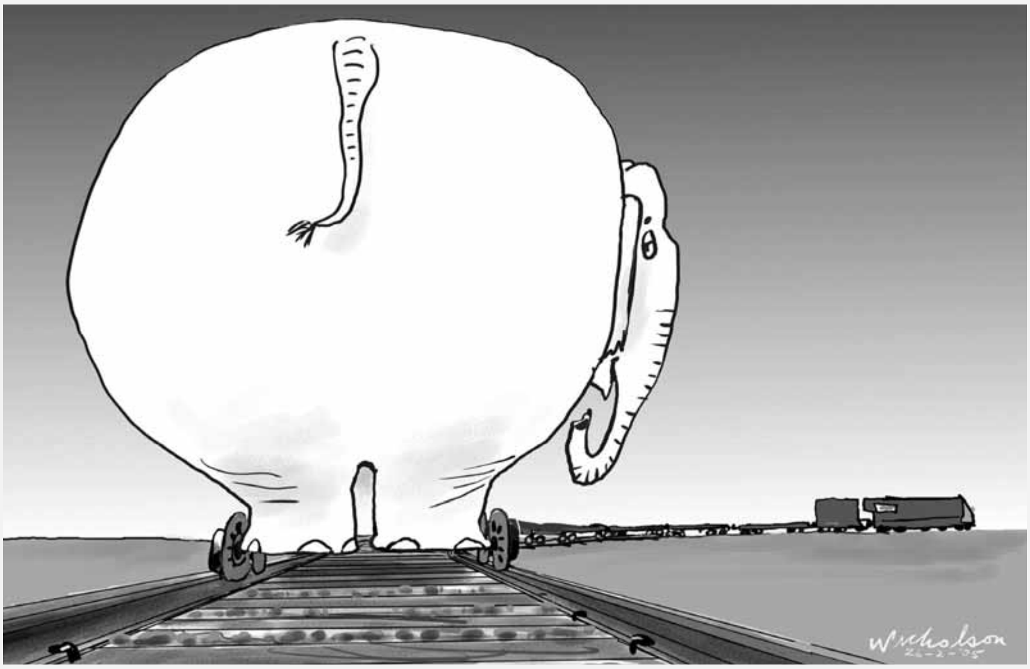
PART 2

REGULATION AND COMPETITION AS DRIVERS OF PERFORMANCE

Regulation is essential to a well-functioning economy and society. However, designing and administering regulation to achieve its ends in a cost-effective way is challenging. The Commission has found that much existing regulation has given rise to undue costs by impeding competition and innovation, or imposing compliance burdens. The speeches in this section cover these issues, noting that a lasting remedy requires reforms not only to existing regulation, but also to the institutions and processes responsible for new regulation.



Cartoon by Nicholson from *The Australian*. www.nicholsoncartoons.com.au

The good, the bad and the ugly: economic perspectives on regulation in Australia*

Regulation has expanded greatly in developed economies in the post-World War II era — encompassing a much wider sphere of influence over the economy and society generally. In almost any aspect of our economy or society, a piece of paper somewhere will establish some degree of regulatory control.

This regulatory cornucopia is a mixed blessing. On the positive side, regulation serves a vital role in improving social, environmental and economic standards for Australians. By shaping incentives and influencing how people behave and interact, regulation can help societies deal with otherwise intractable problems. At their best, regulations create order, preserve norms and provide a basis for stable progress.

Unfortunately, regulations are rarely, if ever, at their best. Indeed, the community is increasingly sceptical about the benefits of some regulations and about the way in which they are designed and delivered. The American humorist, P.J. O'Rourke, captured the current attitude towards regulation when he quipped that the 'mystery of government is not how it works, but how to make it stop'. Early enthusiasts for regulation — often economists — were sanguine about their ability to design regulatory solutions to perceived economic and social problems. But even well-intentioned regulation can bring problems of its own. The costs associated with these have to be balanced against the potential benefits. Moreover, in some cases regulation is not even intended to further the public interest, being tailored to the needs of particular constituencies.

Administering and complying with regulation is costly

Regulation is not free. Like any other activity, it uses scarce resources that have other uses. Indeed, there are many institutions and large numbers of government personnel whose main function is regulatory.

* Address to the Conference of Economists' Business Symposium, Canberra, 2 October 2003. (Co-authored with Ralph Lattimore.)

At the federal level, government agencies with explicit regulatory functions alone employed around 30 000 staff and spent some $4.5 billion in 2001-02. This ignores other government departments that have regulatory functions, not to mention ministerial councils and inter-governmental bodies (such as the National Transport Commission).

Only partial indicators of the volume of regulation associated with these bodies are available, but they suggest that not only has the number of new regulations been increasing, but there has also been a steady increase in the average *length* of legislation.

The Income Tax Assessment Act (ITAA) — often taken as a regulatory 'barometer' — has grown particularly rapidly since its inception. At nearly 7000 pages, the ITAA (the 1936 and 1997 statutes together) is now nearly 60 times longer than the paltry 120 pages that did the job when it was first introduced in 1936 — notwithstanding admirable recent attempts at simplification. To take a fanciful turn, were this rate of growth to continue unabated, I am informed that by the end of this century the paper version of the Tax Act would amount to 830 billion pages; it would take over 3 million years of continuous reading to assimilate and weigh the equivalent of around 20 aircraft carriers!

The stock of other less 'visible' types of regulation has also increased over the last couple of decades. Unfortunately there is not (yet) a consolidated and comprehensive register of all subordinate instruments, but more than 7200 statutory rules and disallowable instruments were made in the past five years.

Thus far, I have only been talking about trends in Commonwealth legislation. Regulation by state, territory and local government often impacts more directly on the activities of firms and the community. Its growth may well be higher than at the Commonwealth level.

Compliance is burdensome

The burgeoning of regulation and its increasing complexity are major irritants for the regulated. According to an OECD survey conducted in the late-1990s, around 80 per cent of Australian firms consider tax compliance burdens have increased, with the main reason being the added complexity of provisions (OECD 2001).

This is compounded by the inaccessible language that characterises much regulation. In a recent conference on regulation, Senator Coonan (2001) cited a delightful example — the *Nuts Unground Other Than Ground Nuts Order*:

> In the Nuts (unground), (other than ground nuts) Order, the expression 'nuts' shall have reference to such nuts, other than ground nuts, as would but for this amending Order not qualify as nuts (unground) (other than ground nuts) by reason of their being nuts (unground).

Getting a good grasp of the overall magnitude of compliance burdens on business (let alone consumers) is difficult — being plagued by methodological problems and the absence of quality data. Nevertheless, the picture emerging from a range of studies suggests that the costs are large. For example, an assessment by Productivity Commission staff identified administrative regulatory compliance burdens of around $11 billion on business in 1994-95. Around 85 per cent of this was borne by small and medium-seized enterprises (Lattimore et al. 1998).

A major recent international study suggests an even higher compliance burden associated with three major regulatory areas (taxation, employment, environment) of around $17 billion in 1998 (OECD 2001).

While assessments of this kind sometimes exaggerate identified compliance burdens because of respondent bias, they are likely to *underestimate* the total compliance costs of regulations. For example, regulations not only create paperwork, they can also distort decisions about inputs, stifle entrepreneurship and innovation, divert managers from their core business, prolong decision making and reduce flexibility. One American analyst has suggested that paperwork-related compliance burdens amounted to only around one-third of the aggregate regulatory burden in the United States (Hopkins 1996). Were a similar multiplier to prevail in Australia, aggregate business compliance costs could amount to as much as 7 per cent of GDP.

Of course, these are *gross* costs, neglecting the associated benefits which motivated the regulations in the first place. But the point is that the costs of pursuing such benefits are not trifling and the dividends from better or fewer regulations could be large.

Collateral damage and 'friendly fire'

Regulations often have unintended impacts. Sometimes these can actually undermine the goals of the regulator. There are many reasons for this, among which three stand out.

Substitution effects

Regulations explicitly or implicitly alter prices, resulting in demand or supply effects that may frustrate the objectives of those regulations.

- On the *demand* side, regulations can fail if they do not take account of how people respond to regulatory-induced price rises. For instance, safety and risk abatement measures tend to drive up the costs and therefore prices of regulated products and services, which can divert demand to less safe alternatives.
- On the *supply* side, a cautionary tale is provided by the case of small-firm access to finance from banks. Prior to financial deregulation, an interest rate cap was imposed as a measure to assist small business. However, the cap made lending to small business less attractive to banks, given the relative risks involved. The result was reduced credit availability for those groups, undermining the goal of the measure.

In general, price restrictions of this overt kind are waning. A major exception is the regulation of infrastructure with network or natural monopoly characteristics. Telecommunications, energy, water and other infrastructure services are subject to price regulation. A number of these regimes have been reviewed by the Productivity Commission in recent years. While the Commission has found that regulation appears warranted, it has signalled a need for greater recognition of the tradeoff between cheap services today and inadequate services tomorrow.

An offshore case study that exemplifies the perils of regulatory frameworks paying insufficient attention to both the supply and the demand sides is the notorious Californian electricity crisis. It is now clear that this was the outcome of poorly coordinated and applied regulation, not deregulation, as some have maintained. Electricity wholesalers were playing 'pig in the middle' — squeezed by price caps at the retail end and high prices charged by generators whose capacity had been constrained by past regulatory initiatives. The financial insecurity of wholesalers eventually led to rolling blackouts and economic dislocation for the state. California has demonstrated that even sophisticated regulators could make errors that cumulatively led to unprecedented regulatory failure. Recent massive (if temporary) disruptions to electricity supply in North America and Europe also give one pause. Can we be sure that it could not happen here?

Overly prescriptive regulation

Regulations are sometimes unduly prescriptive, setting down subsidiary rather than fundamental objectives as requirements, with the result that while the subsidiary requirement is met, the underlying purpose of the regulation may not. Take the case of that little Aussie icon, the platypus.

As is well known, the sale of any of Australia's native animals is prohibited, except on a government-to-government basis, presumably with the laudable objective of protecting our unique native species. Earth Sanctuaries Pty Ltd, a private conservation agency based in South Australia, has somehow managed to generate a surplus of platypuses — indeed, 40 above a sustainable population for the sanctuary. However, it cannot sell any of these platypuses due to the prohibition (offers well in excess of $1 million per animal have been made). In the absence of sales, surplus animals will need to be culled. It is, therefore, literally possible to kill with good regulatory intentions.

Standards for consumer goods often provide detailed specifications about processes or ingredients rather than setting general performance levels, with the potential result that quality products are less accessible to consumers because of added production, delivery and retailing costs. To take an offshore example again, food standards in the European Union are quite particular about the curvature of cucumbers. Any cucumber with an arc greater than 10 mm per 10 cm of its length, though in all other respects of excellent quality, cannot be described as either an ‘Extra’ class or Class 1 cucumber (Commission Regulation 1677/88). Anyone caught so describing such a cucumber is subject to criminal prosecution.

Australia also has many questionable, if less imaginative, standards. For example, government regulation mandates a high definition standard for digital television (unlike other countries, which have settled for — still high quality — ‘standard definition’ digital television). High definition should really be called ‘ultra-high’ definition, providing cinema quality pictures. However, it turns out that this cinema quality can really only be distinguished on large sets that are extremely expensive, and it requires high cost investments by content providers. The technology is so hungry for bandwidth that few of the innovative possibilities for digital television or greater competition between broadcasters will be feasible. As noted previously, for some regulations it is easier to see the private than the public interest.

Dangerous ‘cocktails’

Another source of (potentially) unintended impacts can come from the regulatory equivalent to adverse drug interactions. Regulations generally come not in ones or even twos, but as ‘cocktails’ with interactions that are often unforseen.

For example, during the Productivity Commission’s study of the Great Barrier Reef and related water catchment issues, some graziers expressed concern that drought relief assistance was reducing the incentive for some property managers to stock their properties conservatively so as to manage periods of climatic variability. Overstocking was in turn contributing to increased soil erosion and sediment discharges into rivers draining into the Great Barrier Reef lagoon (PC 2003d).

Sometimes the interplay of different regulatory requirements just produces confusion — risking non-compliance or simply contempt for regulatory processes. For example, at one point there were three different requirements in New South Wales for the distance from a watercourse at which earthworks could be carried out.

The problem of regulatory overreach, or undue ambition

Regulation is often seen as the obvious response to imperfections in the market. However, imperfections in the market are ubiquitous. They are a necessary, but far from sufficient, basis for regulation. In many cases, the costs and risks of regulation will outweigh the good intended from them — the best response to many imperfections will be to accept them as the lesser evil.

While the risks of overreach are apparent in many areas of regulation, one in which it has been particularly apparent from the Productivity Commission's recent inquiries is competition policy.

The seductiveness of controlling 'market power'

There is a natural (and popular) tendency to urge greater regulatory control over perceived market power. Some manifestations of market power — of the endemic or obdurate kind that raises prices inefficiently and for long periods — are worth stamping on. But other forms of market power are less clearly appropriate targets.

Even the existence of natural monopoly need not mean that hardline price regulation is required to produce acceptable outcomes. For example, in the case of airports, there are factors at work that reduce the risk that their latent market power will be used to inefficiently constrain airline use of airports. In particular, airports have the ability to price air services flexibly so as to increase airport capacity utilisation. And the potential magnitude of non-aeronautical revenue (retailing, car parking) also means that they have incentives to moderate their pricing of aeronautical services so as not to reduce passenger throughput and undermine their total profitability.

The Commission accordingly recommended more light-handed regulation, involving a prices monitoring regime that carried with it the threat of more prescriptive pricing regulation if prices became excessive (PC 2002d). This recommendation was accepted by Government. In the short time since the regime has been operating it appears to have worked satisfactorily. Day-to-day regulatory involvement in investment decision making has been removed — offering scope for long-run improvement in services. Genuine commercial negotiations between airports and airlines are beginning. And initial price increases have reflected the efficient costs of supplying airport services.

This innovative approach is now in jeopardy. The National Competition Council has issued a draft recommendation for the declaration of airside services at Sydney Airport under the National Access Regime (NCC 2003). In the Commission's view, key parts of the assessment are unconvincing and require further consideration (PC 2003e). It seems unlikely that the regulation of access would bring any additional benefits, whereas the potential costs of reinstating what will inevitably amount to heavy-handed regulation have already been demonstrated.

How much help does David need against Goliath?

Small business has an ambivalent relationship with regulation. On the one hand, as already discussed, small business bears the brunt of compliance burdens and is often (appropriately) sceptical of the need for government regulation. On the other hand, they often call for regulation that assists them and, in particular, protects them from larger businesses. While there are grounds for regulations in this area, such as the unconscionable conduct sections of the Trade Practices Act (TPA), some mooted changes to the TPA risk undermining broader economic policy objectives.

For example, in its submission to the Baird review (1999), the National Association of Retail Grocers of Australia argued that the domination of the retail grocery market by several chains undermined effective competition. It called for a cap of 25 per cent on the market share of any one retailer, with mandatory divestiture to achieve that aim. Such regulation would be unlikely to achieve its objective, but it would almost certainly have the effect of curtailing efficiencies of scale and scope in grocery retailing, to the detriment of consumers.

A problem with using trade practices legislation to shift the balance of power in arrangements between big and small parties is that it may encourage firms to seek regulators (and then courts) to arbitrate in the distribution of gains in bargaining arrangements where efficiency considerations are not at stake.

Regulatory culture and capture

There is clearly a need for regulators to have some discretion, to enable them to respond flexibly depending on contexts. But the greater the discretion that statutes allow, the more that regulatory decisions will require judgment, which will inevitably be influenced by the governance arrangements and incentives facing the regulator. This raises the prospect of regulatory bias and 'capture'.

Originally, capture was seen in relatively simplistic terms as a regulator getting 'too close' to the regulated. Economically self-interested regulatory capture of this blatant kind seems pretty rare today in Australia — especially given much better controls over the accountability, transparency and governance structures of regulatory authorities. But there are other forms of influence, which can distort decision making.

- *Government*. For example, a major concern of many participants in the Productivity Commission's inquiry into gambling, was that some of the agencies responsible for regulating gambling were not sufficiently independent of government and its budgetary imperatives — showing more concern for financial probity than consumer protection (PC 1999a).
- *Populism*. Everyone likes their work to be valued and regulators are no exception. However as is the case in competition regulation what is 'popular' may not always be what is right.
- *Technophiles*. Where regulators are required to endorse or develop standards, they can be captured by those who value technology or elegant technological solutions for their own sakes. The high-definition television debacle may partly reflect such technological exuberance.
- *Risk aversion*. Regulators face risks with asymmetric returns. It is rare that a regulator will be found deficient for overregulation, partly because the costs are not generally or immediately apparent, but will often face censure if a low adverse risk is realised (for example, death of a child on play equipment).
- *Precedent.* Regulators may be constrained by past decisions in which they have vested their reputation, and which firms have relied upon for key business decisions. This may be one impediment to more investment-friendly administration of competition rules in the infrastructure area (PC 2001b).

Even without such constraints and influences, regulators face a daunting task. It is expected that they should be SNARs — sensitive new age regulators — generally avoiding mistakes, being fair, informed, transparent, consultative, balancing interests, speedy, responsive and sensitive. When technology and market demands are changing rapidly — which is increasingly the case — the informational and decision making difficulties for regulators multiply. The reality is that it is impossible to meet all of these imperatives simultaneously. Any expectation of zero regulatory error is naive and indeed dangerous.

Administrative fallibility needs to be taken into account when assessing the costs and benefits of regulations, especially where symmetric errors have asymmetric welfare effects; and when a regulatory mistake does occur it does not necessarily signal a need for further regulations or increased powers.

So what is 'good' regulation?

Defining what is good regulation is a starting point for doing better. To qualify, regulation needs to exhibit several characteristics (ORR 1998).

- *It must actually do good*. It must have a sound rationale and be shown to bring a net benefit to society, requiring costs as well as benefits to be brought into account.
- *It must be better* than any alternative regulation or policy tool, including no regulation.
- *It should contain the seeds of its own destruction*. If a regulation endures, that should be because it continues to pass stringent tests of its cost effectiveness.
- *It should state (ex ante) what it is going to do* and, as far as possible, establish verifiable performance criteria.
- *It should be clear and concise.* It should also be communicated effectively and be readily accessible to those affected by it.
- *It should be consistent* with other laws, agreements and international obligations.
- *It must be enforceable.* But it should embody incentives or disciplines no greater than are needed for reasonable enforcement, and involve adequate resources for the purpose.
- Finally, it needs to be *administered by accountable bodies* in a fair and consistent manner. Governance arrangements for regulators are clearly a big topic in their own right and currently under review at the Commonwealth level. Apart from the nature of reporting responsibilities (to a Minister or the Parliament) and the scope for judicial or administrative review, important features of good governance include clear statutory guidance, transparency of both process and judgement, and public accessibility.

Working *with* the market

A major failing in past regulatory approaches was the assumption that if there was a market failure, then the appropriate mechanisms for dealing with it were 'command and control' approaches that were often highly prescriptive. The generally acknowledged goal now is to achieve desired regulatory outcomes at least cost. This has facilitated a wider array of regulatory approaches, including recognition of the flexibility and information-richness of market-based mechanisms.

Economic incentives

Markets offer the potential for achieving regulatory objectives more efficiently than prescriptive regulations. For example, it is possible to make a reduction in some undesirable outcome (for example, pollution) a market good in itself, bringing to bear the inventiveness and cost consciousness that characterises market competition. Regulations of this kind can, among other things:

- allow for the fact that the costs and benefits of regulation vary across firms, as well as time (as in discharge trading)
- allow firms the freedom to determine what technology is used to achieve a given performance standard or target, thereby also placing few informational demands on regulators.

Australian examples are the use of tradeable emission permits to limit saline discharges into rivers, and a trial of competitive tendering as a cost-effective way of encouraging landholders to supply conservation of biodiversity on private land for profit (the Victorian Government's BushTender trial (PC 2002a)).

Self- and co-regulation

Self-regulation has the virtue of allowing much greater freedom by an industry about the 'whats and hows' of regulation, including dispute resolution. It economises on administration costs to government and utilises specialist industry information more efficiently than command and control rules. Self-regulation is used widely (advertising, real estate, financial services, telecommunications, many professions, and funeral directors). It is not appropriate if compliance with performance standards cannot be readily verified, or if penalties are too weak relative to the costs of poor performance, or dispute resolution poor (ORR 1997). But where these criteria are met, self-regulation can be a cost-effective alternative to government intervention.

Good process is fundamental

Many of the conceptual and practical underpinnings for better regulation are now established. But that is not enough. Bad regulation is tenacious because the governance arrangements for regulation making are still far from perfect.

The adoption of more stringent *ex ante* assessment processes by regulators, together with independent verification of their use, can make a significant difference — as in the Regulatory Impact Statements now required at the Commonwealth level.

Improved transparency and independent assessment can also help provide greater discipline on regulation making.

The fact of regulatory fallibility suggests that there should be appropriate checks and balances (including merit reviews) and clear statutory guidance to regulators to constrain potential biases. Regulators also need to consult much more widely about the potential effects of regulations (particularly compliance costs) and ensure that regulations are regularly tested for continued relevance and cost effectiveness.

Regulatory norms also need confronting. If nothing else, the risks and failures associated with the regulatory endeavour, of which I have only mentioned a few — should cool the ardour of those for whom every problem has an apparent regulatory fix. Regulatory forbearance is likely to be the best option in situations in which market outcomes are only a little bit imperfect.

Reducing the regulatory burden: the way forward*

The task assigned to the Regulation Taskforce by the Prime Minister and Treasurer in late-2005, was to identify and propose remedies for areas of Australian Government regulation that are 'unnecessarily burdensome, complex, redundant or duplicate regulations in other jurisdictions'. Behind this initiative were mounting concerns from business at the growth of regulation and its cumulative burdens.

Following wide-ranging consultations and analysis, the Taskforce became convinced that many of the concerns raised by business and other organisations were fully justified. Australia clearly could not function well without regulation. However, in the Taskforce's view, there is too much regulation and, in many cases, it imposes excessive and unnecessary costs on business. In so doing, it also imposes costs on the wider Australian community, through higher prices, less innovation and reduced choice.

The Taskforce identified a forward agenda comprising some 100 specific reforms to existing regulation and proposed that about another 50 areas of regulation be investigated in greater depth. In addition, we considered how the processes and institutions responsible for regulation could be improved to avoid the same problems simply re-emerging (Regulation Taskforce 2006).

However, a little perspective is in order. Regulation in Australia undoubtedly needs reform and it is important that this be given priority by our governments. But this country's regulatory regime, taken as a whole, is by no means a poor one by international standards. In part, that is a reflection on the state of regulation in other countries. For example, it is no surprise that a highly-regulated country like the Netherlands is at the vanguard of regulatory reform in Europe. And while Australia's federation brings with it some unnecessary and costly duplication and fragmentation, European countries have an arguably more onerous regulatory overlay emanating from Brussels. In the United States there are eight times as many

* Inaugural Public Lecture, Monash Centre for Regulatory Studies, Melbourne, 17 May 2006. Gary Banks chaired the Regulation Taskforce, which issued its report *Rethinking Regulation* in January 2006.

state governments as we have, each exercising substantial independent regulatory powers. The regulatory morass in most developing countries is legion.

The second reason for our above-average performance internationally is that we have undergone considerable regulatory reform over the past couple of decades, directed at removing long-standing impediments to competition and structural efficiency (through trade liberalisation, the National Competition Policy and industrial relations reforms). According to the OECD, we now have the least market-restrictive regulatory environment among member countries. However, in undertaking reforms to reduce or remove the major distortions in our economy, we appear not to have paid sufficient attention to the growth of new regulation and, especially, the costs imposed via firm compliance.

The bottom line is that Australia cannot afford to take too much comfort from international comparisons. As a relatively small-scale, trade-dependent economy, lacking proximity to major markets, we need to do whatever we can to drive any unnecessary costs out of our economy. The fact that many other countries are now pursuing reform themselves only adds to this need.

Having made important progress in many policy areas, Australia risks undermining these gains through burgeoning regulatory imposts on business. It is important both for business and the wider community to introduce reforms that can provide relief on a sustainable basis.

Priority reforms to existing regulation

The Taskforce went to some trouble to identify what we saw as the priorities among the 178 recommendations in our report, in terms of their likely impact on individual business and the number of businesses potentially affected. These covered a variety of areas of regulation. However, they shared some common themes in relation to compliance issues or burdens, and the actions needed to address them.

Reducing regulatory creep

The most effective relief from regulatory burdens, of course, is not to be covered by regulation in the first place. We identified a number of regulations that appeared to catch more activity than warranted, or where the coverage of smaller businesses had become more extensive over time as the real value of thresholds had been eroded by inflation. Such 'regulatory creep' can have pervasive effects, particularly on small business.

Inter-jurisdictional overlaps and inconsistencies

While the Taskforce identified some overlapping and inconsistent requirements between different areas of Australian Government regulation, the more vexed instances occur across jurisdictions. Of these, the undisputed priority is the need to implement nationally-consistent occupational health and safety standards, in particular by adopting a consistent definition of 'duty of care'.

Removing regulation that is redundant or not justified by policy intent

The Taskforce identified only a few regulations that were clearly redundant — more regulations were assessed as not being justified by the policy intent behind them. Some of the reform priorities that we identified include pursuing identified reforms to native vegetation and biodiversity regulations, and further refining the regulation of financial services.

Reducing reporting and recording burdens

The Taskforce was alerted to numerous areas of regulation where recording and reporting obligations on business were clearly excessive. Priority should be given to reforms that have the potential to reduce compliance burdens across a range of businesses. We found a number, but a key one is developing a 'whole-of-government' business reporting standard to make it easier for businesses to submit information to multiple government agencies.

Aligning definitions and criteria

There is a surprising degree of variation in definitional and operational reporting requirements across areas of regulation. Stand-outs for reform included the need to limit the use of 'uniquely Australian' variations from international standards in such areas as chemicals and plastics and therapeutic products.

Other common themes that emerged across different areas of regulation that explained excessive burdens on business included:

- specific regulations duplicating generic regulation: for example, the overlap of corporate governance requirements imposed by ASIC, the Australian Stock Exchange and APRA
- excessive prescription and micromanagement: for example, the prescriptive nature of the capital gains tax small business concessions in relation to controlling individuals

- blunt or poorly targeted regulation: for example, the Building Code of Australia being used to deliver standards beyond minimum effective standards, and non-compliance with reporting requirements resulting in ineligibility for school funding
- a lack of timeliness of regulatory decisions: for example, delays in securing short-term business migration visas.

Priorities for further review

In the course of the review, the Taskforce identified many more regulatory problem areas than it could confidently make specific recommendations about. Of the reviews covering mainly Australian Government regulation, the identified priorities included superannuation tax provisions, directors' liability provisions under the Corporations Act and privacy laws.

Of the reviews involving Commonwealth-state overlaps, or focusing principally on state and territory regulation, priorities include:

- food regulation
- consumer protection policy and administration
- chemical and plastics regulations
- childcare accreditation and regulation
- energy efficiency standards for premises.

All of the inter-jurisdictional reviews should focus on options for achieving harmonisation, or at least greater consistency. They should also include consideration of the scope to rationalise the number of regulatory bodies involved. There would be value in COAG sponsoring the reviews, although in some cases the Australian Government could take the initiative in consultation with state and territory governments.

Moving forward

When the Government announced that a taskforce would review business red tape, some business groups were understandably a little sceptical. 'What will another review achieve? Especially in 3 months?' Nevertheless, the cooperation and input received from business was substantial and of high quality. The Taskforce sought to do this extensive input justice in our report, and I believe the Government has been similarly motivated in its response thus far.

As the Taskforce emphasised in concluding its report, the Government's response should demonstrate its commitment to the principles of good regulatory process. In particular, it should convey clearly that government will not take regulatory action (including in reaction to perceived 'crises') without careful assessment of all the options and only after appropriate consultation. It should also clarify in the public mind that regulation is not a panacea, and that it cannot seek to eliminate risk without exposing Australians to even greater threats to their wellbeing in the years ahead.

Finally, were these principles to be reflected in the approach of all Australian governments to their regulatory responsibilities, we are confident that this country could build on the successful reform efforts of the past, and better meet the undoubted challenges of the future.

Regulation for Australia's federation in the 21st century*

Prompted by a series of complaints by business groups about the growing regulatory burden, the Regulation Taskforce was established in late-2005. Its report confirmed that there are widespread problems with the volume and quality of regulation, the processes used for making, administering and enforcing it, and — not least — the coherence of regulation across our nation's nine jurisdictions (Regulation Taskforce 2006).

In response, the Australian Government agreed to almost 90 per cent of the Taskforce's 178 recommendations. Some state governments have also commissioned 'red tape' reviews or announced reforms. Further, the Council of Australian Governments (COAG) has made broad commitments to address a number of regulatory problems, including those of a cross-jurisdictional nature, as part of the National Reform Agenda (NRA).

In this paper, I revisit the problems and solutions proposed by the Taskforce and others, take stock of the reforms agreed to date and consider what further actions may be needed.

Australia's regulatory problem

The Taskforce's report identified a number of problems with Australia's regulatory environment. Regulation is growing apace (see figure 1) and, while regulation can be justified in many areas, its efficiency often leaves much to be desired. Furthermore, its cumulative compliance burden on business and the economy has escalated beyond what is justifiable. A major part of the problem lies in the way regulation is formulated and designed. Notwithstanding improvements in some areas, common faults include:

- unclear or questionable objectives
- failure to properly target the regulation at the source of the 'problem'

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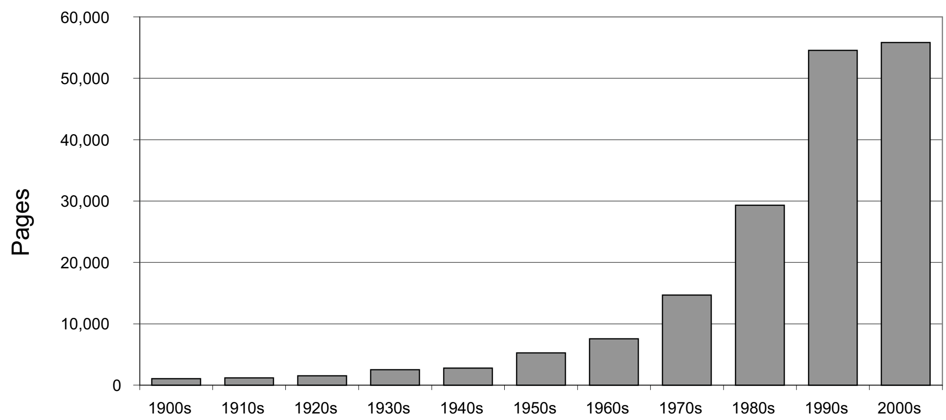
* Opening presentation to the Melbourne Institute Economic and Social Outlook Conference, 'Making the Boom Pay: Securing the Next Generation of Prosperity', Melbourne, 2-3 November 2006. (Co-authored with Ian Monday and Tom Nankivell.)

- undue prescription and complexity
- overlap, duplication or inconsistency with other regulation, especially across jurisdictions
- excessive reporting or other paperwork requirements
- poorly expressed, and confusing use of terms
- unwarranted differentiation from international standards.

These problems are often exacerbated by the agencies charged with administering and enforcing regulation. There are many instances of regulators being unduly heavy-handed or legalistic; failing to use risk assessment when determining how stringently or widely to enforce a regulation; not adequately consulting or communicating with those being regulated, and leaving business uncertain about compliance requirements.

The Taskforce's findings have lent support to the conclusion emerging from successive Productivity Commission reviews in a variety of regulatory areas, that there are few regulations that could not be significantly improved. This is true within each of the jurisdictions in Australia's federation. However, the fact that we have multiple jurisdictions, while not without benefits, introduces further problems.

Figure 1 **Growth in Commonwealth primary legislation**



Nationally incoherent regulation

One oft-noted example of the resultant costs and complexities occurs in rail — an area that the Commission examined as part of its inquiry into road and rail freight infrastructure pricing (PC 2006e). While the colonial hangover of different track gauges has now been largely addressed, it is still the case that Australia, with a population of 20 million, has seven rail-safety regulators administering nine pieces of legislation, whereas the 300 million citizens of the United States are able to make do with one. Further, an operator of an interstate train in Australia may also have to deal with up to six access regulators, three transport accident investigators, 15 pieces of legislation covering occupational health and safety of rail operations, and 75 pieces of legislation with powers over environmental management.

Economic activity is increasingly 'national'

The Australian Constitution, in Section 51, gives the federal Parliament powers over a number of matters, including those considered in the 1890s to be important for the formation of a national market. They include quarantine, currency, bills of exchange, bankruptcy, copyright and corporations. There has been a trend towards the centralisation of functions over time — for example, in the area of income taxation and companies regulation — through High Court decisions in relation to Commonwealth and state powers, and negotiations and agreements reached between the governments themselves. However, in many areas, regulation remains first and foremost a state-government responsibility.

In the early decades of federation, the fact that other regulations differed between states was not greatly problematic for the conduct of business, given the limited geographic reach of economic activity at the time. However, technological advances in transport, communications, production processes and distribution systems over the last century have meant that the geographic scale of much economic activity has increased dramatically.

One century after federation, there are clearly advantages in workers and businesses in Australia being able to operate as seamlessly as possible across state borders. Unnecessary variations and inconsistencies in regulatory requirements between jurisdictions add to the costs and complexities of doing business. Further, the overlay of requirements from different levels of government can add complexity and cost to doing business even for workers and businesses operating entirely within the one state. This can translate into less choice and higher prices for consumers and business users, in addition to the cost to taxpayers associated with regulatory duplication and overlap.

Imperatives for reform

We face important challenges in the years ahead, not least the domestic pressures of an ageing population, and international competitive pressures from countries such as India and China. Australia is already at a disadvantage by dint of the tyranny of distance. As globalisation proceeds, it makes increasingly less sense to maintain many regulations and bureaucratic structures designed for eight separate markets.

The potential benefits associated with regulatory reform are large. Analysis by the Productivity Commission, as part of its assessment of the potential gains achievable through the NRA, suggests that the cost of *unnecessary* regulatory compliance requirements alone could be as high as $7 billion per annum, with a significantly higher cost in GDP forgone (PC 2006b). Added to such compliance burdens are the potentially much larger efficiency costs associated with regulatory impacts on decision making about production or investment, or constraints on firm innovation and responsiveness to changing market conditions.

In response to the Regulation Taskforce's report, the Australian Government announced a number of reforms to specific areas of regulation as well as strengthened processes to improve regulation making and enforcement generally. Some similar exercises have been undertaken by individual states. COAG has made a broad commitment to review and reform ten interjurisdictional 'hot-spot' areas. There has also been agreement to improve processes for regulation making.

Who should regulate what?

In contrast to 100 years ago, when 'states rights' held supreme in public opinion, today there is a growing tendency to presume that all functions currently undertaken by state governments would be best centralised under the Australian Government.

It is thus worth recalling the potential advantages that federal arrangements offer their citizens, as compared with unitary states. Among other things, power in a federation is dispersed across multiple jurisdictions, encouraging more responsive and less autocratic government. The existence of multiple governments also creates opportunities for interjurisdictional competition and learning from different policy approaches and innovations. A state that over-regulates can lose business and people to other, less *dirigiste* states. Further, federations allow the provision of sub-national goods and services to be attuned to the preferences of constituents in particular jurisdictions, while facilitating the provision of 'national' goods and services by a central government.

Thus, the question of which level of government should regulate which activities generally hinges on more than the transaction costs of running multiple regulatory regimes. Indeed, a number of criteria or considerations are relevant:

- the scale of the activity
- the extent to which actions in one jurisdiction impact on others

- the degree of differentiation in circumstances or preferences across jurisdictions
- the ease and costs of administration
- the state of knowledge about the best regulatory approaches.

It follows that the question of which level of government is best placed to regulate in different areas is not always straightforward. A balancing of considerations will normally be required, and no one regulatory size will fit all.

Nevertheless, it seems clear that the case for national approaches is strengthening over time. The imperatives of forging an efficient national economy through national regulation are greater, as is the need to address spillovers across jurisdictions. Regional variations remain, but in some respects may be less pronounced than they were. And, in some cases, they can be accommodated by 'mixed' regimes which set high level principles in national regulation, while allowing significant devolution in regulatory interventions.

That said, the fact remains that the best regulatory solutions are not always evident, and national or centralised approaches allow no escape from uniformly bad regulatory outcomes. Regulatory variations will remain desirable in some areas, even where other criteria may favour national consistency. This makes it particularly important that the consequences of regulatory proposals with national coverage are carefully assessed at the outset, and that outcomes are periodically reviewed to identify any necessary adjustments.

Mechanisms for achieving national consistency in regulation

There is an array of mechanisms through which governments can achieve more nationally consistent regulation, or at least reduce the effects of inconsistencies between jurisdictions. The mechanisms include centralised, decentralised and mixed approaches. Each has pros and cons, and their success in generating appropriate and nationally coherent regulation depends critically on how they are implemented and utilised in practice.

Transfer of powers to the Australian Government

At one end of the spectrum, a national approach can be achieved through the transfer of regulatory responsibility from the states to the Australian Government. This can occur by the states simply 'referring' their powers to regulate in a particular area to the Australian Government. This approach, which guarantees uniformity, has been successfully followed in relation to corporations law. Following the 2006 High Court decision on the WorkChoices legislation, it would now appear to be within the Australian Government's powers to assume responsibility for a number of areas previously understood to be the sole province of the states, thereby opening up a new avenue for attaining national uniformity.

Cooperative national standards

Another model involves the creation of national regulation through joint Commonwealth-State Ministerial Councils. These bring together the relevant ministers from the Australian Government and the states and territories (and, in many cases, from New Zealand) to agree on particular standards, with the intention that these should then be embedded or referred to in each jurisdiction's legislation. Examples of such bodies include the National Resource Management Ministerial Council, the Australian Transport Council, the Ministerial Council on Consumer Affairs, and the Australian New Zealand Food Regulation Ministerial Council.

A significant body of 'national' regulation has been developed through such Ministerial Councils, as well as by national standard-setting bodies (such as the Australian Building Codes Board and the National Health and Safety Commission). A concern with this model, however, at least as it has been implemented to date, is that the regulation generated has not always been justified or well designed.

The approach to regulating access to nationally-significant infrastructure, adopted as part of the Hilmer reforms, represents another model for achieving nationally-consistent regulation. In this case, governments agreed to the development of a generic National Access Regime, which allowed individual states to develop their own regimes provided they were certified by the National Competition Council (NCC) as complying with nationally-agreed principles. In practice, in a number of areas of infrastructure, such as electricity and gas, industry-specific regimes were established. An important exception is rail, where state variations from the national model have not been certified and have proven problematic for the industry.

Mutual recognition

At the other end of the spectrum is mutual recognition. Subject to certain exceptions, the Australian Mutual Recognition Agreement allows goods sold lawfully in one jurisdiction to be sold in any other, even though the goods may not comply with the regulatory standards in the other jurisdiction. Similar provisions apply to the registration of occupations.

The marvel of mutual recognition, at least in theory, is that it does not require the adoption of uniform or even consistent regulations in each jurisdiction; only that jurisdictions agree to live with whatever differences exist. It can also be a force for jurisdictions with demonstrably uncompetitive regulatory features to bring them into line with other jurisdictions. There is some evidence of these benefits occurring in Australia, but also evidence to the contrary.

Problem areas remain

Notwithstanding these various mechanisms for achieving more nationally coherent regulatory outcomes, many problem areas remain. The different state-based occupational health and safety regimes are a particular sore point for business, and I have already mentioned the mess that is rail-safety regulation. The Regulation Taskforce also identified major problems of regulatory overlap or inconsistency between jurisdictions in relation to workers' compensation, childcare, consumer protection, chemicals and plastics, vocational education and training, privacy legislation, trade measurement, building, food, and environmental regulation.

In many such areas, the problems are well known and a blueprint for reform has been drawn up, but gaining agreement has proven difficult. For example, a 2004 Productivity Commission review into national frameworks for workers' compensation and occupational health and safety, identified clear net benefits in creating a national framework (PC 2004c), but this was not fully supported by the Government at the time. While there has been disagreement about the merits of a single regime, the Australian Government has set about creating an opt-in nationwide alternative to state regimes. Such 'vertical competition' will see the national approach become dominant only if it proves superior over time. The Commission saw this as a viable way forward for workers' compensation, and also raised it as a possible approach to advancing reform in the industrial relations domain as part of its review of National Competition Policy (NCP) reforms (PC 2005e).

Even where a national approach has been agreed to, adherence to national standards has been tenuous. Take the case of building standards. While the Inter-Governmental Agreement sensibly allows for 'local' variations, a Productivity Commission inquiry found that due to poor regulatory assessment, such variations were undermining a sound national building regulation system (PC 2004d).

Why do problems arise — and persist?

There are several reasons as to why regulatory overlaps and inconsistencies continue to arise and persist, both within and between jurisdictions.

The sheer growth in regulation in Australia over recent decades inevitably increases the risks of duplication, overlap and inconsistency. These trends are not confined to Australia: the regulatory regimes of many other advanced countries have experienced similar growth. There are, of course, many legitimate reasons for some of this growth. But perverse factors, including media scares, pressure group politics and excessive risk aversion within our more affluent society, are also to blame.

Some drivers of regulatory problems

In these circumstances, there seems to be a tendency for policy makers and regulators to focus on new regulation, and less on whether existing regulation is sufficient (or is at least not inconsistent with the new regulation). Indeed, when faced with the crisis of the moment, 'doing something *new*' has obvious political attractions, even if it overlays existing measures partly directed at the same thing.

There is also more scope to 'get away with' regulatory overlaps and inconsistencies because many of the costs of regulation are diffuse and 'off-budget' — they are incurred by a multitude of businesses and individuals across the economy.

The risks of overlap and inconsistency are exacerbated where regulation is developed within individual portfolios or jurisdictions. In these cases, those inside a particular 'silo' are likely to be less aware of, or concerned about, outside regulation, or whether the regulations are consistent, or whether information/reporting requirements overlap with those of another portfolio or jurisdiction. For example, the natural inclination of officials in environmental or consumer agencies is to protect the environment or consumers, not minimise compliance costs to businesses, nor even maintain consistency with other jurisdictions.

Another growing source of overlap and duplication in certain areas of regulation is associated with the fiscal mismatch between the Australian Government and the states. Specifically, while the states and territories have had formal responsibility for areas like aged care, childcare and education, the Australian Government provides funding for these services. To ensure 'value for money', it has increasingly been overlaying existing state and territory regulation with its own quality accreditation mechanisms and reporting requirements.

Bad regulation 'sticks'

While factors such as these may explain why deficiencies in regulation arise, they do not explain why they persist, even after their costs have been exposed and reforms recommended. For this we need to look for other explanations.

Part of the story no doubt is that sometimes there are substantive disagreements about the virtues of the regulatory approaches adopted in different jurisdictions or of the merits of reform proposals. For example, in relation to occupational health and safety and workers' compensation arrangements, divergent views are held by different groups on how an employers' 'duty of care' should be applied and on the extent to which employers should be held liable for the costs of workplace injuries.

Part of the story might also be bureaucratic inertia. Even so, it was clear to the Regulation Taskforce that with three levels of government and as many as 1300 regulatory bodies Australia-wide (including more than 700 local councils), interjurisdictional rivalries, parochialism, turf protection and bureaucratic self-interest are often a bigger problem.

It is also perhaps inevitable that government ministers themselves will sometimes find it politically advantageous to act in ways that undermine cooperation and imperil intergovernmental reforms.

Four areas of focus for reform efforts

We have recently seen an unprecedented coalescence of actions by governments seeking to reform Australia's regulatory regimes. Examples include the Australian Government's response to the recommendations of the Regulation Taskforce, and the regulatory reform stream recently endorsed by COAG as part of the NRA. However, history suggests that, after an initial flurry of activity, enthusiasm for regulatory reform can wane. Australia therefore needs additional reforms to secure sustainable solutions to the problems that bedevil the regulatory landscape. These will need to bring about lasting systemic or institutional improvements in the following areas:

- regulation-making processes within, and across, jurisdictions
- reviews of regulatory problem areas, including interjurisdictional overlaps and inconsistencies
- ensuring that regulations remain relevant and effective over time.

Better regulation-making processes within jurisdictions

Poor regulatory outcomes are generally attributable to poor regulation-making processes. In seeking more coherent national regulation, a good place to start, therefore, is through reforms to the processes and institutions responsible for regulation *within* each jurisdiction.

The Regulation Taskforce found that a 'regulate first, ask questions later' culture was a root cause of many of the problems it identified. The Taskforce concluded that good process for developing and administering regulation requires the application of six principles, among which the key ones are already embedded in regulation impact statement requirements (Regulation Taskforce 2006).

COAG has agreed to a number of significant undertakings within the National Reform Agenda to achieve better regulation. On the basic need for better processes for *making* regulation, First Ministers agreed that their governments will:

> … establish and maintain effective arrangements to maximise the efficiency of new and amended regulation and avoid unnecessary compliance costs and restrictions on competition.

It was agreed that, to achieve this, governments would improve the quality of regulation-impact analysis 'through the use, where appropriate, of cost-benefit analysis', undertaking better measurements of compliance costs and recognising cumulative burdens of regulation. Importantly, they also agreed that such analysis should consider whether existing regulatory regimes in other jurisdictions might 'offer a viable alternative'.

While this represents a considerable advance, a major omission is any reference to public consultation. Governments need to reach agreement on key principles relating to the nature and timing of consultation. This should include a requirement to consult early, when different approaches to intervention (including self-regulatory or non-regulatory options) are still open for consideration.

The greatest deficiency, however, is the in-principle nature of the COAG agreement and lack of specifics as to how its aspirations can be translated into actual practice. Indeed, most of the areas identified by COAG are already codified within the best-practice manuals of most governments. The real challenge is to implement and enforce them.

Drawing on the work of the Regulation Taskforce, the key to this is for COAG to agree to two further principles:

- that no regulatory proposal which has not met the best-practice requirements can proceed to Cabinet or other decision makers
- that assessments of the adequacy of compliance will be undertaken by a body with statutory independence from the Executive.

The Australian Government has implemented both of these requirements in its own processes, following recommendations of the Taskforce. While there is an escape clause for 'exceptional circumstances', its use is constrained by the need for the

Prime Minister's approval. In addition, a post-implementation review must be held within one to two years of the regulation being introduced. Extending these requirements to all governments could do much to align regulatory practice with good regulatory principles.

Better regulation making across jurisdictions

Inculcating more rigorous processes for making regulations within jurisdictions would help ensure that any variations were justified by circumstances specific to different jurisdictions. It would also provide greater assurance that nation-wide application of the regulatory regime of any individual jurisdiction in specific areas would yield net benefits. Regulatory benchmarking across jurisdictions could also assist, and the Productivity Commission has been asked by COAG to develop a framework of indicators for this purpose.

As noted, the main forums for developing national regulation, outside COAG, are the 40 or so Ministerial Councils and several national standard-setting agencies. These bodies are required by COAG to follow the steps for a regulation-impact statement, with the Commonwealth's Office of Best Practice Regulation providing independent monitoring and reporting of compliance. The provisions include a requirement that draft regulation impact statements (RISs) be released for the purposes of public consultation — a stricter provision than applies within individual jurisdictions.

The proportion of the regulatory proposals from those national bodies that have adequately complied with the RIS requirements has averaged around 75 to 80 per cent in recent years. However, compliance has in some years been lowest for the more significant regulatory interventions. Moreover, even where RISs have been assessed as adequate by the ORR, the quality of analysis has generally not been high and too often decisions to regulate have preceded analysis of the issue or problem, or any real consideration of different options.

There is also scope to improve regulation-making across jurisdictions by implementing failsafe mechanisms to ensure that jurisdictional variations from national regulations are either legitimated by all parties or terminated. A model canvassed in a recent Commission report on consumer product safety involved a process whereby product bans unilaterally imposed by a given jurisdiction would automatically lapse after 120 days, unless the Ministerial Council agreed that the ban should apply across the nation, or that a mandatory standard relating to the product should be developed (PC 2006d).

As a means of not only reducing the costs of regulatory differences, but creating pressures on jurisdictions with less ‘attractive’ regulation to bring them into line, mutual recognition agreements have great appeal. As noted, however, in practice a number of difficulties with these arrangements have emerged which impair their ability to facilitate nationally consistent regulatory outcomes. Current arrangements contain a number of exemptions and, paradoxically, are narrower in scope than those applying in the European Union. Beyond this, their intent is being circumvented in some areas (PC 2003a).

Reviews of regulatory ‘hot spots’

Introducing better processes Australia-wide for assessing the need for regulation and testing the cost effectiveness of different approaches could make a difference to the flow of regulation in the future, but in itself cannot do much about the existing *stock*, which is where today’s problems mainly reside.

This will require reviews and reform of regulation already in place. Previous reviews, focussing on anticompetitive regulation, were conducted across all jurisdictions as part of the NCP. In its NRA, COAG has agreed that there will be further rounds of reviews within and across jurisdictions directed at reducing business compliance burdens.

An important threshold issue in establishing reviews is to ensure that terms of references allow rationales to be re-examined and various options canvassed. In some areas it could be that no existing regime provides the best way forward. It is also important that such reviews are able to consider the scope to rationalise the number of regulators involved. It follows that in many areas such reviews will necessitate independence of the reviewer from the policy arms of governments (rather than, for example, being undertaken by officials within the relevant portfolio or Ministerial Council).

It is important that governments provide leadership in initiating and undertaking effective reviews, but it is just as important that they respond to them. Reviews have already been undertaken in a number of the hot-spot areas in recent years without much resulting action. It would seem appropriate for COAG to revisit the merits of the recommendations from such reviews, given the greater weight now being given by governments to the need to reduce regulatory inconsistencies and overlaps and the costs they impose.

Ensuring regulation remains appropriate over time

Looking forward, even with best-practice processes for making regulation, ensuring that existing regulations remain relevant and effective over time is fundamentally important.

As observed in the Regulation Taskforce report, regulation in many areas raises complex conceptual and practical issues. As a result, there is often some uncertainty about the likely effectiveness of many regulations and considerable scope for unintended consequences.

Sunset provisions can be useful because, in the absence of appropriate actions (such as a built-in review) a regulation would automatically lapse. However, these provisions are unlikely to be appropriate for major primary legislation, such as that applying to the financial market or regulations supporting the tax and superannuation systems. For such regulation, alternative review mechanisms are needed.

The Regulation Taskforce saw a role for two types of reviews: early post-implementation reviews and periodic reviews at, say, five-yearly intervals. These in-built review mechanisms have been accepted by the Australian Government and should apply in all jurisdictions. If implemented they would provide a measure of confidence that the regulatory stock will remain 'fit for purpose' over time, regardless of whether there is sustained political interest in cutting red tape.

Summing up: regulatory governance for the 21st century

The regulatory stream of COAG's NRA has made a promising start in addressing key problems in Australia's multiple regulatory regimes. However, to be confident of achieving the goal of a regulatory system that can meet the contemporary needs of Australia's national economy and society at least national cost, much more needs to be done to entrench good practice and ongoing reform. This essentially amounts to establishing nationally a new governance and reform framework for regulation. Actions in the following six areas are integral to its success.

First, the regulation-making framework at the jurisdictional level agreed to by COAG needs to be extended and strengthened to entrench best practice, including by requiring more effective consultation; tightening sanctions on non-compliance; and establishing best-practice governance principles for all regulatory bodies.

Second, there is a need to apply the (augmented) principles to Ministerial Councils and national standard-setting bodies, to enhance regulatory practice at the national level as well. Beyond this, there is scope to draw on other institutional arrangements to promote national consistency. In particular, governments need to adopt failsafe mechanisms to avoid unwarranted jurisdictional variations from agreed national standards. And mutual recognition arrangements need to be strengthened to enable that regime to realise more of its potential.

Third, reviews of the existing stock of regulation need to be progressed in a systematic and coordinated way. If not handled well, there is a danger that although reviews may proliferate, their average quality may not be high and little real reform may result.

Fourth, in-built mechanisms are needed to ensure that regulations remain relevant and effective over time. COAG should endorse stricter provisions for sunset clauses and post-implementation reviews.

Fifth, the funding arrangements under the NRA recognise a case for providing financial incentives to the states and territories to enable an appropriate sharing of the costs and benefits of reform. While many regulatory reforms will be clearly beneficial to the jurisdictions implementing them, reforms directed primarily at achieving national consistency may not yield benefits to individual jurisdictions commensurate with the national gains. In such circumstances, there may be a case for the Australian Government to provide financial incentives for jurisdictions to take a broader view.

Lastly, the effectiveness of the NRA, including its regulatory reform stream, will be enhanced if its governance arrangements include provision for the independent monitoring and assessment of progress in implementing agreed reforms. At this stage, COAG has agreed to establish an independent Reform Council to report to it on progress in implementing the NRA. For the Council to play an effective role, there will need to be robust accountability arrangements comprising concrete reform commitments and progress measures. This would also facilitate and complement any reform-related financial transfers.

This may all seem like a big ask, when considered in the context of our federal history. But promising foundations have been laid as part of the embryonic NRA. The secular challenges confronting Australia, as we move beyond the current 'boom' into this new century, provide a compelling case for completing the job.

The ‘baby and the bath water’: avoiding mishaps in regulating infrastructure*

Over the past decade and a half, Governments have radically transformed regulatory, governance and ownership arrangements for essential infrastructure services — such as telecommunications, water, energy and transport. Statutory monopolies have largely been swept away to be replaced by competition in infrastructure services. This has facilitated greater innovation and brought more efficient pricing of essential infrastructure. The gains to the community are big, as recent Productivity Commission reports have shown. This in turn reflects the inefficiency of previous arrangements and the fact that such infrastructure accounts for about one fifth of Australia’s total capital stock and plays a pivotal role in producing services to business and directly to consumers.

This competitive transformation has involved the construction of an elaborate regulatory apparatus. Left unchecked, incumbents operating in previously legislated monopolies, or firms in markets characterised by natural monopoly, may wield enduring market power as a result of the large and (usually) irreversible investments — sunk costs — required by entrants. In seeking to maximise their profits, they may strive not only to be more efficient in their operations, but also to set prices above costs.

National Competition Policy sought to address this infrastructure problem by:

- enhancing competitive disciplines on government business enterprises through the application of competitive neutrality principles and structural reform of public monopolies
- establishing in each jurisdiction arrangements to oversee prices charged by utilities and other corporations with substantial monopoly power
- establishing rules to enable potential competitors to gain access to the services of significant monopoly infrastructure.

* Presentation to the Independent Pricing and Regulatory Tribunal conference, ‘Incentive Regulation at the Crossroads’, Sydney, 5 July 2002. (Co-authored with Ralph Lattimore.)

There are also specific arrangements for sectors such as telecommunications, where the initial lack of competition and the fast pace of change meant that the Government was reluctant to rely on general trade practices law.

Given the ‘experimental’ nature of some of these reforms, and the potential for them to generate costs as well as benefits, it was envisaged at the outset that there would need to be independent reviews of the new regulatory arrangements after a few years. A recent suite of Productivity Commission inquiries — encompassing reviews of the National Access Regime, telecommunications competition regulation, airport services pricing, rail reform, harbour towage services and the Prices Surveillance Act — has provided the opportunity for an independent and public stocktake of key elements of the pro-competition regulation governing Australia’s economic infrastructure (PC 1999d, 2001b, 2001c, 2001e, 2002b, 2002d).

The Commission has generally found that there are legitimate grounds for maintaining regulatory oversight of some form in the areas it analysed. However, the current regulatory framework is not free from flaws, risks and some important unresolved issues.

Competition is not an end in itself

National Competition Policy and related policies were based on an understanding by all governments that, by and large, competition leads to stronger incentives for innovation, lower costs and improved service, and so eventually to higher incomes. It is broadly understood by regulators — as emphasised by Hilmer back in 1993 — that competition itself is not the goal of competition regulation, but a means of achieving higher standards of living for Australians.

Even so, the notion of exposing former monopolies to competitive disciplines is so alluring, the political rhetoric so compelling and the statutes themselves so structured, that at times regulators may understandably give undue emphasis to competition and push the fundamental objective of efficiency into the background. In the context of infrastructure regulation, this poses several risks for regulators and to adjudicators of competition regimes.

‘Perfect’ competition would be costly

First, and most importantly, the trigger for regulatory action must not just be a departure from some competitive ideal. Entry barriers and market power lie on a continuum, with some market structures and outcomes closer to those of perfect competition than others, but none attaining that theoretical abstraction. The costs of a particular unconstrained market outcome depend on what alternative is realistically achievable. Given the compliance, administrative and other more significant costs of regulation, there is limited scope for beneficial policy interventions in markets that remain ‘workably’ competitive.

The more sophisticated regulators no doubt accept this. However, tolerance for imperfection in competition seems to be rather lower for infrastructure than for other sectors of the economy, despite the fact that the costs of regulatory error may well be higher — a point I’ll get back to.

In its telecommunications inquiry, the Commission recommended that one way of reducing the risk of interventions in workably competitive markets was to set a stricter threshold for regulatory action (PC 2001e). We proposed that a necessary hurdle for declaring a service was an expectation that this would promote a *substantial* increase in competition, not just any increase.

Another dimension of ‘workable’ competition is how quickly any market power is likely to be eroded. Market power may be high, but short-lived, as new technologies compete with the old or as services converge. In telecommunications services, wireless local loops, new fibre optic networks and additional satellite services are increasingly threatening the dominance of incumbents reliant on copper lines. Competition can spring from surprising sources. When Alexander Bell patented the telephone in 1876 it was dismissed as a fleeting novelty. Western Union, the largest telegraph service of the time, decided not to buy the patent, and the rest, as they say, is history. In some countries, Internet and telecommunications services are now being provided through the electricity system — a new and unexpected source of competition to the conventional conduits for such services.

The point to emphasise is that the prospect of market power is what motivates firms to innovate and new firms to enter markets. Such transitory market power is not inimical to competition. Rather, it invites it. The patent system recognises this by statutorily protecting intellectual property from competitors — and the Trade Practices Act exempts access to these forms of property. However, the Act does not cover other aspects of innovation. A danger is that the pursuit of static competitive outcomes might choke the incentives for innovation. This is particularly relevant in those areas of infrastructure where technologies are evolving quickly, such as telecommunications.

The collective impact of substitution possibilities

Second, the availability of substitutes limits the exercise of market power. For example, rail track providers may be sole suppliers but, for most freight or other services, they face intense competition from other transport modes, notably road.

A key issue in determining whether competition is adequate is not to get pre-occupied with technological descriptions of markets or indeed in mechanically defining markets at all, but on testing the extent of competitive pressure on firms arising from the collective impact of a whole set of substitution possibilities.

An example that illustrates the drawbacks of a technologically-oriented approach to market definition is given by the declaration of analogue subscription pay TV services back in 1999. Among other reasons given for this decision, it was judged that videos were not a substitute for pay TV because they are less convenient to acquire, and that free-to-air TV was also not a substitute because it is paid for by advertisers rather than by subscription. But the fact that the form in which these services are provided differs from pay TV need not disqualify them as substitutes. Even if, individually, services are not *close* substitutes, collectively they may exert enough discipline to remove any significant scope for excess profits.

Incomplete incentives to exploit market power

Third, there will not always be an incentive or the scope to exploit market power, even where it appears to exist. Taking airports as an example, with more than four times as much operating profit earned from non-aeronautical activities such as retailing and car parking, the owners of the major airports have clear incentives to moderate their pricing of aeronautical services so as not to reduce passenger throughput and undermine total airport profitability. This has been recognised by Government in accepting the Productivity Commission's recommendations to adopt a more light handed approach to airport regulation (PC 2002d).

Countervailing power

Fourth, any countervailing power of major users can also be a constraint on monopoly behaviour. Taking the example of airports again, attempts to exercise market power can be expected to be resisted by airlines, who have some commercial clout of their own (especially in dealing with smaller airports reliant on holiday markets).

Avoiding a numbers game

Undue emphasis on competition may encourage a 'numbers game' in which competition is not measured primarily by entry barriers but by how many actual competitors there are. This risks:

- potentially inefficient entry in certain technologies
- the 'double marginalisation' problem, whereby multiple firms, each with monopoly power in a local market, charge even more inefficient prices to each other than would the arms of an integrated monopolist.

In short, regulators have a tough task in gauging and responding to potential market power. The complexities facing them cautions against assessing competition and market power in a static context, or one which does not account for market reactions to that power being exercised.

Monopoly power may be used efficiently

Even where monopoly power is exercised, it may not have significant negative impacts on efficiency. In particular, to the extent that monopolists can structure their price menus efficiently, so that prices are high for the inelastic segment of demand and low for the elastic segment, there may be little distortion in supply or consumption patterns.

For example, in the case of airports, there are numerous examples of airport price structures designed to promote or retain marginal users, including direct incentives designed to encourage additional flights and new entrant airlines.

Of course, there may be *distributional* consequences, but whether these warrant concern is not always straightforward. For example, the losers from higher than necessary airport charges would potentially be passengers paying higher fares and airline shareholders earning lower returns. But the diversity of share ownership in airlines and airports — directly or indirectly through large superannuation funds — and the mix of foreigners and Australian residents amongst shareholders and passengers, mean that any distributional effects may be largely 'neutralised'.

Ironically, a possible victim of the regulatory response to market power has been to limit the scope for the very feature that reduced the adverse efficiency effects of that power in an unregulated setting — multi-part pricing at the access and retail level. Regulated access prices have generally been uniform and cost based. Where services use common fixed costs — which is a ubiquitous feature of infrastructure services — the regulator is forced to use arbitrary cost-allocation rules, instead of seeking to recover a greater portion of common fixed costs from inelastic demand.

Investment matters too

Access and price regulation have the potential to improve efficiency where natural monopoly is a problem and/or markets are in transition. However, the regulatory challenge is to ensure that prices are set neither too high nor too low. There are dangers both ways. Given the legacy of government ownership and control of vertically-integrated monopolies, it is not surprising that much of the initial regulatory focus has been on reducing prices. This has been to the direct benefit of consumers and using industries and has led to market innovations and expanded choice.

However, the major risk associated with the regulation of essential infrastructure is that setting prices too low could deter new investment in the facilities themselves. At a conceptual level it is clear that access and price regulation involve a significant intrusion into the property rights of facility owners and can distort their investment behaviour. While available evidence of adverse impacts on past investment is largely anecdotal and difficult to verify, the potential risks of adverse consequences from regulatory action appear to be looming larger. Some of these are documented in the Commission's final report on the National Access Regime (PC 2001b).

There is a potential tension between the efficient use of existing facilities and incentives to build new ones. Once investments have been made, the actual costs of running transmission and distribution networks are relatively low. With capital effectively having no alternative uses, there is a theoretical case — at least from a short-term perspective — in setting prices to recover only marginal or operating costs. However, this would deny the firm the opportunity to recover its fixed costs. While the service might continue to be provided for the asset's economic life (though possibly with inadequate maintenance), such a pricing policy would destroy incentives for any replacement investment.

The 'truncation problem'

No firm, including existing facility owners, will commit to major new capital outlays without the expectation of profits commensurate with the commercial risks involved. Realised returns can be affected by unforseen delays and costs during the construction phase, unanticipated changes in market demand, uncertainty about how an untried technology will perform or the possible emergence of a superior competing technology. So even without regulatory risk, profitability cannot be assured. For investments that are particularly risky, or that have the expectation of only normal returns allowing for such risk, the potential for regulatory action to deter or even stop new investment is very real.

Regulators may sometimes unwittingly appropriate what appear to be excess returns, but which are in fact the necessary upside of a risky investment. By contrast, regulators cannot compensate firms for any downsides. With an investment that is already in place, a regulator can engage in regulatory taking without threatening the existing service. But future investment incentives may be undermined. Indeed, an important function of a regulator is to provide signals to guide future investment.

An example from Melbourne University's Stephen King illustrates the problem. A cable TV provider is considering investing in a regional town. The investment costs $51 million and, in the absence of access provisions, returns $100 million if pay TV is very successful, $60 million if it is moderately successful and only $20 million if unsuccessful. Say the likelihood of each of these outcomes is 25 per cent, 50 per cent and 25 per cent respectively. In that case, the expected net return is $9 million.

Now consider the situation whereby the facility is not immune from access and that the regulator would reign in any apparent excess profits by granting access to the facilities to rivals. The maximum potential return drops from $100 million to $60 million. The regulator sees this as a benign outcome because the provider would still get $9 million if the venture were very successful. But because the regulator does not subsidise the less successful outcomes, the expected *ex ante* return from investing is now negative. By 'truncating' the potential returns from risky investments, an apparently benign regulatory policy can actually kill the incentive to invest in the first place.

In the case of access regulation, there may also be perverse incentives for investors to build smaller facilities than would be sociably desirable, so as to ensure that there is little spare capacity beyond their immediate requirements, thereby removing any threat that they would be required to grant access at prices they considered too low.

Regulatory-induced service failure

Another disadvantage of unduly low regulated prices is that the investment required to maintain, extend or replace existing infrastructure may be delayed. This can result in a deterioration in service through breakdowns, increasing congestion and, depending where price restraints are imposed, profit squeezes on intermediary suppliers. The effects of this may go unnoticed for some years, until a crisis point is reached.

The California energy crisis in 2000 provides an apt illustration. For some time, retail prices were low, reflecting retail price caps imposed by the regulator.

However, in the summer of 2000, wholesale energy prices rose steeply as electricity generating capacity failed to keep up with soaring demand and higher energy prices. The supply problems mainly reflected the fact that no new generating capacity was built in the 1990s and few transmission lines were constructed. This stemmed from environmental requirements and an uncertain regulatory environment. The retail price caps meant that the wholesalers were unable to pass on their higher costs to customers, so that they made huge losses. This undermined the confidence of electricity generators to supply wholesalers when they might not get paid, which was a major factor leading to rolling black outs. Ultimately, the retail caps were not sustainable, and prices for consumers rose by 40 per cent in April 2001 and some by 80 per cent. The knock on effects to the broader Californian economy have been severe.

The Californian electricity crisis is sometimes attributed to deregulation. In fact, what it demonstrates is that the regulations that persist after breaking up monopolies have to be carefully designed and adapted as markets change. Otherwise consumers can be made worse off in the long run.

To motivate adequate investment, prices need to be *at least* sufficient to cover the long-run costs of facility operators, including an adequate return for the risk involved.

But prices should not be set so far above costs as to detract from the efficient use of services or to inhibit investment and innovation in related markets. This is a particular risk in markets such as new value-adding telecommunication services, where investors are already grappling with rapid and unpredictable technological change and demand for the platform service is sensitive to price. There is also the possibility that high regulated prices could lead to the inefficient duplication of facilities where users have no option but to build their own.

It follows that there needs to be a balance between the short-term gains for users and consumers in having low prices, and the long-term interests of those same users and consumers, which requires the efficient timing and scale of investment. The Commission considers that regulatory frameworks need to provide clearer signals about how this balance is best achieved.

Regulatory measures must be ‘workable’

Notwithstanding the risks and complexities, the rationale for regulation *is* strong in many infrastructure areas. However, the choice of regulatory instrument and the processes used for declaring, arbitrating and otherwise managing a regulated regime then come to the fore. These can make or break the regulatory regime.

For example, in its report on harbour towage services, the Commission found that the instrument used was ineffective (PC 2002b). The requirement for price notification under the Prices Surveillance Act had no impact on the (modest) market power present in those services. Probably the most effective constraint on market power is the potential for entry — if, as they say, planes are capital with wings, then tugs are mobile floating capital. From a policy perspective, allowing port authorities the discretion to license towage operators through competitive tender 'for the market' was found to be a superior option for lowering prices while maintaining quality than price regulation.

For a given approach, the *details* of regulatory provisions can matter a great deal. For example, lack of clarity about price capping arrangements for airports promoted strategic behaviour by all parties. This led to increased compliance burdens and discouraged commercial negotiations.

And of course, the speed and ease with which the regulatory regime works can be critical. Access regulations have often proven to be cumbersome and slow. Even the telecommunications access regime, which was designed to be speedy to suit the pace of technological change in that sector, has taken years in some cases to reach preliminary determinations. For example, for the fundamental telecommunications access service (originating and terminating PSTN access services), the delay between the first notification of a dispute and the finalisation of the appeal is expected to be around five years. Changes have since been made to speed up the process.

A factor shaping these delays is the breadth of the regulatory regime. The longest lasting disputes in the telecommunications access regime have tended to be for services that are workably competitive and involve parties without much market power. The median delay to first resolution of a dispute involving Telstra as an access provider was around 300 days; it was 550 days for a dispute that did not involve Telstra at all. This is testimony to the wise decision by the Australian Competition and Consumer Commission (ACCC) to prioritise the cases that really matter, but it is also symptomatic of the willingness of parties to use the regulatory regime to press for commercial advantage in negotiations that should really be outside the scope of that regime. (Some of the disputes have been trivial, with one party claiming that in one dispute the ACCC arbitrated over a total sum in dispute between two carriers of $12 per month.)

If nothing else, these points suggest that the more heavy-handed price or access regulations can involve some steep transaction costs, while not always being effective. Regulatory forbearance might avoid some of these. Or, where regulation is required, lighter-handed alternatives may have fewer downsides. For example, the prices monitoring regime proposed by the Commission for major airports, and effectively accepted by Government, provides some deterrence for abuse of market power, while allowing a lot of commercial latitude and sustained incentives for investment (PC 2002d). Similarly, the ACCC has appropriately not proposed stipulating prices for mobile telephone services.

Regulators, too, are only human

The expectations placed on the competition regulator are high. The regulator is required to find a reasonably implementable system for encouraging efficient competition; to avoid appropriating the returns that motivate investment, and prevent tangling everyone in a mire of complex directives and procedures in the process. Regulators must simultaneously hold at bay game-playing participants and meet public requirements for fairness and transparency.

The tasks regulators must perform require considerable information if they are to improve consistently on market outcomes. That information must largely come from incumbents, who are naturally reluctant to lay all the relevant information in the hands of regulators. When technology and market demands are changing rapidly — which is increasingly the case — the informational difficulties for regulators multiply.

Persistent methodological quandaries over such delphic issues as tilted or non-tilted depreciation, provisioning, common trenching costs, and fierce battles of the accounting acronyms — the DACs versus the DORCs — suggest we still face big uncertainties in some key areas that define the relevant asset bases and valuation.

Ultimately, a large element of judgment is unavoidable in deciding whether and how to intervene, and this raises the prospect of regulatory error.

The inevitability of error has special risks where long-lived investments in essential infrastructure are involved. The Californian energy crisis sent a chill through regulators around the world. Here was a situation in which a modern sophisticated regulatory authority had presided over, at least in hindsight, what appeared to be grave regulatory mistakes. This is sobering stuff and hopefully has done some good for the future.

Statutory guidance is fundamental

Regulatory discretion cannot be eliminated, and indeed, some discretion is desirable. However, to reduce the risk of regulatory error, statutes need to be clear about three things:

- the objectives of regulation
- the behaviour at which intervention should be targeted
- the principles governing the type of intervention.

These basic requirements are not often met. For example, the Productivity Commission found that the National Access Regime was deficient in all three respects (PC 2001b). It proposed the inclusion of an objects clause and pricing principles in the national regime and a change to the regime's 'declaration' criteria to reduce the possibility that services will be subjected to access arrangements without the prospect of a significant economic payoff.

Given the manifold uncertainties and information difficulties, there are limits to what regulators can be expected to achieve. Rather than aiming for an ideal but unattainable outcome, the public policy goal should *be a set of regulatory arrangements that will improve efficiency through time, while minimising the scope for regulatory errors*. A framework is needed in which regulators are encouraged to intervene only when significant improvements in efficiency are in prospect and not to be too ambitious in fine tuning the prices they regulate.

A number of the Productivity Commission's general regulatory proposals, while they mainly apply to existing assets, would also help facilitate efficient investment in essential infrastructure services. However, the Commission has come to the view that special additional provisions will also be needed if new investment is not to suffer from an inherent regulatory tendency to truncate the up-side potential of a proposed investment, while allowing investors to bear all the downside risks — illustrated by recent references by regulators to average rates of return earned by companies on the stock exchange, as if these were an appropriate benchmark for prospective investment.

The problem of regulatory truncation is an important policy issue, but determining the best approach to dealing with it is not at all straightforward. It should nevertheless become a priority for government consideration and the Commission's final report on the National Access Regime provides guidance on how governments might go about it (PC 2001b).

The need for balance

In conclusion, the task of regulating monopoly infrastructure is complex and faces major informational obstacles. Much has been achieved over the past decade, however, and the community has realised substantial gains. On the basis of the Commission's detailed reviews of particular areas of infrastructure regulation, further gains now hinge on making adjustments to the regulatory apparatus to minimise the risks for investment and to ensure that competition can discharge its rightful function of achieving more efficient outcomes for the long-term benefit of the community.

Competition and the public interest*

A core principle of the National Competition Policy (NCP) is that governments should retain (or introduce) restrictions on competition only where they can demonstrate that the benefits to the community exceed the costs. The factors relevant to making such an assessment — which have come to be known as the 'public interest test' — are enshrined in Clause 1(3) of the Competition Principles Agreement. They include:

- government legislation and policies relating to ecologically sustainable development
- social welfare and equity considerations, including community service obligations
- government legislation and policies relating to matters such as occupational health and safety, industrial relations and access and equity
- economic and regional development, including employment and investment growth
- the interests of consumers generally or of a class of consumers
- the competitiveness of Australian businesses
- the efficient allocation of resources.

A radical initiative?

A requirement for governments to demonstrate that their regulatory arrangements are in the interests of the community would at face value seem not only unexceptionable, but essential to democratic governance (abstracting for the moment from questions of implementation). And the policy's presumption in favour of competition can be seen as a logical extension of the approach taken in the *Trade Practices Act 1974*. The Act prohibits anticompetitive conduct by private corporations, but allows the Australian Competition and Consumer Commission (ACCC) to authorise some such conduct — including exclusive dealing or mergers

* Presentation to the National Competition Council workshop, 'The Public Interest Test Under National Competition Policy', Melbourne, 12 July 2001.

that substantially lessen competition — if it can be shown to provide sufficient public benefit to exceed the anticompetitive detriment.

Nevertheless, the extension of this approach to government restrictions on competition has proven contentious. This is so for a number of reasons, which I shall explore. Not least is that it has essentially turned on its head a long-standing approach in this country to policy formulation and reform.

For one thing, many of the restrictions on competition that have been targeted under the NCP (and related reforms) got there in the first place because the wider effects on the community had not been adequately accounted for. Indeed in many cases the interests of particular groups were the dominant consideration.

Secondly, the NCP has reversed the traditional onus of proof in policy reform, whereby it has generally been up to the *proponents* of change to demonstrate that change will be worthwhile. As a general rule this principle has much to commend it. Change can be disruptive. People organise their lives and expectations around existing rules. They even find ways of minimising the impact of bad rules. Given the costs and uncertainties in changing established ways of doing things, it is not unreasonable to require a good case to be made for change.

Indeed, establishing a public interest case *for* policy reform has been the *modus operandi* of the Productivity Commission and its predecessors over many years. In coming to judgements about the merits of particular reform options to put before government, the Commission, as an independent statutory body, is required to have regard to a series of 'policy guidelines' in its Act. These reflect social and environmental as well as economic goals, and underpin the community-wide perspective that the Commission seeks to bring to all of its work. The Commission's statutory guidelines are not dissimilar to the provisions in Clause 1(3) of the Competition Principles Act or, for that matter, the factors considered as part of the ACCC's authorisation process.

In the case of competition policy reforms, governments have essentially taken the view that reversing the onus of proof is justified on the grounds that removing restrictions on competition *will* typically be in the public interest.

This was clearly the position advocated by the 1993 Hilmer report to COAG which formed the basis for the NCP. It observed:

> Competition provides the spur for businesses to improve their performance, develop new products and respond to changing circumstances. Competition offers the promise of lower prices and improved choice for consumers and greater efficiency, higher economic growth and increased employment opportunities for the economy as a whole. (Independent Committee of Inquiry into Competition Policy in Australia 1993, p. 1)

The need for reform

Indeed, the Hilmer review was initiated by governments in recognition of the costs stemming from the lack of competitive disciplines and incentives facing many government business enterprises, previously highlighted by a succession of state and national reviews (see, for example, IAC 1989b).

Government monopolies in the energy, transport and communications sectors were characterised by low productivity, poor service and high costs. As barriers to international trade and investment declined, it became evident that the poor performance of these domestic services was handicapping the competitiveness of Australian industries and, notwithstanding the cross-subsidisation of households, reducing the income of the Australian community.

In a report commissioned by COAG in 1995 to guide judgements about the tax revenue implications of the NCP, the Industry Commission estimated that identified pro-competitive reforms to public utilities and certain regulatory restrictions could eventually lift Australia's GDP by some $23 billion — 5.5 per cent above what it would otherwise be (IC 1995).

Like all model-based constructs of complex economic relationships, the estimates could be no more than broadly indicative. They nevertheless were accepted as the basis for subsequent negotiation by the states and territories on the competition payments to be delivered by the Australian Government. They were also criticised by some observers as being too optimistic.

The productivity dividend

In the event, as the OECD has concluded, the surge in Australia's aggregate productivity and output growth in the 1990s — one percentage point or more above the previous trend for at least six years — is broadly consistent with the Industry Commission's projections, notwithstanding that some reforms are yet to be fully implemented. Indeed, the surge in Australia's productivity performance is hard to explain by factors other than the microeconomic reforms of the 1980s and 1990s.

The fact that this productivity boom was sustained through the 1990s despite the collapse of key export markets in Asia, is itself hard to explain other than as a result of our economy's enhanced flexibility and adaptability. That Australia was one of only a few high-income countries to lift its performance in the 1990s, reinforces the point that the major explanation must lie in domestic influences.

Australia's productivity performance deserves this attention in considering the public interest implications of reform, because productivity growth is the foundation for higher incomes and standards of living. The American economist Paul Krugman once put it as follows: 'Productivity isn't everything, but in the long run it is almost everything' (Krugman 1992). Growth in average incomes accelerated from 1.4 per cent a year in the 1970s and 1980s to 2.5 per cent a year in the 1990s. Faster productivity growth accounted for 90 per cent of that acceleration in average incomes. If Australia's productivity had grown in the 1990s at its previous trend rate, annual income in 2000 would have averaged around $2700 less per person (or roughly $7000 less per household).

Distribution matters too

While productivity growth is the fundamental driver of a country's income levels over the long term, it is the *distribution* of these gains and the transitional impacts of reforms on different groups that have seized most political attention. Concerns that NCP and other microeconomic reforms have been anti-worker or anti-region have been instrumental in a popular backlash against reform.

Understanding and analysing the distributional and adjustment implications of competition reforms is a key issue for all governments. It has not always been done well — in part because it is difficult to do. Nevertheless, such analysis is an important part of the assessments needed in making decisions about policy change under the NCP. And, notwithstanding the availability of general assistance programs to help people deal with change, there are circumstances in which more targeted compensation or assistance to address the adjustment consequences of reforms are called for (PC 2001d).

What the Commission's own research has shown, however, is that while reforms inevitably create some losers as well as winners, particularly in the short term, the perceptions of a general bias against workers or net losses to regional Australia are not well founded.

Recent Commission research into the distribution of the productivity-induced income gains in the 1990s, found that labour maintained its share at the aggregate level throughout that period (Parham et al. 2000). A shift in the distribution of income towards capital in some industries was offset by a shift towards labour in other industries. Overall, growth in real wages was accompanied by employment growth and falling unemployment.

In addition, the Commission found that the benefits of productivity gains at the industry level were mostly passed on to consumers in the form of lower prices. This has occurred to a significantly greater extent than in the past, suggesting that increased competition has not only contributed to the generation of productivity gains, but also ensured that those gains have not just been absorbed by profit taking or higher nominal wage claims.

The passing on of productivity gains to the community through lower prices is likely to have its own distributional effects. These warrant more detailed examination, but there is reason to believe that they would be beneficial. Previous research by the Industry Commission into the effects of price changes for some utility services has revealed that even where the narrowing of cross-subsidies had seen prices to households rise, when the indirect effects through lower business costs were accounted for, most households benefited overall, including those on lower incomes (IC 1996a).

Regional impacts

The regional distribution of gains and losses from reform has been of particular interest in recent years, with many country people attributing the declines in population, services and incomes to NCP. The Productivity Commission's public inquiry on this matter found that those perceptions were generally misplaced (PC 1999b). The major drivers of the fortunes of rural and regional Australia remain ongoing technological advances and intensifying competition on export markets, which have relentlessly pushed down rural terms of trade and made farming a much less people-intensive activity.

Many pro-competitive reforms have *helped* rural industries cope with these external pressures, by reducing the costs of major inputs such as energy, rail, transport and communications.

Following widespread public consultation, information gathering and analysis, the Commission concluded that country Australia as a whole would benefit from NCP. It also found that there was likely to be more variation in the incidence of benefits and costs among regions than among more diversified urban centres. Nevertheless, economic modelling suggested that only one of 57 regions modelled would not show an output gain from NCP. In the majority of regions, employment was estimated either to rise as a result of NCP, or to decline by an amount that could be absorbed by less than one year of recent employment growth (PC 1999b).

Of course, such modelling is only indicative and cannot capture all the impacts within particular communities or over time. Nevertheless, it supports other information and analysis in suggesting that NCP will deliver benefits to most Australians.

‘Strategic’ considerations in NCP

The empirical story lends support to the presumption in favour of competition that governments brought to the design of the NCP. Placing the onus on those defending anticompetitive arrangements might also be seen as having a strategic function. By requiring those who benefit from such restrictions — and thus typically have more incentive to see them retained — to address the wider community effects, it can act as a counterweight to what may otherwise be lop-sided political pressure to ignore the less readily identifiable costs. In other words, the NCP obliges those who have the most interest in making a case on such matters, to make the right sort of case. Moreover, through the device of the competition payments from the Australian Government, it creates a fiscal incentive for governments to resist political pressure for restrictive arrangements when such a case has not been made.

NCP is not ‘open slather’

Governments recognised, as did the Hilmer Committee, that there are circumstances in which restraints on competition can be justified from a community-wide perspective. Indeed, there is really no such thing as completely unfettered competition in any area of economic life. As on the sports field, market competition occurs within a framework of rules, obligations and rights which constrain the behaviour of the players. To some extent, the question is really about the nature and degree of any constraints and how they affect performance. (For example we would not accept rules in sport that kept aspiring champions out of the game.)

In some situations, competition may need to be more ‘fettered’ than in others, to address social objectives such as equity of access or quality standards, or to overcome market failures, including environmental externalities and information asymmetries. But restricting the potential entry of (qualified) players will rarely be the best way of meeting such concerns. Indeed, in the case of natural monopoly, government has regulated to ensure that effective competition can occur at all: as in the national regime for third party access to essential infrastructure. NCP needs to be seen in conjunction with other policy measures that are likely to be able to address environmental or social concerns more directly and cost-effectively.

In other words, in implementing national competition policy, the underlying goal is to achieve *appropriate* regulation of market conditions rather than just *de*regulation.

To achieve this, it is important that each case be assessed according to its particular characteristics and market circumstances. And, regardless of where the onus is placed, it is essential that the costs and benefits of different regulatory options are given adequate consideration.

In principle, the NCP makes abundant allowance for this. Firstly, Clause 1(3) provides for a range of economic and social matters to be considered in weighing up the benefits and costs of reforms involving the structure of public monopolies, competitive neutrality, and reviews of legislation (existing and prospective) with anticompetitive effects.

Secondly, the decision making framework under the NCP recognises that such a weighing up ultimately requires political judgement. However, it also recognises that to be well informed, such judgement needs to be underpinned by impartial and transparent review processes, in which affected interests can have their say, and in which information relevant to the political tradeoffs can be effectively brought to bear.

Misunderstandings and misuse of NCP

In practice, however, the application of the public interest framework has encountered difficulties. A number of these became evident to the Commission in its inquiry into the impacts of NCP on rural and regional Australia (PC 1999b). Some of them involve misunderstandings about NCP processes, others are more to do with their implementation.

The most basic difficulty has been lack of knowledge about the public interest provisions themselves. This was particularly evident within local government in regional Australia. For example, the very first submission to the Commission's inquiry, from the Shire of Jerramungup (1998, p. 3), contained the following (incorrect) statement:

> Competitive Neutrality does not accept the government's obligations to provide universal access to essential services and provide certain customer service obligations on the basis of equity.

It would appear that NCP's bad name in rural areas has at least in part been acquired through its inappropriate application by local government — sometimes at the instigation of a state government — including through it being wrongly invoked to pursue cost-cutting budgetary objectives.

Some participants argued that public interest matters were being ignored in the Victorian Government's requirements for compulsory competitive tendering by local councils and for commercialisation of local government services in other jurisdictions. In principle, competitive tendering is not required under the NCP, although it may be used as a way of implementing competitive neutrality. Even so, it allows the wider effects on the local community to be taken into account. The Commission learnt of a number of instances of local governments making decisions not to contract out on that basis — trading off the local employment, skill development or other perceived benefits, against higher charges for ratepayers.

Nevertheless, there does seem to have been considerable confusion about the nature of the public interest test and how to apply it. At face value, this is difficult to reconcile, since all the test is really asking is that governments justify any anticompetitive arrangements by demonstrating that they deliver net benefits to the community. It would be an indictment of our policy making or regulatory institutions if they found this an entirely novel notion.

Clause 1(3) contains a (non-exhaustive) list of the sorts of economic, social and environmental factors that need to be considered in making a net benefit judgement. They are not unfamiliar or intrinsically difficult to understand. But they can pull in different directions, and not all will be relevant to every case.

Assessing the tradeoffs

The real difficulty therefore is in how the tradeoffs among any competing effects should be made. The National Competition Council (NCC) has noted that in principle 'all public interest considerations intrinsically carry equal weight' (NCC 1996, 1999). As the Commission has previously observed, this could be misconstrued as them having equal importance in all cases. It may be better to describe the criteria as having equal *status*, which is consistent with a low or high weighting being given to different criteria according to the degree of relevance.

If all the factors were amenable to quantification and valuation, then the various benefits and costs could simply be added up. But even in that situation weighting issues would arise. For example, should a dollar lost by a poor household as a result of a policy change be assigned equal weight to a dollar correspondingly gained by a wealthy household? What if all the costs of a reform that would boost national income are likely to be concentrated on an already struggling region? Answering such questions is clearly not straightforward.

In practice, some factors bearing on the public interest — especially social and environmental impacts — cannot be easily quantified or valued. This brings the danger that only the measurable will be influential in decision making.

For this reason it is important to do more to evaluate social and environmental impacts in quantitative as well as qualitative terms. For example, in its gambling inquiry, the Commission developed an analytical framework which integrated both the social and economic impacts of gambling. Using survey information and other sources, the Commission was able to impute values for various impacts on families that had previously not loomed large in policy decisions, but which turned out to be substantial (PC 1999a).

However, attempts to level the analytical playing field can only go so far. In the gambling report, we were obliged to give a range of high and low estimates for most of the social impacts, which reduced their policy usefulness. And in a report that we did for the ACT Government on battery hen regulation, we provided estimates of the costs of banning battery production, but left it to the Government and ultimately the Assembly to judge whether the community placed a sufficient value on the identified impacts on hen welfare to justify incurring the costs (PC 1998b).

Thus, while it is important that a thorough assessment be conducted of the various community impacts of retaining or removing restrictions on competition, and while there are good reasons for not leaving such a task entirely to the political process, ultimately a judgement call must be made that requires political accountability.

The Commission has previously recommended, in common with the Hawker Parliamentary Committee, that governments produce public guidelines on the nature of the public interest test and how it should be applied. However, as Mulgan (2000, p. 9) has pointed out, this should not be taken to mean that:

> … with the right principles and the right information correctly weighed, experts will be able to come up with robust and uncontestable assessments of the public interest … such assessments are inherently contestable and should be looked on as political rather than technical judgements.

In this light, it is notable that nearly all of the Hawker Committee's recommendations concerning the application of the public interest test relate to questions of procedure and institutional design, rather than how elements of the test should be interpreted or any tradeoffs resolved. (The main exception is its recognition of the related point that qualitative considerations can be as important to effective analysis as the quantitative.) (House of Representatives Standing Committee on Financial Institutions and Public Administration 1997)

That the task of interpreting the public interest is inherently subjective and political is illustrated by McEwin's calculation, in a search of 1167 Commonwealth Acts and 566 Regulations, that the term 'public interest' was mentioned 386 times without once being defined (McEwin 1995).

Are politicians in control?

There is a widespread perception that, in practice, the NCP has allowed political judgements about public interest matters to be circumvented or undermined.

At the time of the Commission's inquiry, for example, some state governments were claiming loss of sovereignty under the NCP — a proposition which, as a matter of principle, would seem inconsistent with them having taken the (sovereign) decision to become signatories in the first place.

In practice, governments have given themselves considerable latitude and discretion under the NCP. Among other things, governments are free to implement their own approaches to prices oversight, competitive neutrality and structural reform for government enterprises; they can determine how competition principles will be applied to local government; they can institute their own (effective) regimes for access to bottleneck infrastructure; they can continue to deliver community service obligations; and they can institute their own reviews of legislation that restricts competition.

The fact that each jurisdiction has considerable control over how NCP is implemented has been freely acknowledged by some states. For example, in its submission to the Commission's inquiry, the Tasmanian Government (1999, p. 6) observed:

> … the NCP agreements do not, in general, compel governments to introduce specific reforms. For example, they do not require privatisation of government business or contracting out and do not expect that deregulation will be the outcome of an independent review. In fact, NCP provides government with flexibility to deal with circumstances where competition might be inconsistent with particular objectives that are valued by the community. For example, under NCP, there is no restriction on governments subsidising social services to rural and regional Australia.

The Western Australian Treasury (1998, p. 4) said that:

> The impacts of NCP are to a large extent within the hands of Western Australians, since there is considerable flexibility in interpreting the agreements and scope to consider more than purely economic or commercial considerations in choosing to what extent and by what mechanisms to implement the reforms.

This does not get around the need, of course, for each government under the NCP to justify retaining any anticompetitive arrangements, or failing to implement agreed reforms in such sectors as energy and water. And, under the Competition Principles Agreement, if a government is found wanting in these respects, it risks forfeiting competition payments from the Australian Government — which after all are a *dividend* contingent on projected revenue gains flowing from the reforms, not an *entitlement*.

While the sums involved in the competition payments are not large by state-budget standards, they do assume significance at the margin. The prospect that the Australian Government may withhold them, on advice from the NCC, may well be the true source of concern about loss of sovereignty and helps explain the critical attention directed at the Council and its approach.

This is the flip side of the more constructive political economy function of those fiscal incentives, noted previously. When political pressures are considered too strong to resist, the potential to withhold payments can be portrayed as inappropriate external interference in a jurisdiction's own policy development processes.

The NCC's role

In its submission to the Commission's inquiry, the South Australian Government (1998, p. 15) alleged:

> … the NCC brings its own ideological position to consideration of policy outcomes and should not seek to dictate those outcomes to Governments, particularly in legislation review where the final decisions on reform outcomes must rest with elected Government.

Similar concerns were raised by the Tasmanian and Queensland Governments, as well as about differences in interpretation of NCP agreements between the NCC and state governments.

While the Commission was not in a position to evaluate all such claims in its inquiry, it considered that the available evidence, particularly for legislation reviews, did not support the contention that the NCC dictated outcomes. It is after all an *advisory* body and, unlike the ACCC, it cannot take regulatory action based on its own interpretation of what is in the public interest. While the NCC clearly does seek to satisfy itself about the integrity of NCP processes, that is what it is required to do.

The Commission raised questions, however, about whether the integrity of the NCC's own role as an impartial adviser had the potential to be compromised by its perceived advocacy activities, including the conducting of legislation reviews (a function that has subsequently been withdrawn). Since then, the NCC has issued a number of pamphlets targeted at key areas requiring government decisions (such as taxi regulations and the regulation of the medical and legal professions). These took a firm policy line and while they clearly sought to generate debate, they may have served to reinforce earlier concerns about the potential for conflicting roles.

However, it should be noted that, in the absence of greater involvement by governments in selling competition reforms to their electorates, the NCC has had to do more in this area than might otherwise have been necessary (and governments may well have been happy for it to take the lead.)

It is also relevant that while the NCC formally has only an advisory role, as an independent national body its advice clearly carries considerable weight, particularly at the Commonwealth level. Thus, although its advice has on occasion been rejected by state Ministers (on infrastructural access matters), it has always been accepted by the Australian Government. (This includes advice to the Industry Minister on coverage of the Eastern Gas Pipeline under the National Access Regime — a decision which was subsequently overturned on appeal to the Australian Competition Tribunal.)

In its report, the Commission considered that the way in which the NCC and the states 'worked together and/or communicated' could benefit from a re-examination in the COAG review of the NCP. In the event, COAG agreed at its November 2000 meeting on a number of changes, including enhancing the opportunity for states to make their case, where the NCC recommends a penalty, before the Australian Government's final decision on competition payments.

With respect to Legislation Reviews, the following (obscurely worded) amendment was made to the Competition Principles Agreement to guide the NCC's assessment of compliance.

> In assessing whether the threshold requirement of Clause 5 has been achieved, the NCC should consider whether the conclusion reached in the report is within a range of outcomes that could reasonably be reached based on the information available to a properly constituted review process. Within the range of outcomes that could reasonably be reached, it is a matter for Government to determine what policy is in the public interest. (COAG 2000, Attachment B)

This appears to suggest that a government need not comply with the recommendation of a review, provided that its decision is within a range of outcomes that a 'properly constituted review' might consider reasonable. On this point, the President of the NCC has recently stated:

> I would take issue with suggestions that the November amendments give the States more autonomy in determining what policies are in the public interest. The amendments show that the States are prepared to set rigorous disciplines on themselves in applying the public interest test. (Samuel 2001, p. 6)

One important discipline is the requirement for governments to provide more transparent reasons for any decisions to retain any anticompetitive arrangements. Governments agreed that they:

> … should document the public interest reasons supporting a decision or assessment and make them available to interested parties and the public. (COAG 2000, Attachment B)

This would seem fundamental to the integrity of the process. Among other examples, such an approach would have assisted public understanding of the Australian Government's rejection of the Irving Committee's (relatively mild) recommendations to partially free up the single export desk for wheat (Irving, Arney and Lindner, 2000).

Well-informed political decisions

There also seems to be general acceptance that a 'properly constituted review process' is the key to achieving appropriate outcomes. This applies to most elements of the NCP, but it is particularly relevant to assessments under the Legislation Review Program and for new regulations, including national standard setting by Ministerial Councils.

Processes which systematically review the objectives and rationales for regulatory arrangements, and the relative merits of different options for meeting them, are critical to informed political decision making. They can also play a pivotal role in promoting public awareness of the tradeoffs in different policy approaches, thereby facilitating broader acceptance of change. Reforms to longstanding arrangements are always politically difficult, particularly those that involve losses by particular groups. Bringing the wider community along — at least some of the way — is often the key to achieving durable reform. For this reason, as well as for its informational value, public consultation needs to be a central feature of any review process.

For similar reasons, it is also important that placing the onus of proof on defenders of anticompetitive arrangements does not preclude an adequate case being made for the *removal* of such arrangements. In its own assessments, the NCC appears to permit 'short cuts' to be taken when jurisdictions are removing restrictions (NCC 2001, pp. 5.8–5.9). While this clearly accords with the underlying logic of the NCP, to the extent that governments do so, it could add to perceptions that the process is a loaded one, in which the interests of parties benefiting from existing arrangements cannot get a fair hearing.

By the same token, it is important that review processes are conducted at arm's length from those who may be affected by regulation, as well as those responsible for administering it. Input from all interests is important to an understanding of the issues, but that input should be transparently offered in submissions or public evidence, not by compromising the capacity of a review group to make (and be seen to make) an impartial assessment.

That said, the time and resource requirements of best-practice reviews can be substantial. Given the demanding schedule of the Legislation Review Program alone — involving some 1700 reviews across all jurisdictions, within an initial timeframe of just five years — it was inevitable that some corners would be cut. That may not matter much for insignificant or uncontentious matters, but many restrictions on competition are almost by definition not of that character. Poorly structured or hurried reviews neither assist the public image of NCP, nor enhance the prospects of achieving beneficial change.

It might be noted, as a footnote to this discussion, that the scheduled five-year review of the NCP was essentially conducted by governments as an 'in-house' exercise, although explicitly drawing on the Commission's public inquiry on regional aspects, as well as two Parliamentary inquiries.

The fact that governments have once again signed off on what is only a slightly modified NCP is nevertheless of great significance. COAG, in its own words,

> ... affirmed the importance of the National Competition Policy in sustaining the competitiveness and flexibility of the Australian economy and contributing to higher standards of living (COAG 2000, p. 4).

As a renewed commitment in support of competition, made at the highest political level in Australia, this should itself be seen as a clear expression of the public interest.

Competition is the best price regulator*

A few weeks after the introduction of the GST, an article in the *Australian Financial Review* observed that the Australian Competition and Consumer Commission (ACCC) had found 'no widespread GST ripoffs'. It quoted the ACCC's designated GST Commissioner as saying, 'we are not seeing any systematic price exploitation'. But should we have expected any? Was there ever a Medusa for a regulatory Perseus to slay?

The short answer is no. The prospect today of systematic exploitation of consumers by Australian businesses in such circumstances is pretty small. As the Government itself recognised in introducing the GST-related amendments to the Trade Practices Act:

> Competitive pressures that already exist in the economy should largely ensure that the benefits of reductions in tax rates are passed on to consumers in the form of lower prices.

However, the Government's view that those provisions were needed to deal with the *exceptions* ('those instances where price exploitation could occur') did not get enough attention. It soon got swamped by the strong message that regulatory vigilance on a large scale was needed to avoid opportunistic exploitation of the Australian public by businesses throughout the country.

I am not suggesting that there was no need for government action to ensure the smooth implementation of the GST. Clearly there was considerable scope for confusion both within the business sector and the wider community. Effective information dissemination was central to minimising errors which could have significantly disadvantaged some people — and, in the politically charged atmosphere of the time, conditioned community reaction to the new tax system itself. The special anti-price exploitation legislation may also have provided necessary reassurance to a public rattled by media stories equating the GST's introduction to Armageddon.

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* Presentation to the Committee for Economic Development of Australia, Perth, 21 November 2000. (Co-authored with Lisa Gropp.)

That said, I would suggest that the economic need for such regulation was limited at best. For the most part, the forces of competition would have ensured that price adjustments were in keeping with net tax effects. And arguably that is the way it turned out. My concern is that because this side of the story hasn't had much airplay, the public is likely to have drawn the opposite conclusion. A legacy of the GST's implementation could well be heightened community suspicion about markets and a predisposition towards stronger price regulation — at the very time when these are least warranted. This could in turn make it more difficult to achieve reforms to existing mechanisms for the regulatory oversight of prices, a number of which are currently the subject of Productivity Commission reviews. It is important therefore that we do not lose sight of the considerable benefits that have flowed from past reforms.

I would like to use the opportunity of this address to CEDA to put the pricing benefits of those reforms back into focus. I will also outline those circumstances in which pricing does raise legitimate policy issues and highlight some of the challenges for government regulation.

Transformation of the Australian economy

There is currently an active public debate about whether Australia has claims to being a technologically 'new economy' like the United States. Some are finding this a convenient opportunity to freshen up old arguments for protecting domestic production, when it is where and how well new technology is *used* which is more important to economic performance (as Western Australia's mining industry attests).

But there is another important respect in which the Australian economy truly deserves the label 'new': and that is in its openness to competition for the benefit of Australian consumers and efficient businesses alike.

The *old* Australian economy was more directed at protecting inefficient producers from competition. It was regulated and organised in such a way as to foster market power. In a fundamental sense, policy was premised on the exploitation of consumers and exporters for the benefit of selected firms and industries serving the local market.

Those inward-looking policies included import licensing and tariffs made-to-measure to protect Australian manufacturing and some agricultural industries. They were also used for many years to bolster an exchange rate firmly fixed to the British pound. In addition, there were entrenched regulatory restrictions on domestic competition (for example, the two-airline policy) and government monopolies in key utilities.

Their legacy included industries that were inefficient and fragmented. Export industries exposed to increasingly competitive world markets (especially after the loss of UK agricultural markets in the early 1970s) bore the burden of import protection in the form of higher costs. (This particularly disadvantaged Western Australia compared to those eastern states where manufacturing loomed larger.) By the 1970s and 1980s, growth in real income per person in Australia had fallen to about 1.4 per cent per year; and growth in multifactor productivity to about 0.6 per cent per year.

Although there were some preliminary skirmishes in the 1970s, the dismantling of Fortress Australia really began with initiatives by the incoming Labor Government in 1983. In that year, the dollar was floated and exchange controls removed. From 1984, foreign investment restrictions, which had escalated over the 1970s, were progressively eased.

A lower exchange rate in turn facilitated protection reform. This progressed from painfully slow industry-by-industry decision making (following specific reviews by the Industry Assistance Commission) to successive waves of general reductions in tariffs, combined with the dismantling of quantitative restrictions. It is salutary to recall, given the current anxiety in some quarters about reducing the general 5 per cent tariffs, that in the early 1980s, average effective assistance to manufacturing was five times what it is today.

As a consequence of this liberalisation, the Australian economy is now far more integrated into world markets than it was just 10 years ago. The value of foreign trade (exports plus imports) expressed as a percentage of GDP today exceeds 40 per cent; 10 years ago the figure was around 30 per cent.

Importantly, exposure to international competition in goods markets also exposed shortcomings in key input and factor markets (especially public utilities and the labour market) and provided the impetus for upstream reforms. Trade liberalisation turned out to be a stalking horse of wider domestic competition reform.

Thus, by the end of the 1980s, the focus had shifted to opening to competition key service sectors and Government Business Enterprises — including in telecommunications, domestic aviation, banking and finance and public utilities. The Hilmer report in 1993 spurred the adoption by all levels of government of a National Competition Policy, implementation of which has resulted in the introduction of competition in markets hitherto dominated by government-owned legislated monopolies (Independent Committee of Inquiry into Competition Policy in Australia1993).

Over the same period, industrial relations reforms have progressively shifted the focus away from a centralised to a decentralised system of fixing wages and conditions, with greater emphasis on negotiation at the enterprise level.

While the commitment to reform has not always been consistent, and the process is by no means complete, the upshot of all this has been a far more dynamic, flexible and competitive economy, which has delivered real efficiency gains and greater market discipline on pricing by businesses and government enterprises.

Reform has yielded significant benefits

It is therefore no coincidence that throughout the 1990s, Australia experienced historically high productivity growth. Multifactor productivity growth in the market sector was of the order of 1.5 per cent per year, double the average growth in the preceding decade and a half. This sustained rise cannot be explained simply by normal business cycle effects or developments in technology. Output per hour worked is estimated to be around 15 per cent higher today than it would have been if Australia had continued on its historical growth path. Put another way, the growth that would have taken 13 years on the old path has been achieved in just six years.

Incomes and jobs have expanded

This surge in productivity growth has in turn been the major contributor to faster growth in average incomes in the 1990s. GDP per person grew by 2.5 per cent per year over the 1990s compared with 1.5 per cent over the 1970s and 1980s.

Our most recent published research reveals that the income gains appear to have been shared fairly evenly between labour and capital, with higher productivity growth sustaining increases in real wages as well as profitability. (In other words, contrary to some preconceptions, businesses have clearly not pocketed all the gains from efficiency improvements.) Even in the presence of higher real wages, productivity growth was sufficient to allow employment to increase and the unemployment rate to decrease. This has provided a major boost in income and opportunity for many people on lower incomes.

Prices have been 'disciplined'

The increased competition that has come with these reforms has also helped to ensure that the productivity improvements have benefited consumers, through consequent reductions in prices (and improvements in quality). For example:

- households and industrial users have benefited from declines in real electricity prices in the 1990s averaging around 16 per cent
- telephone calls were more than 20 per cent cheaper in real terms in 1997 than in 1992
- national rail freight rates were 16 per cent lower
- the real price of posting a standard letter fell by around 10 per cent.

Again, contrary to popular belief, rural and regional Australia have shared in the benefits of the new competitive economy, not least through access to lower cost inputs that have assisted the competitiveness of rural exports in world markets.

Increased exposure to world markets and greater domestic competition also appear to have facilitated lower inflation, breaking the long-standing link between protection and institutionalised wage increases. While monetary policy ultimately controls inflation, it is now under far less pressure to respond to and accommodate domestic cost pressures. Though nominal wages are growing, they are broadly tracking labour productivity growth. Lower, more stable inflation, in turn, provides a more attractive investment climate with less of the price 'noise' which can blur signals about relative prospective rates of return from different investments — especially longer-term ventures.

Clearer price signals, combined with more flexibility for enterprises to respond, appear to have facilitated adjustment of the Australian economy to the shocks of the Asian financial crisis. For example, with exports to South-East Asia stagnant, Australia's exports to the European Union increased by 25 per cent in 1997-98 compared with the previous year.

It will be interesting to see how rapidly Australian exporters now respond to their improved competitiveness *vis-à-vis* the United States (provided, of course, that country does not respond to an inevitably widening trade gap by increasing its trade barriers).

The price disciplining effects of heightened competition are further illustrated by the muted initial response of domestic prices to the inflationary pressures resulting from rising oil prices and the fall in the Australian dollar. Analysis of the most recent producer price data has revealed that:

> At each stage of the production chain [firms] were absorbing cost increases. The result was consistent with a high degree of competitive pressure, and indicated that the flow-through to retail prices might be less than previously feared. (*Australian Financial Review,* 24 October 2000, p. 3)

This is consistent with the results of post-GST price surveys, which reveal that 60 per cent of the prices either rose by less, or fell by more, than had been anticipated by the ACCC.

When *is* pricing a policy problem?

Clearly the microeconomic reforms of the past decade and a half have enabled the market to become a pretty effective price regulator in the public interest.

The main focus for policy concern about pricing behaviour today, should be those firms and industries that for some reason are able to retain sufficient market power to keep their prices well above their costs.

The key to market power is how much business a firm would lose if it increased its prices. Returning to the GST, many firms were already clearly concerned that the new tax would depress demand for their goods and services, without courting further disadvantage by raising their prices more than their competitors. And for those looking forward to gaining more business from a net reduction in their taxes, not passing on the tax reduction in lower prices would have compromised this.

Ross Gittins, writing in the *Sydney Morning Herald*, has argued that one reason why this may not have held, was the consumer's relative lack of information about the incidence of the GST (the problem of 'asymmetric information') which might make them appear 'ripe for the picking' (Gittins 2000). However, the nice thing about competitive markets is that their effectiveness in disciplining prices does not depend on consumers knowing how prices are *calculated;* only how they *compare* among alternative suppliers.

No doubt, in the very short term, and especially for low-cost items, consumers may not bother looking around much. But, in time, they could be expected to find out if their preferred outlet has been charging more than elsewhere (even if they weren't sure why) and to act accordingly. Most suppliers would anticipate and wish to avert such loss of business. The risk to a firm's reputation of consumers actually concluding that they had been *had* would only reinforce this.

This process depends of course on there being adequate alternative sources of supply of substitute goods and services. Analysis of this question is central to the case for government intervention.

Market shares and market concentration are long-standing indicators of market power. But taken on their own they can be misleading. For example, in markets that face (arms-length) import competition, even a single local supplier may have no real market power. These days there are not many manufacturing industries for which import penetration is below 5 per cent of the market. And once imports have a toehold, they generally can be increased quickly to displace more highly-priced domestic goods.

But even where imports are not a direct threat, as in many service industries, there can be strong competitive pressures in concentrated markets. Rivalry within duopoly market structures is commonplace. For example, competition between Australia's two airlines after deregulation removed price controls and entry restrictions, led to a 25 per cent drop in airfares. The entry of Optus accelerated the rate of decline in long-distance telephone charges on top of technological gains. The dominance of Coles and Woolworths has seen no diminution of price competition in food retailing (as smaller outlets through the country have testified). These outcomes are consistent with some US research into highly concentrated markets where the number of firms has increased, which revealed that most of the consequent price reductions came from the entry of the second or third firms, with little further reductions from additional entrants.

Prices in some concentrated industries in Australia are of perennial concern, yet there is little evidence of persistent abuse of market power. For example, a number of reviews of the petroleum industry by the ACCC and the Productivity Commission have found little evidence of profiteering. The main problem in this industry is episodes of cartel pricing by overseas oil producers. In US dollar terms, crude prices have risen almost three-fold in the past couple of years. Add to that the effects of the depreciation of the Australian dollar and most of the recent price rises at the petrol pump are accounted for.

Ultimately, persistent market power necessitates a constraint on actual or potential competition. Firms strive constantly to develop market advantages in order to earn higher profits. But unless they are protected from competitors, they will generally be forced to charge competitive prices. For it to be sustained, market power requires not only a large market share and no major competitors, but also the presence of significant barriers to entry.

In the old Australian economy, barriers to entry were pervasive and generally introduced by governments themselves. They included regulatory barriers to foreign trade and investment, as well as sanctioned and protected domestic monopolies such as public utilities. Many, but not all, of these have been removed.

Apart from such regulatory impediments — which should be tackled directly — the only barriers to entry that should matter these days are those that involve a sustainable cost penalty on new entrants relative to established firms. Some features of markets which dissuade potential competitors are not barriers in this sense, having more to do with the efficiency or superior marketing performance or reputation of the incumbent. The main barriers of policy relevance involve major scale or network economies and sunk costs, such that entry becomes too costly or risky for efficient potential rivals even when the incumbent's prices are generating above normal profits.

Markets that are highly concentrated, with little or no import potential and significant (non-regulatory) barriers to entry are not widespread in Australia's new economy. That also means that there aren't too many markets where governments need to intervene to address the consequences of market power.

The Commission has previously emphasised the importance of ensuring that, in seeking to prevent mergers that 'substantially lessen competition' under Australia's trade practices laws, markets are not too narrowly defined, or market shares and concentration ratios set too low. Otherwise there is a danger of inhibiting efficiency enhancing mergers, including those needed to generate sufficient scale to compete effectively in global markets.

It has been argued that prevention of market power through merger regulation does have an important role to play, because government lacks effective price control powers once market power develops. Another way of looking at this is that the potential for costs from merger regulation, while significant, may be smaller than those associated with price regulation.

Perils of price regulation

Prices perform a number of functions critical to the effective operation of any economy. In the shorter term, prices signal market changes to consumers and producers and encourage responses. Prices ration supply amongst consumers according to willingness to pay and indicate the opportunity cost of resources used in production of goods and services. If prices are artificially constrained, they may be prevented from performing these functions efficiently. Artificially low prices of goods and services can be at least as costly to society as excessively high prices.

You might recall (not so long ago) the hurdles that potential borrowers had to jump to obtain mortgage finance when ceilings applied to home-loan interest rates. As well as being highly inefficient in allocating available funds, the interest-rate ceiling did not appear to be superior in terms of 'fairness'. Potential borrowers had to build up savings and demonstrate bank loyalty. Single men found it difficult to get finance and single women were virtually excluded from the market.

If markets are to clear, prices must be allowed to adjust both upwards and downwards to changes in input costs, tastes, technology and other market influences. Usually this adjustment will take time (depending on the nature of the industry) during which above or below normal profits might emerge. These apparently aberrant prices and returns are an essential but temporary part of the market dynamic.

In a reasonably competitive market, a rise in a price above long-run cost (including a 'normal' profit) will signal the opportunity for profitable investment. This is the key mechanism for attracting increased supply which, in turn, competes away any short-term 'rents'. If the signal — that is, the increase in price and profitability — is repressed or obscured, so too is the desirable investment and production.

The informational difficulties facing regulators attempting to second-guess efficient market prices are legion. To be able to set efficient prices in circumstances of changing market conditions, a regulator essentially needs to know everything that the managers of regulated firms know. And of course those managers have every incentive to ensure that that doesn't happen.

The critical importance of prices to decision making by producers and consumers, together with the informational and other constraints on regulators, mean that price oversight must always face the real risk of distorting investment and reducing incentives to be efficient and innovative, as well as placing a compliance burden on the firms subject to regulatory oversight. In other words, against the possible consequences of market failure need to be set the possible consequences of government regulatory failure.

Thus the Commission has concluded, in its current review of the Prices Surveillance Act (PSA), that price oversight should be treated as an instrument of last resort. It should be confined to those situations of substantial market power where there are no direct pro-competitive alternatives for dealing with it, and where the benefits are likely to exceed the costs (PC 2001c).

For example, there are legitimate concerns about the potential for inefficient pricing arising from natural monopoly. But these and other areas of monopoly infrastructure are also covered by alternative instruments of prices oversight outside the PSA under industry-specific regulatory regimes (such as for water, rail, and telecommunications) and the general provisions of the Trade Practices Act relating to access to essential or bottleneck facilities (Part IIIA).

The National Access Regime

The National Access Regime had its origins in the Hilmer review of National Competition Policy. It was designed to ensure that owners of major bottleneck facilities — such as some gas pipelines, rail tracks or electricity grids — could not deny access to potential competitors in upstream or downstream markets, leading to excessive prices to final users or consumers.

Hilmer's main concern was with vertically integrated facilities, which can have a clear incentive to deny access to a competitor. However, the enacted national regime also covers owners of separate essential facilities (like airports and some rail lines) who have every incentive to allow access to users (who do not compete with them), but who are potentially in a position to set monopoly prices.

In both cases, it seems clear that the primary concern is the prices and conditions of access, rather than access itself. And, while the regime allows the parties to negotiate their own arrangements — and thus would appear more light handed than explicit price regulation — the arbitration role of the regulator stands behind those negotiations, and over time might be expected increasingly to condition the outcomes.

As in the case of the PSA, a threshold question in reviewing these regulations is whether the problem justifies the solution.

The concern is that denial of access, or its excessive pricing, will reduce competition to the detriment of consumers or users of the final service — through high prices or reduced quality or choice. Working out how detrimental this might be to efficiency, however, is not straightforward. The answer may well depend on the particular circumstances of each case — which leads to questions about the pros and cons of general versus industry-specific approaches to such regulation.

Against the potential gains from lower-cost or more abundant services in the shorter term, access regulation needs to consider the potential impacts on investment in infrastructure and thus the provision of such essential services in the long term.

The challenge, in common with other more direct forms of price oversight, is to constrain the scope for inefficient monopoly behaviour without deterring or delaying efficient investment. Questions have been raised with the Commission as to whether the current National Access Regime (and the regulatory regimes for specific industries) adequately meet this objective.

Restrictions on competition remain

These issues are complex and contentious and will benefit from a thorough public examination. However, the fact that they are confined to specific circumstances — largely to do with natural monopoly — underlines my broader message that in most markets, pricing raises no policy concerns.

That is not to imply that there is nothing more for governments to do in this respect. Indeed, there are several industries and activities in the economy where prices remain too high as a consequence of government actions.

- The textile, clothing and footwear and automotive sectors continue to be protected from international competition by tariff rates several times greater than those for other manufacturing industries. The resulting higher prices not only hit consumers, they can also act as a tax on many producers using these goods.
- Monopoly marketing of many agricultural commodities (including wheat and sugar) continues despite the cost disadvantage borne by domestic users (including food processors) who pay higher than world prices for key inputs. In its recent draft report, the Independent Committee assessing the wheat single desk against National Competition Policy criteria found that the benefits did not outweigh the costs (a proposition which many Western Australian wheat growers would support) (Irving, Arney and Lindner 2000).
- Many professions are protected by long-standing licensing and registration requirements, which may have laudable objectives, but whose benefits and costs for today's community have not been adequately assessed. In its recently completed review of the architectural profession, the Commission found that the current restrictions on use of the title 'architect' impose costs on the community, for little or no community benefit. In that case the costs were found to be relatively small; in other cases they may be large (PC 2000c).

By no means is this list exhaustive. For example, during the 2000 World Economic Forum conference in Melbourne, the American economic commentator David Hale suggested that regulatory constraints on datacasting and other new communications technologies in Australia might be of concern to potential investors and currency markets. This echoed serious concerns about government constraints on competition expressed by the Productivity Commission, in its recent inquiry into the Australian broadcasting industry (PC 2000a).

Bottom line

In short, work remains to be done for any government concerned about prices. But that work is now confined to a number of clearly identifiable circumstances where competitive forces cannot do the job. The microeconomic reforms of the past decade and a half have ensured that the potential for widespread ‘ripoffs’ of Australian consumers by Australian businesses is a thing of the past. It is ironic that this important message should have become a casualty, rather than a key feature, of the smooth implementation of the GST.

Inter-state bidding wars: calling a truce*

The Adelaide Grand Prix of 1994 is remembered mainly for the controversy that erupted on lap 35. Michael Schumacher, his car dying after clipping a wall, crashed into Damon Hill, taking both drivers out of the race and handing the German his first World Driver's Championship. But cut-throat competition was not confined to the track. Behind the scenes the Victorian Government had been working assiduously to secure the future rights to host Formula One in Australia, at the expense of its neighbour. Victoria's bid prevailed, and the rest is history. What is less clear, however, is precisely who won from this contest — apart from F1 Chief Bernie Ecclestone.

I start with this story to illustrate an important and growing phenomenon in Australia — competition between state and territory governments in the form of financial inducements to attract major events and investment projects and, as they see it, income and jobs to their state. Whether it comes to making them or racing them, Australian governments find it hard to resist the allure of the automobile. But budgetary competition between the states and territories to attract investment projects is by no means limited to the 'horseless carriage'. Other high profile examples include food processing, pharmaceuticals and information technology plants, Australian head offices for airlines and financial services firms, and many others.

State governments generally announce such deals with fanfare, talking up the projected benefits in terms of investment dollars committed, jobs to be created, and multiplied effects throughout the local economy. Where they provide inducements in the form of tax-breaks or tax-holidays, governments may also reassure the community that all they are surrendering is money that they would not have collected anyway. Hence, it is claimed, these deals represent a 'win' not only for the recipient enterprise, but also for the government, its taxpayers and the wider state economy.

* Address to the Committee for Economic Development of Australia, Brisbane, 6 November 2002. (Co-authored with Tom Nankivell.)

But the facts are that these sorts of deals are difficult to justify on economic grounds. Moreover, the processes for clinching them are even harder to justify against basic principles of good government.

In practice, it is difficult to assess the details of the claims made about particular assistance packages because governments generally keep the analysis and budgetary costs of the assistance to themselves. This raises its own problems in terms of transparency, accountability and due process. At the extreme, it opens the door to suspicions of nepotism or even corruption. More generally, when public scrutiny is hindered, there is more risk that an ethos of 'can do' managerialism will swamp more cool-headed *'should* we do?' decision making.

Indeed, on a number of occasions when the books have been opened up, it has turned out that the benefits had been significantly oversold, while the costs had been not only understated but often not understood.

For these and other reasons, the purported gains for the state are often illusory, and even when they are positive there will often be negative outcomes nationally. These conclusions may seem somewhat radical, given the spin that we are accustomed to hearing. But they are well supported by detailed research conducted not only by my own organisation and its predecessors, but also by state and territory Auditors-General and academic researchers in Australia and overseas.

State policies are important to industry development

It goes without saying that state and territory governments have a central role to play in the development of wealth-creating businesses and industries in Australia.

The states and territories plan most of the utilities, transport links and other physical infrastructure, which underpin economic activity. Often they operate these essential services, or have responsibility for regulating those that do. They also have responsibility for many areas of social and environmental regulation. They levy land taxes, payroll taxes and the like, which affect the viability of businesses. And less directly from a business perspective, but just as importantly for economic development, state governments are primarily responsible for the provision of health care, family and community services, primary and secondary education, and vocational training institutions.

These are all arenas in which state governments' decisions have implications — some immediate, some longer-term — for the attractiveness of their state as a place for doing business. They are also arenas in which 'competitive federalism' can operate to good effect. We know that such 'fundamentals' are important determinants of investment decisions worldwide.

Nonetheless, for many years, governments in Australia and overseas have commonly also provided assistance to encourage the creation or expansion of particular firms or industries. Getting accurate estimates of the value of such industry assistance is not easy. The Industry Commission made a comprehensive attempt back in 1996, in a major public inquiry (IC 1996d). The Productivity Commission's more recent research confirms that state and territory budgetary assistance to industry is substantial — totalling now some $3.3 billion annually — and it is growing steadily, being 20 per cent greater in real terms than it was in the mid-1990s. Most of this assistance is provided on an industry basis and is delivered under a wide range of programs administered by several government departments.

As well as these general industry-assistance programs, the states and territories also have a number of schemes from which firm- or project-specific assistance is drawn. Some states have also established specialist agencies to administer event-, project- and firm-specific assistance.

In their attempts to attract particular projects or investments, governments also provide a combination of investment 'facilitation' and 'promotion' services. There is also the coordination of different government agencies to reduce bureaucratic red-tape. These activities are less problematic than selective budgetary support, and are often beneficial.

Savvy spending or business welfare?

Why, in view of the high public demands for state spending on hospitals, schools, and community services — not to mention transport and other economic infrastructure — are state governments so involved in providing direct financial assistance to the business community? Governments obviously see a payoff in providing this assistance, even if only because other governments are doing it. But does it really provide economic benefits to the community, or is it just 'business welfare', as some commentators would have it?

There are of course sound economic rationales for some forms of industry assistance. For example, it is well established that (well-designed) government assistance to encourage more R&D can improve the performance of the economy. Other possible 'market failures' potentially warranting government support include information failures, labour training and mobility (although the most effective interventions do not necessarily involve financial assistance to firms). There can also be equity rationales for some funding of industry — adjustment assistance being one example. And some measures that have the effect of assisting particular industries might be intended to meet other non-economic objectives. Some funding of art and film production might fall into this category.

For much state assistance to industry, however, it is difficult to pin down a market failure, equity or specific social or cultural objective that could justify the funding. Certainly governments themselves do not normally articulate the objectives of the programs in such terms. Rather, the thinking underpinning the provision of assistance often appears more rudimentary — at its simplest: 'Investment is beneficial, so *subsiding* investment must also be beneficial'!

Tying down footloose capital?

A primary rationale given for corporate assistance is the perceived need to attract mobile capital, in competition with other jurisdictions. Proponents of such assistance assert that government inducements are necessary to 'tip the balance' — not just in relation to firms' locational choices within Australia, but also for firms that could locate their operations overseas. For example, the Queensland and Australian Governments, in offering a combined incentive package of $300 million for Comalco's alumina project at Gladstone, indicated that the company had been considering a rival site in Malaysia. Other countries typically offer financial inducements, it is observed, so why shouldn't we?

Apart from the (domestic) costs of such support, to which I'll come, a threshold issue is the extent to which financial assistance really *does* make a difference.

An extensive empirical literature indicates that the real drivers of firms' investment location decisions lie elsewhere. For example, a firm considering building an alumina plant in Malaysia or Australia will weigh-up many social, economic and political factors. These include transport and energy costs, infrastructure quality and reliability, regulatory requirements, workforce skills, proximity to key markets and, not least right now, political and social stability. These factors generally overshadow even general policy settings such as company tax rates, let alone specific government inducements. In a Commission survey of Australia's top 300 firms, a large majority considered commercial or market-related factors to be more important overall than government policies in their locational decisions (PC 2002c). Among government policies, the standout influence on decision making was corporate taxation. This highlights the importance of all governments focusing on the economic fundamentals.

It also underlines the strong possibility that the provision of investment incentives might have little influence on a firms' ultimate decision, wasting taxpayers money on firms who would have located in the jurisdiction without a subsidy. Government officials need detailed information to assess the merits of a project and to differentiate between the marginal investor and those who will invest anyway. Businesses have incentives to engage in strategic behaviour to secure the maximum incentives available — overstating both the benefits to the state and the level of assistance necessary to secure them. Government officials are generally at a disadvantage in such games.

As Australia's states and territories could be said to be broadly comparable in terms of the economic fundamentals, investment incentives offered by governments are more likely to 'tip the balance' for investment that is footloose *within* Australia. For example, while Richard Branson's decision to enter Australian skies was facilitated primarily by the Australian Government's relaxation of foreign investment restrictions in 1999, the inducements offered by different state governments may well have influenced his decision of where within Australia to headquarter Virgin Blue.

But this does not end the matter. A footloose firm need not stop being footloose simply because an initial inducement has been accepted. Once the inducement ends, the business again has the option of relocating, unless a further inducement is provided to remain. The trans-Australian travels of the Berri Fruit Juice company are testimony to this. Hence, the cost to the taxpayer can be ongoing, or the investment can be 'lost'. While some states may win, at least initially, such bidding wars can become negative-sum games, with Australia the poorer as a result.

Job creation?

A 'winning' government might well say that its responsibilities are to the residents of its own state or territory, not other jurisdictions. Taking this viewpoint at face value, how real are the benefits to the 'winning' state?

'Jobs, jobs, jobs' is the mantra. It is true of course that if state inducements succeed there will be employment associated with the new activity. But again, this is only the start of the matter. In general, the subsidised project will draw capital and labour, particularly skilled labour, from other local firms. This will mean either that the wage rates of such employees increase, raising the costs of other firms within the local economy; or that some other potential projects will be stymied. At the extreme, there may be little or no change in employment in the local economy — that is, old jobs will be 'crowded out' by the new ones. Indeed, where the induced projects are more capital-intensive than those displaced, total employment in theory could fall.

It is for this reason that the Commonwealth Department of Finance and, at the state level, bodies such as the New South Wales Treasury and the ACT Auditor-General, have indicated that those agencies preparing cost-benefit assessments should as a general rule not count employment gains among the benefits of particular projects.

Exceptions may of course arise in depressed regions with high unemployment, provided the required skill profile matches that of the unemployed, which in most cases means a need for relatively low skills.

But even here the answer is not straight-forward. This is because low-skilled labour is a complement for high-skilled labour in many industries — you can not have production workers without tradesmen and supervisors, for instance. So, once again, the induced project can draw the labour that is scarce away from other projects. This in turn can affect the viability of those other projects, and the employment prospects of the workers — skilled and unskilled — who depend on them.

Even in those cases where selective assistance *does* generate a net gain in employment, it needn't represent 'value for money' compared to alternative spending options to address employment. For example, the Comalco assistance package mentioned earlier reportedly equated to some $750 000 per permanent job. The assistance per *net* job created would be much higher.

The bottom line is that governments expecting to reduce unemployment through selective assistance are likely to be disappointed. Aggregate employment is related principally to aggregate economic activity and regulation that affects the labour market directly, not industry assistance.

The magic of multipliers?

A second trap into which proponents of selective industry support often fall is the superficial appeal of 'multipliers' — the seeming science by which investment ripples are transformed into tidal waves of economic activity. In reality the science of multipliers is the economics of the free lunch.

The common claim is that each extra dollar of output generated by the recipient firm generates several more dollars worth of activity — investment, sales and jobs — as the initial expenditure is spent in several subsequent rounds in the local economy. This is correct as far as it goes but, once again, it does not go nearly far enough. It fails to consider the 'opportunity costs' of the spending. Just as the spending created in and by the recipient firm has multiplier effects, so too does the spending that is displaced from other firms and industries. Looked at another way, while public funds devoted to a project will have multiplier effects, those public funds would also have had multiplier effects if spent on other purposes, or left in the hands of taxpayers to be spent on the things that they value.

Multipliers are just an illustration of the complex inter-linkages between different parts of the economy — the knee bone is connected to the thigh bone is connected to the hip bone. The economic benefits from new investment come not simply from such interconnections, but from improvements in efficiency and resource allocation that new investment can bring, which allow the production of more goods and services from available resources.

A magic tax pudding?

There are also some fundamental misconceptions about the budgetary and other costs of providing investment incentives. Where incentives are provided in the form of tax-breaks or tax-holidays, it is often claimed that the states are simply surrendering revenue that they would not otherwise have collected. And where inducements are provided through budgetary subsidies, it is sometimes claimed these subsidies will be more than paid for by the taxes paid by the firm and its employees, as well as taxes generated from the flow-on effects on the economy.

The latter argument depends in part on the flawed logic of multipliers. Similarly, the notion that the tax revenue forgone would not have been collected anyway ignores the crowding-out effects of induced investments on employment and investment elsewhere in the economy, and thus ignores the tax revenue that would have been paid on that other economic activity. For example, where labour is drawn away from existing firms to work in the induced project, payroll tax will be lost from those firms.

Another example of the tax merry-go-round occurred in the mid-1990s as states competed to attract the Australian Stock Exchange to locate in their jurisdiction. Thus Queensland cut its financial taxes, which resulted in New South Wales and Victoria responding in kind. But these tax-cuts were then followed by increases in other state taxes to make-up the shortfall. We should bear in mind that many of the taxes available to the states have undesirable efficiency and equity implications.

In the case of some 'special events', the total taxation receipts generated in the local economy and attributable to the event itself have been far less than the government outlay. For example, in relation to the V8 Super Car event staged in Canberra over the last few years (yes, cars again!), the ACT Audit Office found that, in 2001, net outlays on the event were over $5 million, which was more than double the direct and indirect benefits attributable to the event — including from additional tourist spending. The tax receipts from this spending were smaller again. The shortfall has of course been borne by ACT taxpayers (ACT Auditor-General's Office 2002).

But this is by no means the only sporting event to return less than hoped-for benefits to the host city. Detailed US research could not find a positive correlation between professional sport and the tax base. And even hosting a major event like the Super Bowl had no discernible *net* impact on spending in the region — merely diverting spending from other things.

The Victorian Auditor-General has reported that, while there have been some positive outcomes from investment attraction programs (abstracting from costs) they are 'lower than initially anticipated'. Moreover, 'the publicly announced estimates do not appear to be revised as time goes by'(Victorian Auditor-General 2002).

The provision of selective subsidies can also create other costs, although they are not always visible in the government budget, or acknowledged by proponents of such schemes.

- As the Commission documented in its 1996 inquiry, selective assistance can have high administrative and compliance costs — ranging from 20 to 80 per cent of the assistance provided for some programs (IC 1996d).
- Obtaining the tax revenue required to fund subsidies can entail collection costs and disincentive effects. Commission staff have estimated that (pre-GST) these 'deadweight losses' ranged up to 71 cents for each additional state tax dollar collected. (Gabbitas and Eldridge 1998)

In sum, we need to be wary of any presumption that a government will recoup the costs, properly defined, of selective assistance to new firms or projects.

Synergies, 'head turning' or other intangible benefits?

This leaves some claims that are fairly difficult to substantiate and operationalise about industry synergies and various intangibles associated, in particular, with the attraction of major events.

There is little doubt that there can be 'knowledge spill-overs', 'agglomeration economies' and other synergistic benefits associated with industry clusters. Silicon Valley is a prime example. This can happen spontaneously (as in Silicon Valley), but there is also the possibility that government support can be a catalyst.

While many local governments use zoning laws and investment-promotion programs to encourage small-scale cluster development, and while sympathetic infrastructure planning can also promote clusters, it is quite a challenge to devise selective industry-assistance policies that would cost-effectively capture the benefits at the state level. Adelaide's experiment with the now defunct Multi Function Polis, although beset by an array of problems, bears testimony to some of the difficulties.

Another hard-to-verify rationale is the so-called 'lighthouse' effect, in which attracting a high-profile project or event is said to demonstrate the benefits from conducting business in the particular locality. The way Sydney executed its Olympics would seem a good example. On the other hand, the fallout from the Atlanta Games before it suggests that, depending on the competence with which the event is hosted, these effects could go either way. As the Victorian Auditor-General's report (2002) notes, the success of such a strategy depends on attracting further investment without assistance (countering that aspect of the demonstration effect).

As the Sydney Olympics highlighted, there may also be a 'feel good' factor associated with attracting a major investment, which should not be dismissed just because it is hard to measure. However, as the Grand Prix saga illustrated, in some cases there may be a 'feel bad' factor to consider for the losing state! And in the ACT, while the 'petrol heads' may have felt good about the V8 Super Car race, opinion polls showed them to be in a minority. The Audit view was that the net effect on 'civic pride' was 'likely to be very small' (ACT Auditor-General's Office 2002).

Finally, we should not discount the possibility that subsidising a high profile firm's entry will tend to damage incumbent rivals, and dampen their enthusiasm for doing business in that jurisdiction.

Bottom line on firm subsidies

In sum, claims of economic benefit from selective assistance are often poorly founded. They generally arise from a restricted consideration of the linkages in an economy, and what those linkages and associated multipliers mean for policy. They focus on the direct impacts of an assisted project, often without considering the indirect economic effects or the opportunity costs of the assistance and resources expended on the project.

It is of course possible for a state to 'win' on some individual projects. The Commission's modelling in 1996 suggested that Victoria could indeed gain some net economic benefit from the relocation of the Grand Prix (depending on the size of the inducements, which had not been disclosed).

But again it is necessary to consider the wider picture. In bidding wars, a state or territory that wins today could lose tomorrow, so that over time no jurisdiction is better off than it would have been simply competing on its merits. The sense of 'payback' in some of these contests is palpable. In relation to the Grand Prix, the Commission's modelling indicated that the South Australian economy lost not only the lion's share of the national benefits associated with that event, but also saw its tax base reduce as some spending and business activity migrated to Victoria (although there were also some savings).

From a national perspective, inter-state competition for investment conducted via selective assistance is a negative-sum game. The analysis shows that states have an incentive to 'overbid' for projects and events, relative to the national benefits to be obtained. Even if the investment is genuinely 'new' to Australia, interstate bidding can cause any national benefits to be dissipated, with foreign shareholders the only sure winners. For such reasons, if Australia is to be in the bidding game internationally, it is preferable that the Commonwealth be the main player.

Opening up the books

The scope for misunderstandings about the benefits and costs of selective assistance, and the risks in its provision, highlight the need for careful analysis and transparent evaluation of assistance packages. Public scrutiny is desirable to test the assumptions, methodologies and claims made for projects, and to allow those who might be adversely affected to have their concerns considered too. Without public disclosure, a 'can do' mentality within agencies 'responsible' for business is more likely to neglect a robust examination of the costs and benefits of assistance.

In its 1996 inquiry, the Commission found considerable variability in reporting procedures and the degree of transparency about selective assistance, both between states and between different government departments and programs. However, the lack of disclosure was greatest in all jurisdictions when it came to incentives for specific firms or activities. In many cases, neither the extent of the assistance provided, nor the analysis that underpinned the government's decision, were made publicly available. That remains so today and is an issue at the Commonwealth level as well.

One argument made for non-disclosure is a need to protect information that the recipient considers commercially sensitive. However, it is not clear how disclosing the size of the assistance provided to a firm, or the reasons for providing it, could be used by competitors in the marketplace. Some aspects of the analysis of the firm's commercial operations or prospects, which may have some value to its competitors or customers, may be of a potentially damaging nature if released. However, even this can be overstated. When private businesses are receiving tax-payers' money, the presumption should be that tax-payers are entitled to know the details. Otherwise, as the Victorian Auditor-General has commented:

> … the [lack] of information on public expenditure undermines public confidence in the integrity of the process and creates suspicion of corruption and waste. Indeed, if there is widespread public support for the provision of assistance to industry, then this can only be enhanced by the provision of reliable information.

The more credible or logical argument mounted for non-disclosure is to strengthen the position of the government in subsequent negotiations with other firms, by denying them knowledge of how much the government is willing to pay for particular types of projects or investment commitments. Non-disclosure, it is argued, can also prevent or minimise the 'me-too' factor. The Victorian Auditor-General (2002), in agreeing to limits on disclosure in his recent report, accepted the government's argument that disclosure would affect the state's negotiating position and could escalate the costs of investment attraction programs.

While there may be some logic in this position, in my view there are stronger reasons in favour of full public disclosure. These include the misconceptions about the merits of selective assistance that I have already mentioned, together with evidence of poor process and analysis, and ill-advised assistance packages being offered in some cases. It is, in any case, questionable whether secrecy does facilitate the minimisation of government outlays. Rent-seeking could arguably be greater when undefined pots of money appear to be up for grabs.

Non-disclosure allows poor analysis of the effects of incentives to go unchallenged. The experience in subsidising the V8 Super Car series in Canberra illustrates how problematic and costly an opaque evaluation of selective assistance can be. As you may be aware, Canberra in winter is no Surfers Paradise, and Holden and Ford V8s are not as alluring as Indy Racing Carts. Nevertheless, in 1999 the ACT Government decided to stage the V8 Super Car event in Canberra. Its decision was based on an 'economic evaluation' contained in a (confidential) Cabinet submission that the event would produce significant economic benefits for the Territory. However, as the ACT Auditor-General (2002) has recently documented, the analysis of benefits from staging the race suffered from several deficiencies:

> The economic benefit evaluation contained simple arithmetical errors, double counting, did not systematically allow for inflation, and did not discount future benefit and cost flows. The forecasts of interstate visitor impact, publicity value, jobs created and ticket sales are all overstated. The submission did not adequately deal with the financial risks associated with the race. The actual net financial cost of the race has been far above the predictions made in the submission, the indirect benefits much less.

Indeed, contrary to public proclamations at the time, subsidising the race actually yielded a *net loss* to the ACT community of more than $11 million over three years. It was only after this was exposed publicly that the event was abandoned. Why was the sort of analysis conducted so expertly by the Auditor-General not undertaken when it was most needed — *before* taxpayers' money was wasted? 'Inconvenience' or incompetence are perhaps the mildest explanations among those that come to mind. But lack of transparency was plainly the facilitator.

A recent Victorian Auditor-General report (2002) also provides evidence of some of the problems that non-disclosure can cause. For example, it documents the experience of Melton Shire in attracting a group of manufacturing companies to relocate from New South Wales. Between 1995 and 1999, the Council provided these companies with assistance valued at $7.5 million. The assistance included the provision of land and interest-free loans. Although one of the companies subsequently defaulted on an employment target, it was not required to repay the assistance. In this case, nondisclosure reduced pressure on the Shire to monitor and evaluate the outcomes to ensure that the rate-payers of Melton were getting value for their assistance dollar.

And of course, the controversy surrounding the assistance package offered to Motorola in 1994 to establish a second software centre in Adelaide, and about the veracity of subsequent statements to the Cramond inquiry (1999) on this matter, reminds us that perceptions of shady deals are not confined to foreign governments. (Fortunately, in Australia, when governments keep their electorates in the dark, voters have the opportunity to repay the favour, as recent history attests.)

The general lack of transparency means that we cannot be sure how widespread the problems are in this country. Thus many independent agencies and parliamentary committees have called for greater transparency in industry assistance in several jurisdictions. They have also recommended sensible reforms to the administration, evaluation and monitoring of assistance programs. For example:

- The Tasmanian Auditor-General recommended that there be public disclosure of the details of government assistance, and that commercial confidentiality should not take precedence over governmental accountability (Tasmanian Audit Office 2000).
- The New South Wales Auditor-General recommended that accountability and transparency for the provision of assistance be increased, and information not be classified as commercial-in-confidence unless it was demonstrably necessary (Audit Office of New South Wales 1998).
- The New South Wales Public Accounts Committee similarly found no valid reason why government assistance should remain confidential and recommended

several ways for greater disclosure of information on industry assistance (Public Accounts Committee 2001).

- The South Australian Economic and Finance Committee recommended that information on individual assistance packages be tabled and reported to the State Parliament annually (Economic and Finance Committee 2000).
- The Victorian Auditor-General (2002) recommended annual reporting of details of assisted investment projects, their progress and the performance of sectors in which investment incentives were targeted.
- And the ACT Auditor-General (2002) recommended that all agencies review their procedures for developing and verifying the veracity of input to Cabinet submissions and public announcements, as well as reviewing their recordkeeping processes.

Clearly, there are many measures that could enhance the quality of analyses and bring greater transparency to selective industry assistance. Four measures would be particularly beneficial:

- Explicit selection criteria should be developed and published (as the Commonwealth has done for its Strategic Investment Incentive Program).
- Rigorous economic assessments should be institutionalised, and take into account the full economic costs and risks, as well as the benefits, of investment incentives. (If agencies lack the necessary analytical skills, they should make a prior investment in that area. And in all cases such analysis should be tested by officials outside the agency directly involved, ideally by an independent review unit within Treasury.)
- The nature and value of assistance to individual firms should be made public from the outset, including any conditions attached to it.
- There should be regular monitoring and review of the eventual outcomes by independent agencies (such as the Audit Offices).

Calling a truce

While improved analysis, better processes and greater transparency would reduce a number of the problems in the provision of selective assistance, such reforms alone are unlikely to address the incentives individual states can face to compete financially for high-profile projects. In some ways the situation represents a classic prisoners' dilemma, because while all states would be better off by cooperating, in some cases individual states will see benefits in defecting.

The need to avoid mutually impoverishing 'beggar-thy-neighbour' policies was an important reason for the formation of Australia's Federation in the first place. Elimination of tariffs at state borders was critical in enabling a national economy to develop from early last century. Over time, regulatory and other impediments were also gradually removed or reduced, including through cooperative agreements on Mutual Recognition, National Competition Policy and government procurement over the past decade or so. But selective assistance remains a growing threat to the realisation of this nationally beneficial goal.

State governments are conscious of the problems. The concerns of some jurisdictions led to the Industry Commission inquiry back in 1996. Drawing on precedents in Europe and North America, the Commission identified several options for an agreement between the states and territories to limit or prevent bidding wars. States could agree to limits on the forms and levels of assistance available for individual projects and assistance packages, and/or global limits to the assistance they provide. An inter-government agreement could also entail a transparency and monitoring mechanism. The Commission also saw a potential role for the Commonwealth to encourage the states to limit the provision of selective industry assistance (IC 1996d).

It is clear from submissions to that inquiry that, while some states were attracted to an explicit code of conduct, others were not. Smaller jurisdictions were ambivalent. They felt at a disadvantage bidding against larger states, but also felt that without a capacity to provide financial inducements themselves, the inherent advantages of larger states would prevail anyway. One state seemed to want to have it both ways — binding others but not itself — and some just didn't believe an accord in this area could work.

So is it a hopeless cause? While the difficulties are clear, I do not believe it is. Other countries, like Canada and the European Union, have made significant progress. And in the last couple of years there has been some movement in Australia. Indeed, the New South Wales and Victorian Governments have called for an inter-governmental agreement, sponsored by the Commonwealth. The three governments agreed to 'Operating Guidelines' in 2000 which, although limited in scope, require them to meet annually to review the efficiency and effectiveness of investment incentives. Then, in March 2001, New South Wales and Victoria developed a joint working party on investment, and called for other governments to 'eliminate unnecessary bidding wars and… work to contain fiscal incentives'. South Australia has now indicated that it favours an initiative in this area.

So far the steps have been modest. But they are in the right direction. They can be taken further. As in international trade liberalisation, the key to achieving a meaningful agreement is for each government to accept that it would be beneficial to its own jurisdiction. Some Australian states and territories remain to be convinced. I call on those governments to undertake hard-headed, independent reviews of their programs to determine what, in retrospect, they have *really* achieved. Once we dispel the magic of multipliers and other free-lunch thinking — and take a broader view of the interjurisdictional repercussions — the answer should become clear.

If governments can agree to a truce on inter-state bidding wars and other selective corporate support, they can then concentrate their forces on a much more worthy and productive battle: improving further their economic governance, tax regimes, infrastructure and other service delivery. These are the real mainstays of the contribution of state and territory governments to economic performance in the long term.