. The Productivity Commission (1999) notes that general and case study evidence suggests that microeconomic reforms have been a major influence on positive developments in the economy such as increased specialisation of production within industries, improvements in management practices and workplace arrangements, the increased use of up-to-date technologies, improving workforce skills and more productive allocation of resources.

Furthermore, de Brouwer (2003) argues that international trade reforms and the floating of the \$A have produced an outwardly-orientated and flexible economy which can deal effectively with international shocks, as in the case of the Asian financial crisis, where the depreciating \$A and the ability of Australian firms to shift exports to the US and Europe enabled Australia to weather the storm better than regional neighbours⁴. De Brouwer (2003) also notes that the deregulation of the finance sector has enabled the more effective diversification of risk throughout the economy and enabled individuals and firms to borrow more to acquire assets and smooth income.

The Dangers of Reform Complacency

The above suggests that a major contributor to the impressive performance of the Australian economy in recent years has been the implementation of economic reforms, including NCP. Such a result also highlights the importance of further reform for continued and sustained improvements in the performance of the economy. The role of further economic reforms in achieving future efficiency gains will be crucial. Despite over two decades of concerted effort to deliver broad-ranging reforms, the reform pipeline is far from empty. Furthermore, the need for economic reforms is constantly growing as the Australian economy faces new challenges, such as those associated with the environment and an ageing population.

Good economic performance should not be taken for granted. It is earned through the continued pursuit of economic efficiency. In the recent BCA publication, 'Aspire

³ Parham, D. (2002) 'Microeconomic Reforms and the Revival in Australia's Growth in Productivity and Living Standards', Paper presented to the Conference of Economists, October 2002.

⁴ de Brouwer, G. (2003) 'Economic Reform and Growth in Australia', Paper prepared for the Australian Studies Association of Japan Symposium, June 2003.

Australia 2025', a scenario of the effects of reform complacency was assessed⁵. The results are alarming. Under the scenario, public and government expectations that Australia will continue to be successful and prosperous without further changes or hard decisions leads to a shift in government priorities away from restructuring economic activity and providing the conditions for investment needed to maintain Australia's competitive position. Over time the result is declining economic performance as the structural growth rate of the economy is diminished. This situation creates a vicious cycle as a slow growing economy places pressure on governments' financial positions, which adversely affect their ability to deliver further reforms, infrastructure and services that are required to improve the economy's performance. The scenario presents a clear warning of the consequences if we shy away from ongoing reform.

The economy is currently in a virtuous cycle of growth and reform. Surging taxation revenues, in particular company tax receipts, as a result of a strong economy provide governments' with the resources to implement further reform. It is important that these reform efforts continue, to maintain this virtuous cycle. In this respect, there is a need to re-invigorate the NCP reform process. The NCP framework has provided many benefits to the Australian economy, but further reform is needed to ensure that these gains are maintained and enhanced.

Re-invigorating NCP

NCP's Goals

Before considering what reforms are needed to further the NCP process, it is important to consider what the goals of NCP should be. This is important as it helps to identify appropriate instruments for the implementation of NCP and possible areas for further reform.

The ultimate goal of NCP should be to improve the living standards of Australians by improving economic efficiency in the Australian economy. Competition is not an end in itself, but rather the means through which NCP achieves gains in economic efficiency.

It is critical to ensure that NCP focuses on the ultimate goal of attaining efficiency gains in the economy and not simply achieving competition *per se* or indicators of competition (such as certain market structures or concentrations).

Such a statement prompts the questions: Isn't the achievement of 'competitive' market structures synonymous with the attainment of efficiency gains? Doesn't the existence of numerous competitors in markets ensure economic efficiency?

Under the restrictive assumptions of simple economic theory the answer to these questions is 'yes'. However, when more pragmatic considerations about the real world economic environment are introduced the answer becomes more ambiguous.

⁵ Business Council of Australia (2004) 'Scenario 1: Riding the Wave', *Aspire Australia 2025*.

This is particularly so for the case of the Australian economy which has a number of unique characteristics that distinguish it from a text-book economy.

Realities for Australia

The Australian economy is relatively small, internally-dispersed and geographically-isolated. These characteristics result in a situation where many markets in Australia can only realistically support a small number of firms, leading to high levels of market concentration. In 2000-01, large businesses comprised only 0.52 per cent of total businesses in Australia, while they accounted for 50.6 per cent of total industry value added⁶. Furthermore, even in relatively concentrated markets many Australian firms are small by international comparisons. For example, at the end of 2003 the market capitalisation of Australia's 200 largest publicly listed firms (ASX 200) was around \$639 billion, while the market capitalisation of only the UK's 100 largest publicly listed companies (FTSE 100) stood at approximately \$2,638 billion⁷. This suggests that even many large firms in Australia are unable to achieve minimum efficient scale, especially by simply serving the domestic market.

In isolation, the existence of high market concentration in an economy would suggest the need for competition policy to ensure more market competitors so that incumbent firms cannot use their market power to raise prices above competitive levels. Thus, competition policy theoretically results in an efficient allocation of economic resources. However, as noted above, relatively high levels of market concentration in Australia are not the result of obstacles to competition but are related to the smallness of domestic markets and the need for firms to achieve scale economies. Therefore, the introduction of competition policies in Australia aimed at achieving indicators of competition, such as certain market structures, may achieve allocative efficiency (related to market concentration and power issues) at the expense of productive and dynamic efficiency (related to scale and critical mass issues)⁸.

The potential for dynamic efficiency in Australia to be detrimentally affected by competition policies aimed at achieving indicators of competition is particularly important given the primary importance of dynamic efficiency over static efficiency in improving living standards over time. Investments in education, research and innovation are important for dynamic efficiency. There is evidence to suggest that the scale of firms may be an important factor in determining the amount of investment in Australia that is allocated to these areas. In 2000-01, large businesses accounted for 62.9 per cent of business expenditure on R&D, while small firms accounted for just 37.1 per cent. The contribution of large firms to R&D was much larger than their employment share (38.2 per cent), whereas the R&D contribution of small businesses was significantly smaller than their employment share (61.8 per cent)⁹. In addition, the Australian Business Foundation (1997) has found that

⁶ Figures calculated from data contained in ABS 8140.0. Large businesses include all management units which employ 200 or more persons or have assets worth more than \$200 million.

⁷ Figures calculated from data contained at www.asx.com.au; www.ftse.com; and www.rba.gov.au.

⁸ It should also be noted that competition policy aimed at achieving indicators of competition in small, isolated economies, such as Australia, may also not achieve allocative efficiency as smaller firms that are unable to achieve minimum efficient scale will have higher unit costs than those firms able to achieve scale economies, and therefore may charge higher prices.

⁹ Figures calculated from data contained in ABS 8104.0 and ABS 8140.0.

business R&D spending in Australia is highly concentrated in a few large firms, and that technologically innovative activity by firms in Australia varies positively with firm size¹⁰.

While it is true that highly concentrated markets which are protected from competitive forces are not likely to maximize such investment, it is also unlikely that a market of many small firms with restricted resources and an inability to achieve minimum efficient scale would provide the greatest incentive to innovate. The importance of scale has also been raised in the context of modern-globalised economies where the shortening of time between innovation, markets and obsolescence means that firms must have sufficient size and resources to take a concept to market quickly in order for innovative activities to be commercially viable¹¹. Furthermore, there is evidence to suggest that in modern-economy industries, incentives for innovation are maximized in markets where there is the prospect of securing profits, ie. in market structures other than perfect competition where there is likely to be relatively high levels of market concentration and the prevalence of scale economies¹².

Policies for Competitiveness

Given that in Australia there may be a difference between targeting indicators of competition and targeting economic efficiency, the question needs to be asked: what type of policies should be implemented to achieve economy efficiency? Such consideration should not only judge which competition policy instruments are the most effective in achieving economic efficiency, but also whether competition policy is ultimately important in the attainment of efficiency gains. This is an important consideration for a small economy such as Australia.

Evidence suggests that for small economies, the achievement of low barriers to international trade is much more important than competition policy for the efficient performance of domestic markets¹³. Lowering barriers to international trade in small economies can help to achieve economic efficiency without encountering some of the inherent difficulties confronted by competition policy. Trade liberalisation enables domestic firms to achieve minimum efficient scale by allowing them to service foreign markets, while at the same time exposing them to the competitive pressures of imports.

However, the Australian economy is not only small but also geographically isolated from most of the world's GDP and internally dispersed throughout the continent. These factors reduce the effectiveness of trade policy in delivering efficiency benefits.

Australia is one of the most remote economies in the world. Evans and Hughes (2003) calculate that Australia is the second most remote OECD country, behind

¹⁰ Australian Business Foundation (1997) *The High Road or the Low Road? Alternatives for Australia's Future*.

¹¹ Australian Business Foundation (1997) *The High Road or the Low Road? Alternatives for Australia's Future*.

¹² Evans, L. and Hughes, P. (2003) 'Competition Policy in Small Distant Open Economies: Some Lessons from the Economics Literature', New Zealand Treasury Working Paper 03/31.

¹³ Hoekman, B., Kee, H.L., and Olarreaga, M (2001) 'Entry Regulation and Trade: Does Country Size Matter?' in *World Development Report 2001 – Institutions for Markets*, Washington DC: The World Bank.

New Zealand, while Ewing and Battersby (2003a) use a number of indicators of remoteness and find that Australia is on average the 211th most remote nation in the world (consisting of 222 countries)¹⁴. Evidence suggests that physical distance and the existence of borders between countries adversely affect trade by increasing transaction costs associated with transportation, communications, cultural ties and currency regimes¹⁵. Blum and Leamer (2002) estimate that exporting a good to a country 1000 miles away is equivalent to an import tariff of between 7 and 17 per cent depending on the type of good, while Ewing and Battersby (2003b) find that Australian trading performance is adversely affected by its distance from overseas markets¹⁶. Such evidence suggests that in Australia's case, the efficiency gains from decreasing trade barriers may be muted compared to other small economies.

Furthermore, the Australian economy is also relatively internally dispersed. Although, the geographic concentration of production in Australia is high compared to other OECD countries, such concentrated production occurs in markets (capital cities) that are relatively distant from each other¹⁷. For example, within a 1000 kilometre radius of New York there are approximately 30 metropolitan areas with populations higher than 500,000, yet within a 1000 kilometre radius from Sydney there are only two such metropolitan areas, Melbourne and Brisbane¹⁸. The internally dispersed nature of the Australian economy results in a number of regional markets within Australia's borders. Barriers between these regional markets, be they natural or regulatory, further reduce the ability of international trade liberalisation to deliver efficiency benefits. International competitors must not only overcome national barriers to competition but also regional market barriers¹⁹.

These factors suggest that in addition to a program of international trade liberalisation, a comprehensive and effective NCP is still important for achieving efficiency gains within the Australian economy. Given this recognition, what should competition policy aimed at achieving economic efficiency in Australia look like?

NCP Parameters

NCP should aim to achieve economic efficiency by removing obstacles to competition within the economy, rather than attaining certain market structures or concentrations. Furthermore, this should be achieved through a light-hands

¹⁴ Evans, L. and Hughes, P. (2003) 'Competition Policy in Small Distant Open Economies: Some Lessons from the Economics Literature', New Zealand Treasury Working Paper 03/31; Ewing, R. and Battersby B. (2003a) 'Geographic Remoteness: Does the Growth of Asia Improve Australia's Position?', Paper presented to Conference of Economists, September 2003.

¹⁵ Coe, D.T., Subramanian, A. and Tamirisa, N.T. (2002) 'The Missing Globalisation Puzzle', IMF Working Paper WP/02/171; McCallum, J. (1995) 'National Borders Matter: Canada-US Regional Trade Patterns', *American Economic Review*, 85, 615-23.

¹⁶ Blum, B. and Leamer, E. (2002) 'Can FTAAs Suspend the Laws of Gravity and Give the Americas Higher Growth and Better Income Distributions?', Mimeo, UCLA/U. of Toronto; Ewing, R. and Battersby, B. (2003b) 'Gravity Trade Models and Australia's Trade Performance', Paper presented to Conference of Economists, September 2003.

¹⁷ Speizia, V. (2002) 'Geographic Concentration of Production and Unemployment in OECD Countries', Mimeo.

¹⁸ Figures calculated from data contained at www.citypopulation.de.

¹⁹ The fragmentation of the Australian economy into regional markets also amplifies the disadvantages faced by Australian firms operating in a small economy. Dispersed regional markets further reduce the size of home markets, making it difficult for firms to achieve scale economies.

approach to regulation that focuses on achieving efficiency gains rather than adhering to rigid legalistic rules.

NCP should be broad-based. That is, it should focus on all stages of the supply-chain and be applied to a wide-range of markets, in particular to markets where efficient outcomes are critical to the functioning of the economy. In this respect, consideration could be given to the application of NCP principles to the health and education sectors. The efficient operation of these markets will be vital for Australia's economic future as we compete in an international economy that increasingly values knowledge and innovation, and we deal with the health system implications of an ageing population.

NCP should also focus on reducing the country-specific barriers to competition that have been mentioned above. While little can be done to overcome Australia's geographic isolation from the rest of the world, NCP could address the factors that result in market fragmentation within Australia. Natural market barriers within Australia could be reduced by the efficient operation of markets for transportation and communications, while regulatory market barriers could be addressed by reform in areas such as State workplace health and safety, and training and education systems²⁰. The reduction of intranational market barriers that these reforms could precipitate would have a similar effect to reducing international trade barriers: improving scale by increasing the size of the market which firms can service and increasing competition from other regional markets. It also reduces further barriers to international trade, thus providing efficiency benefits from greater international competition.

It is also important to recognise that other policy reforms need to be undertaken in addition to further NCP reforms. The importance of wide-ranging economic reform and the complimentary nature of certain reforms is broadly recognised²¹. The ability of NCP to achieve efficiency gains is inextricably linked to other economic reforms in areas such as taxation, corporate governance and labour markets. For example, without a flexible labour market, the ability of NCP to encourage the efficient allocation of resources throughout the economy is severely reduced. Furthermore, it is vitally important to ensure the further liberalisation of trade barriers. The small, remote and internally dispersed nature of the Australian economy dictates that neither competition nor trade policy will be effective in isolation. There is a need to ensure that both reform agendas are continued to achieve efficient outcomes from competition.

Finally, it is important to realise that the establishment of a NCP regime, focused on achieving economic efficiency, will not necessarily produce perfect competition in every market. Reducing obstacles to competition from both domestic and external sources may indeed result in industry consolidation and increased market

²⁰ The harmonisation of State regulatory regimes in a number of areas could reduce market barriers within Australia. There is evidence to suggest that trade within countries can be adversely affected by the existence of internal borders. This may be partly explained by differing regulatory regimes increasing transaction costs to trade, see: Wolf, H.C. (2000) 'Intranational Home Bias in Trade', *Review of Economics and Statistics*, 82(4), 555-563.

²¹ *Productivity Commission (1999) 'Microeconomic Reforms and Australian Productivity: Exploring the Links', Commission Research Paper.*

concentration²². However, the industry structure that results will be the efficient response to competition pressures and will ensure the achievement of efficiency gains. For example, industry concentration in manufacturing has increased over the last two decades, but there has not been an increase in the pricing power of manufacturers. Such industry consolidation has been a response to international competitive pressures as manufacturers attempt to gain scale economies in order to compete globally²³.

Conclusion

In a small, geographically isolated, internally dispersed economy such as Australia's, the achievement of efficiency gains, in particular productive and dynamic efficiency gains, is linked to the ability of firms to achieve sufficient scale. Competition policy aimed at achieving certain indicators of competition may throw the baby out with the bathwater. NCP should remain focused on its ultimate goal of maximising efficiency gains within Australia and be less concerned with the market structures that result from the attainment of such gains.

National competition policy needs to be re-invigorated to drive the reforms needed to secure Australia's future prosperity. The scope of NCP should be broadened to look at other inhibitors of a competitive economy. This includes applying the principles of NCP to sectors such as health and education, areas that will continue to grow in importance in terms of economic performance and community wellbeing. The reform agenda also needs to address barriers to greater domestic competition within Australia, particularly the inhibiting effect of duplicated and uncoordinated regulation between States and between different levels of government. Finally, the relationship between NCP and other reform areas, such as ongoing reform of the labour market, needs to be examined.

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²² It should be noted that in sectors that are exposed to international competition, the use of domestic market concentration calculations are no longer relevant as the market in which they compete is internationalised.

²³ *Australian Business Foundation (1997) The High Road or the Low Road? Alternatives for Australia's Future.*