Markets: how free?*

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When Eric Sidoti invited me to speak at this symposium, he must have known he was making me an offer I couldn't refuse. First the topic, ‘markets: free but not beyond government intervention’, was appealing. It involves recognition that markets have a very important role to play, but also, as other speakers have indicated today, that governments too have a key role — and it's important to get the mix right for the community’s sake in the long term. I’ve spent much of my career puzzling over the tradeoffs in that territory and indeed that is the principle focus of the Productivity Commission itself.

A second reason why I couldn’t refuse, was that this event is hosted by the Whitlam Institute, named in honour of Gough Whitlam. After all, it was Whitlam’s government which really began the process of opening up Australia's economy to the global market. He was the first Australian leader, I think, to act on the understanding that a freer, more competitive market would facilitate greater economic efficiency and productivity, which would in turn underpin income growth and pay for social programs needed to address inequality and disadvantage. As I recall a catchcry of the time, ‘a government cannot redistribute what its economy does not produce’.

Whitlam saw clearly that the pursuit of economic efficiency and social progress were complementary. And he acted on this insight. It was he who dealt the first blow against Fortress Australia, with the twenty five per cent tariff cut in 1973. While there were multiple rationales, and the reduction was partially reversed in following years, it was a politically brave, indeed unprecedented, gesture that demonstrated what was possible. It contributed greatly to developments in policy thinking that saw the next Labor government, a decade later, pick up where

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Whitlam had left off and succeed in opening up the Australian economy on a more sustainable basis.

Those further reforms, and the reforms that have occurred since then, were Whitlam's legacy in another way. Whitlam also understood that policy reforms to promote efficiency and community wellbeing are often stymied by vocal minorities who stand to lose, while not being adequately appreciated by the much larger section of the community who are the ultimate beneficiaries. He created the Industries Assistance Commission, out of the old Tariff Board, to expose such claims to careful analysis and public scrutiny, and thereby promote more informed policy decision-making in a more neutralised political environment, where the trade-offs in reform could be better appreciated by the community.

Now at this point I must declare my own interest, because my very first job was with Whitlam’s Industries Assistance Commission and, after doing various other things, my current job is with its descendant — the Productivity Commission. The basis of my affinity, I think, is clear!

At one level, the assigned titled of my talk can be interpreted as a simple recognition of reality — a statement of fact. I can't think of any market in Australia which is not subject to intervention of some kind. Indeed some markets could be said to be *creatures* of regulation, depending on it for their very existence. The carbon pollution reduction scheme is currently the most important, and I guess most contentious, example of that. Some other markets have only emerged through the loosening of tight regulatory constraints. The gambling industries, about which I’m going to say a bit in a moment, are a prime example.

In the shadow of the global financial crisis, you can also read into the title the implication that markets can be *too* free — not regulated enough. I think that is a reasonable position for anyone to take, especially in the light of recent experience in financial markets. But it leads to the following big questions for public policy: how free, how much intervention and, very importantly, how should governments go about deciding this in the best interests of the community?

Well, in seeking to address, if not completely answer, those questions I'll first talk about what purpose markets serve, and their contribution to economic progress (and Australia’s in particular); secondly, I will explore the limits of markets — what they *can't* do — and, related to that, why they retain an image problem in the midst of the prosperity that they've engendered; and thirdly, I’ll draw on two case studies from the current work program of the Productivity Commission — executive remuneration and gambling — to illustrate some principles that I believe have wider application.

What do markets offer?

The stories that have emerged from the global financial crisis about complex financial derivative markets — as has been said, 'transferring risk from those who didn't care about it to those who didn't understand it' — together with revelations about numbers of people losing their savings in shonky investment vehicles, the failure of high profile financial intermediaries, and indeed the erratic swings in stock markets and currency markets, are all seen by many people as evidence of fundamental problems with markets. That is understandable. But in reality, markets are the solution to a much bigger problem. They yield benefits to society that have greatly outweighed any costs, including those just experienced.

Problems *in* markets should not be conflated with problems *of* markets. It's easy to lose sight of the simple function of markets. They are a means of connecting willing buyers and sellers to their mutual benefit. That's all they do. Of course, if they do it well, they achieve a lot. But, like the old saying about oils, 'markets ain't markets': some operate a lot better than others. History tells us that those societies with better functioning markets have been the most successful economically, and often the most successful socially as well.

Indeed the economic progress of mankind is broadly coextensive with the evolution of markets: from localised barter, to monetised transactions encompassing large numbers of people over large distances. How rapidly and effectively markets have developed, has depended in turn on the development of institutions and rules to facilitate them and to reduce the costs of transactions in particular. The key ones are how well property rights are defined; how effectively suppliers compete; how well informed are buyers, and the nature and reach of mechanisms for legal redress when things go wrong.

Through the medium of prices, competitive markets ensure that a country's resources get put to use where they can do the most good — taking account of what value people place on different goods and services, and how much those goods and services cost to produce. Competitive markets also ensure that the 'better mousetrap' gets appropriately rewarded, in turn providing incentives for innovation and lower cost production which underpin the growth process.

The logic of markets is that all this happens in a decentralised way, with the actions of many unrelated individuals coordinated spontaneously through the prices they face — Adam Smith's (unjustly derided) 'invisible hand'. Importantly, emerging shortages and surpluses, which are inherent to any economic system, can be signalled automatically in a competitive market through price movements, precipitating spontaneous actions by both buyers and sellers that eventually serve to eliminate them. If a queue persists, whether it be for taxis or hospital beds, you can be sure that a well-functioning market does not.

As noted, not all societies have been persuaded by the logic of markets. However experiments around the world with alternative systems have only served to demonstrate their value. And indeed we've seen a progressive shift towards, or back to, markets across the globe in recent decades; a move which has generally paid off for the countries concerned. Since 1980, world GDP has risen by two and a half times, or an unprecedented forty per cent per capita, with millions of people rising out of extreme poverty.

For example, China's performance since the end of the Cultural Revolution, when it tentatively began to open the door to markets, speaks for itself. Since the beginning of the reforms in China in 1978, we've seen real GDP in that country grow by more than ten per cent a year. That in turn has seen dramatic reductions in poverty, rises in life expectancy, and gains in other indicators of wellbeing and capability, like literacy and health. The OECD has described China's advance to a market economy as among the greatest economic success stories of modern times.

The power of markets to produce prosperity has also been reaffirmed within market economies themselves — wherever impediments to the functioning of particular markets have been reduced, or markets have been introduced to industries or activities where none had previously existed.

Australia itself illustrates how important it is to a country's economic performance to make use of markets in a way that achieves the right balance between freedom and intervention. For much of the previous century, that balance shifted decidedly in favour of intervention. Successive governments imposed policies that impeded competition, distorted prices, constrained business and raised its costs.

For many years, the costs of the inefficiencies that multiplied under that regime were masked by the performance of our broadacre agriculture and mining sectors. But by 1983, when the Hawke government came to power, Australia was falling off the sheep's back. Productivity and income growth were low, deficits had become relatively high, and our per capita GDP had slipped from fifth to fifteenth in the OECD. The 'banana republic' loomed, in Keating's evocative phrase.

The fact that we were able to reverse our economic decline, unlike those Latin American countries that shared top billing with us on the global GDP ladder at the beginning of last century, was largely due to the structural reforms set in train by the Hawke/Keating Government. Key strands of those reforms were directed at freeing up markets, exposing industry to international competition, and allowing prices to perform their proper allocative role, while undertaking reforms to make government infrastructure services more efficient and labour markets more flexible.

The consequent transformation of Australia's economy, from one that was inward looking, high cost and inflexible, to an innovative, adaptable and competitive one, brought a resurgence in productivity and income growth. Australia climbed back to eighth in the OECD's per capita GDP rankings by the end of the century.

These reforms also created a new resilience in Australia's economy, that saw us withstand international disturbances that would have laid us low in earlier decades. These included the Asian financial crisis, despite our greater dependence on Asian export markets. And, no doubt, those earlier reforms have also contributed to our relative success thus far in containing the real impacts of the global financial crisis. One illustration has been the ability, under more accommodating labour market regulation, for businesses to reduce labour inputs and the associated costs without sacking workers.

What markets *can't* do

'If markets are so good, then why do they seem to perform so poorly?', I can hear some people thinking. Why do they have this image problem? Why indeed is the logic of markets resisted?

There are two features of competitive market processes that I think provide much of the explanation or reconciliation.

One is what has become known since Schumpeter as 'creative destruction': survival of the economically fittest. Markets go by results. They pay no respect to good intentions and they punish poor economic performance. If a business can't deliver a product that people want sufficiently, it will fail. That is the *destruction* bit. But the business's human and capital resources won't disappear, or even remain idle for long, at least in most circumstances. They will eventually be absorbed by other, expanding businesses that are meeting the market test — and that's the *creative* bit.

Creative destruction is inherent to the growth process. With limited resources, economies are dependent on successful businesses and industries being able to attract people and capital from less successful ones. Stop that, and you stop the engine of growth, and the 'banana republic' beckons once more.

But that also means that at any time some firms will contract or even close down; some people will become unemployed, at least for a while; and some towns and regions will stagnate or decline, while others prosper. That seems harsh to most people, especially to those most directly impacted. So we see considerable resistance to the logic of markets, and indeed lobbying by industries for taxpayer support.

This can be successful if the industry is influential enough, or regional politics favour it — though Governments generally know that it's better to provide people with transitional income support in a dynamic economy, than to try to help them by making the economy itself less dynamic. Australian governments have been liberal in providing such income support to households and this has underpinned a relatively stable distribution of income in Australia during what has been an extended period of wide-ranging structural reform.

The second reason why markets have acquired an image problem reflects the reality that what the market values need not accord with what *society* values, or indeed even with the interests of the economy as a whole in the long run. Private and social valuations need not be the same. This can manifest itself in several ways, but four principal ones occur to me:

- Firstly, certain kinds of goods and services may not be produced by the market, because although they are socially valuable, firms cannot make a profit out of them, as it would cost too much to stop people 'free-riding'. These are known in the jargon as 'public goods'.
- Secondly, certain people within society may not get adequate access to some services that *are* produced, like healthcare or education — once commonly referred to as 'merit goods'.
- Thirdly, some activities or services may be privately produced, but underdone. This includes production activities like R&D, which give rise to unrewardable spillovers, but also things like safety within the workplace or probity within businesses. Another 'product' that will similarly tend to be under-provided is welfare services.
- And fourthly, some production activities may be *over*done, and I guess pollution is the traditional, yet still topical, example.

These gaps or deficiencies in market provision all involve things that civilized societies care about. They have to do with fairness and quality of life. It could be said that they have to do with the *productivity of societies,* not just the *productivity of economies.* But we shouldn't condemn markets for failing to produce them. Markets make an important contribution, but they cannot satisfy every societal goal or need. They cannot do it all. That's why we have governments and why, realistically, electorates require them to perform a larger role than the minimalist functions advocated by libertarian philosophers.

So in addition to establishing institutions to underpin markets, governments intervene to influence behaviour by the participants, and to provide so-called 'non-market services'. While many of those interventions have been desirable, some have come at a high cost, and some have been motivated by private interests rather than the public interest. Unwinding such arrangements has been the object of the microeconomic reform process since the early 1980s.

Among the more marked trends in government intervention have been the removing of impediments to competition, as well as a shift from public to private provision where it is seen as more efficient or cost effective. And, in financial markets, we've seen a greater emphasis on principle-based regulation focused on outcomes, rather than prescriptive regulation focused on inputs. There has also been more reliance on disclosure and the strengthening of overarching institutional oversight.

While these changes have yielded significant benefits for Australia — and our financial markets and institutions have proven relatively robust — the global financial crisis's origins in regulatory failures overseas, together with Australia's membership of the G20 and that grouping's increased role, has meant that we are inevitably facing pressure to introduce more regulation in Australia. That's not necessarily a bad thing. We need to be reviewing all regulation periodically in the light of experience, particularly in areas as important as financial markets. But managing this process so as to ensure that any new regulations we do introduce are appropriate to Australia's circumstances, and a good fit with the existing regulatory framework, will be quite challenging.

There is much at stake in getting this right. Financial flows are the lifeblood of the economy. Prior to the liberalisation of the 1980s, financial markets in Australia could be said to have been very safe, but credit was costly, hard to get and poorly allocated. The relaxation of credit controls and barriers to competition drove major innovations and cost reductions that boosted economic growth and benefited many people, including low income people.

Any response in Australia to the recent excesses and poor risk management in the United States and other countries should not overlook these important benefits. They imply the need in intervening in this market to get a balance between reducing the risks and costs of financial instability, and its contagion effects on the real economy, and the risks and costs of reducing competition, innovation and productivity in this key industry sector, and the adverse economy-wide impacts that these too would have.

While some regulatory changes look more prospective than others, the Commission hasn't done the work that would inform insights from me today on these complex matters. That said, the challenges in getting the balance right in regulated markets, including financial markets, are illustrated by two areas that the Commission is looking at right now.

One, which has its origins partly in the fallout from the global financial crisis, is executive remuneration; the other is gambling. In both, our assigned task from Government was to come up with a regulatory framework that bridges a perceived clash between private and social values and interests, in order to get better outcomes for the community as a whole. I think both exercises provide some wider lessons.

Executive remuneration: what policy response?

As many of you will know, the Commission's inquiry was triggered by a perceived community backlash against instances of multi-million dollar payouts to CEOs at a time when shares were plummeting, companies were performing poorly, and many Australians were expected to be doing it tough. Many were characterized as payments for failure, and very healthy payments at that. CEOs were seen as feathering their own nests, and taking actions to achieve that which were short termist or heightening risk, with actions in US financial enterprises contributing to the financial crisis that eventuated globally.

This was a conflagration from what had been a smouldering issue in Australia for several years. Since the early 1990s, we have seen executive remuneration for the top one hundred companies in Australia treble, rising from seventeen times to fifty times average weekly earnings. And earnings of ten million dollars on average, or a hundred and fifty times average weekly earnings, for CEOs of the top ten companies. This is seen by many as both inequitable and inefficient. The market for executives was widely seen as being out of control.

When the inquiry was announced, the Government indicated that it was going to act immediately in one key area that was very contentious, namely termination payments, as you would be aware. And they announced a parallel review by APRA focused specifically on the finance sector.

By now you've seen where the Commission came out in its draft report. In short, we found that there were deficiencies in remuneration-setting warranting additional regulation. But, like APRA, we considered it crucial that any regulatory actions serve to strengthen decision-making within markets, rather than overriding the market with controls which would inevitably involve high costs and risks.

The facts are that there are over two thousand public companies in Australia. The multi-million dollar pay packets that get all the attention are largely confined to the top one or two per cent. Big pay is mainly a big company story.

As I indicated, CEOs of the largest companies have pay packets averaging several million dollars plus, but those at the bottom five hundred have remuneration of around $180,000, or three times average weekly earnings. And even our top CEOs were found not to be highly paid, believe it or not, by international standards. Their remuneration is well below that in the USA — admittedly an outlier internationally — and was found to be closer to the remuneration of CEOs in the smaller European countries, and well below that in the UK.

Executive remuneration patterns also vary considerably by sector. We've seen no widening in the divergence with average earnings in the mining sector, for example, whereas the gap has increased greatly in the finance sector. And while there was very rapid growth in executive remuneration in the roaring 90s, pay growth slowed in the 2000s. Moreover, total remuneration fell by thirteen per cent in 2007-08, and by a bit more in 2008-09, subsequent to the global financial crisis.

In its research, the Commission found that for every ten per cent increase in the size of a company, by market capital value, CEO pay typically rose by four per cent. That is consistent with findings in other countries. Bigger companies pay more to compensate for greater job complexity, and because of the greater financial ramifications of decisions made in that job. Large companies compete for the best people, because even a little difference in the quality of decisions, or strategic judgements, could mean millions of dollars worth of additional company profit and returns to shareholders.

It’s understandable, nevertheless, that there's a sense of disbelief or even grievance in the community at the headline numbers relating to executive pay, particularly for the top one or two per cent. I think we’d all agree, or most of us no doubt would, that many CEOs and highly paid executives are earning considerably more than they need. But the key question for policy is whether what they are earning is excessive from an economic efficiency perspective.

Efficiency in a market requires that all the potentially most valuable transactions take place. So, on the one hand, paying a premium above the reservation wage — if you can call a multi-million dollar package a ‘wage’ — to secure the right managers can, indeed, be efficient. The extra pay merely represents a deduction from the extra surpluses that they generate. (Whether they always achieve that in practice is of course another matter.)

On the other hand, efficiency would be reduced if executives can exert influence on their own remuneration to raise it beyond their actual scarcity value. Or if boards get the incentive structures for executives wrong which, particularly in the financial sector, can lead to problems which can contaminate the performance of the wider economy (as we've seen). But even for companies outside the financial sector, it can contaminate community trust in equity investments, and in the public company model itself.

A window on how well all this is working is offered by developments in performance or incentive pay, which include bonuses and equity-based arrangements over various times frames. These were originally imported to Australia with the crop of high profile CEOs from the USA in the 1990s. And they have accounted for much of the growth in remuneration since then.

Such forms of remuneration have been favoured by shareholders and boards as a means of aligning motivations of executives with the interests of shareholders through executives having 'skin in the game' through remuneration linked to equity. But that shift has also increased uncertainty for executives, creating the need for what's called a 'risk premium', and thus higher headline remuneration. And they can also create some risks for companies themselves if those incentive packages are not well designed. (Incentives undoubtedly drive behaviour, but you have to make sure that they are the right incentives.)

So how well has all this worked? The Commission found that the evidence was mixed. On the positive side, the composition of remuneration in terms of performance pay versus base pay seems broadly OK, and to accord with what shareholders say they want. We've also not seen some of the more problematic forms of pay in Australia being employed anywhere near the extent in the USA — like reliance on options or non recourse loans. And, at an aggregate level, we've seen a fairly close correlation between total remuneration increases and overall market returns (the ASX 'accumulation index').

But there are some negatives. One is that the performance hurdles on performance pay could be fairly described as having been relatively permissive in the 1990s, particularly for some firms. Since then, arrangements have become incredibly complex. We've often heard people say that they don't understand them. (Some of those people have been members of boards!) This combination of circumstances is likely to have led to bigger payoffs for executives than warranted, more for 'luck' than for good performance. And we've also seen some termination payments which seem hard to justify, suggesting weaknesses in the boards that endorsed them.

So we found a potential case for intervention, but what kind of intervention by government in this particular market would actually help? The answer, or at least our preliminary answer, is not for government to impose direct controls on executive remuneration. These will have major risks and costs, that could soon backfire on shareholders and the wider community.

Rather, the only viable solution lies in interventions that could secure better board performance. The board is integral to the public company structure, which has been a major source of wealth creation, and it has a central role in a whole range of strategic decisions, including executive remuneration. Boards need to ensure that executive remuneration is appropriate, and they need to be made more accountable for doing that job well.

Therefore, the Commission's recommendations for government intervention are about improving the system by improving the market, not bypassing it or undermining it. We found plenty of scope for such improvement in three broad areas. Firstly, enhancing board capability and addressing the perception of the 'club'. Secondly, removing scope for conflicts of interest that can arise in how decisions are made and who participates in decision-making. And thirdly, increasing accountability to shareholders through better quality disclosure — there is plenty of disclosure now but nobody can understand it — and by increasing shareholders' say on pay. In the last category, our 'two strikes' proposal is plainly the one that excited most controversy.

But we've also argued that any new interventions should be calibrated in ways that recognise the diversity of companies and the fact that one size of regulation will not fit all and shouldn't be imposed on all. We're also conscious that the scope for unintended consequences in such a complex, 'interested' area is pretty high.

Reforming gambling regulation

The second inquiry where we have been called upon to help governments find the right balance between intervention and market freedom is gambling.

As some of you will know, the current inquiry is a reprise of one that we did ten years ago. It was again triggered by community concern that the 'private' is out of kilter with the 'social'. In this case, again as some of you will have seen, the Productivity Commission in its draft report recommended stronger government intervention to constrain decision making within the market.

We concluded that, unlike executive remuneration, there are significant systemic failures that are giving rise to major social costs and need to be addressed.

Gambling is enjoyable for many — the majority of people in this room would have had a flutter at some point, even if only on the Melbourne Cup — but it is a source of significant harm to some gamblers and their families. We've seen a major increase in social costs of this kind with the liberalisation of poker machines over the years.

Poker machines have a number of features which are particularly problematic. They involve intensive play; they involve, in many cases, faulty ‘cognitions’, with people not properly understanding how they operate or what's involved; the prices for playing the game are obscure; they have conditioning effects, partly through the random payouts that they involve; they are highly accessible as a gambling form, probably more so in Australia than anywhere else in the world; and they've proven particularly attractive to vulnerable people.

The industry repeatedly asserts, ‘this is only one or two per cent of the population’. That is correct, but it is also the case that those one or two per cent translate to fifteen to thirty per cent of people who play the pokies regularly, and around forty per cent of industry revenue. That last statistic means that, in this particular market, it's not possible to rely on self regulation. Unfortunately, Government itself, which on average receives ten per cent of own-source revenue at the state level from gambling, is also deeply conflicted.

Hence, while we’ve seen some progress in ‘harm minimisation’ interventions in the decade since the Commission’s last report, many of those actions have been ineffectual. (Characterized as ‘clocks and warnings’.) The rewards from doing this better, from having more effective intervention, are potentially very great, adding up to billions of dollars in potential welfare nationally.

Designing better policy, however, is not straightforward. The goal is to target the source of social costs without detracting from the recreational value to other gamblers, which is considerable.

In pursuit of this, the Commission adopted an eclectic policy framework, which drew on public health, consumer protection, and medical strands. We focused, in particular, on two aspects: the ‘environment’ within venues where gambling takes place; and, secondly, informed consent.

In three key areas we saw a need for increased regulation. I’ll just speak briefly about these, as it is all laid out in our report. One is so-called pre-commitment options; secondly, reducing the intensity of play and the capacity for people to lose a lot of money in a short period of time; and, thirdly, reducing the accessibility of the more harmful gambling forms.

The first of these, pre-commitment, is akin to our approach to executive remuneration in the sense of trying to make the market work better. The focus here is on informed choice, on giving greater power to consumers. Essentially, what pre-commitment involves is making use of technologies — and there are rapid advances going on right now — to allow gamblers to set limits on their own future behaviour in relation to how much they lose and how much time they spend. We’ve accepted that this should be voluntary, but importantly, in drawing on the behavioural economics literature, that the system should be an ‘opt out’ system rather than an ‘opt in’ system. (As some of you will know, which approach is followed can make a big difference to the take-up rate.)

Victoria has indicated it will introduce a pre-commitment regime by 2016. The Commission recommended in its draft report that this be extended to all jurisdictions. But we've also put some pegs in the ground, in terms of what kind of regime would be effective in dealing with these problems. In particular, it needs to be a regime that has universal coverage — one that covers not only all the machines in a venue, but all of the venues within striking distance of any particular gambler.

There is a lot of work that would need to be done to achieve that, which will take time. Coordination in standards will be particularly important. In the meantime, there is a strong case for moving to constrain the scope for losses by problem gamblers without impairing the enjoyment of recreational gamblers. Currently it's possible — I don’t know if anyone has tried it — but it is currently possible to bet up to twelve thousand dollars per hour on a poker machine. And you can lose up to twelve hundred dollars per hour. That's a great deal for a recreational activity! The Commission has therefore recommended that there be a substantial reduction in how much one can bet with each button push — down from ten dollars a push to one dollar a push — and how much money can be fed into a machine at any one time. Believe it or not, you can currently feed ten thousand dollars into a machine and have it sitting there at any one time. We’ve suggested what looks like a revolutionary change, to just under forty dollars at any one time.

The important point is that such changes will make little difference to most recreational gamblers, but will undoubtedly have a significant impact on problem gamblers. Indeed, if effective, the measures may even irritate them, but that's the whole purpose. When in a more lucid state of mind, problem gamblers themselves recognise that they *want* to be irritated at such moments.

While this will help the one to two per cent of the population in that category, without reducing the enjoyment of many of the other ninety eight per cent, it is likely to have a bigger impact on the financial bottom line of clubs, hotels and casinos. And it will affect the tax revenue of governments (another reason why the

Henry Review is so important). But overall, the Commission's judgment is that the nation's welfare would be enhanced by a shift in the balance of regulation back from market freedom to government intervention.

Wider implications for regulatory 'balance'

Some lessons can be drawn from those two inquiries in terms of the bigger picture in balancing freedom and intervention in markets.

First, it should be apparent that, though following the same processes and research methods, the Commission came up with quite different answers on the degree of intervention warranted in each case. So the first lesson about intervention and markets is that it's 'horses for courses'. Unless you are operating in a perfect market with social and private valuations and effects coinciding, and complete information for all, there may be a case for intervention to influence behaviour. But how much and what kind will depend crucially on the particular market.

Secondly, interventions that can target the source of a problem without unwanted side effects or other collateral damage will generally be superior, and give greater confidence of achieving a net benefit to the community over the longer term. In the case of gambling, we calibrated the measures to have impacts mainly on problem gamblers. In the case of executive remuneration, a number of the recommendations that we made essentially involve codifying what already is accepted as best practice, and undertaken by the best firms.

Thirdly, sometimes markets give rise to social costs, but no intervention can be found that would reduce them without giving rise to greater costs. In other words, in some situations, we will see a problem, but there will be no way for Government to solve it without causing greater problems. In those situations, although it can be politically hard to resist, 'no action' is the most appropriate course.

Fourthly, knowing whether and how to intervene so as to do good, or at least not to do harm, is rarely straightforward, and getting this right demands good analysis and good evidence which must include consultation with those likely to be affected. So it also requires good process. The Commission has never had an inquiry where its final recommendations to government haven't benefited from the exposure of a draft report to feedback from the community. The law of unintended consequences holds most firmly when consultation is weakest.

Moreover, the risks of unintended consequences are generally highest when making ad hoc or piecemeal changes to an *interactive* system — which is the essence of a market. One example that came to light in our executive remuneration inquiry illustrates how risky that can be. Public concern in the United States about rising levels of executive remuneration led to a cap of one million dollars being placed on the tax deductibility of base salaries. This had two unforeseen consequences. One was a levelling up of base salaries generally to that ceiling. But the second, more problematic one, was rapid growth in less transparent forms of remuneration, involving incentive structures that have since been implicated in the global financial crisis itself.

In summing up, markets perform a very valuable role. They are integral to the process of economic development and the reduction of poverty worldwide. But they are rarely entirely free, and indeed depend for their existence and proper functioning on a framework of regulation. Markets also cannot satisfy all policy goals and need to be complemented by government intervention that either 'fills the gaps', or influences the behaviour of market participants to align private and public interests. Getting this right is hard. Evidence, analysis and 'learning by doing' are all essential to finding the best balance, in the best interests of the community.