Australian Government
Productivity Commission

An Economy-wide View: Speeches on Structural Reform

Gary Banks

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Preface

Public speech-making is part and parcel of the role of the Chairman of the Productivity Commission, as it was for the Commission's predecessors. Such speeches provide an additional medium through which the findings and policy messages in the Commission's diverse reports can be distilled, discussed and made accessible to wider audiences.

The speeches in this volume were delivered over the past dozen years in a variety of settings. They were selected for inclusion here according to the significance and contemporary relevance of the issues they address, as reflected in continuing requests for them on the Commission's website. Most of the speeches are edited and abbreviated versions of those of approximately the same title that are listed on the website. They come closer to the 'spoken' versions and should be quicker to read than the longer and more detailed papers.

It goes without saying that the speeches, and the papers themselves, draw extensively on the Commission's publications. It also goes without saying that they are not all my own work. Many of them benefitted from the research input of colleagues, and all from their critical feedback. Importantly, for nearly half of them I had 'silent partners', who made substantial written contributions to the text; and the names of these colleagues appear in relevant places within the volume.

I am grateful to everyone who assisted me, either directly or indirectly, in preparing these and other speeches. Often this assistance came in response to requests made at short notice, but it has always been granted readily and expertly. More broadly, I would like to pay special tribute to two former staff members, Graham Blinman and Norm Gingell, who provided invaluable support to me and to those who preceded me in this role over many years. In relation specifically to this volume, I am particularly grateful to Margaret Mead, who ably managed the project and edited all the speeches, and to Tanya Frech, who assisted her. Ultimately, of course, responsibility for the views as expressed remains mine.

Gary Banks AO
Chairman

March 2010

Gary Banks addressing staff and guests at an event for the Productivity Commission's 10th anniversary, 16 April 2008.

Gary Banks AO

Gary Banks has been Chairman of the Productivity Commission since its inception in 1998. He has worked for all three of the Commission's predecessors — the Tariff Board, Industries Assistance Commission and Industry Commission. He also spent nearly a decade working overseas with the GATT Secretariat in Geneva, and at the Trade Policy Research Centre, London. In the late 1980s, he was a consultant with the Centre for International Economics in Canberra. Since his first appointment as a Commissioner in March 1990, Gary Banks has headed two dozen public inquiries. He also chairs the Government Services Review process under the Council of Australian Governments. He headed the Australian Government's Regulation Taskforce in 2006 and was a member of the 1998 Review of Higher Education. He is on advisory boards at three universities, and is an occasional lecturer at the Melbourne Business School. Gary Banks was made an Officer of the Order of Australia in 2007, for 'services to the development of public policy'.

Foreword

The Productivity Commission is a remarkable achievement of Australian governance — an institution whose sole purpose is to promote public policy excellence. As Chairman of the Productivity Commission since its 1998 inception, Gary Banks has championed its intellectual integrity and promoted its policy principles. He occupies an unusual place in public administration since the Commission has no client group, no natural constituency and no easy dividends for the political class.

Its strength lies in its ideas, its analysis and its advancement of the public interest. It needs to be independent but not remote, rigorous but not ideological, constructive but not accommodating. The Commission exists, ultimately, to serve the interests of the Australian people and that defines its value for any intelligent national government. The Productivity Commission and its predecessor organisations, from the Tariff Board to the Industry Commission, have been pivotal to the dynamic and turbulent story of Australia's embrace of economic reforms, structural change and improved public policy over recent decades. This has made Australia not just a more prosperous country but a country with an ongoing commitment to shared prosperity.

This volume of speeches by Gary Banks offers an accessible insight not just into Gary's thinking but the collective wisdom of the organisation that he has headed. The moral for the general reader is that quality political decisions depend upon a quality debate. These speeches highlight some guiding principles of the Commission — that trade liberalisation and competition enhance overall living standards, that special deals for vested interests impose costs upon the public, that new regulations should deliver benefits greater than the costs they impose. But the speeches also reveal the far more expansive reach of the Commission and its Chairman into new areas of social and environmental policy.

A phenomenon largely of the last decade, this expansion has taken the Commission into water markets, energy efficiency, waste management, paid maternity leave, the implications of population ageing, the gambling industry, infrastructure regulation and pricing, health policy and costs and the assessment of approaches to tackle Indigenous disadvantage. This recognises that in the contemporary world economic, social and environment policy need to be integrated.

Inherent in this book of speeches by Gary Banks is a statement about Australian democracy — that transparency about the impact of government decisions is an essential ingredient for a genuine democracy. Transparency lights the trek to better policy. In politics today there are many voices, interests and lobbyists bidding in public and in private for their own special causes, but there are few who speak with authenticity for the general interest. That is a responsibility of the Productivity Commission and its Chairman.

This book testifies to a unique Australian institution, its active Chairman and the renewal of a tradition in our governance that is more important than ever.

Paul Kelly

Editor-at-Large
The Australian

March 2010

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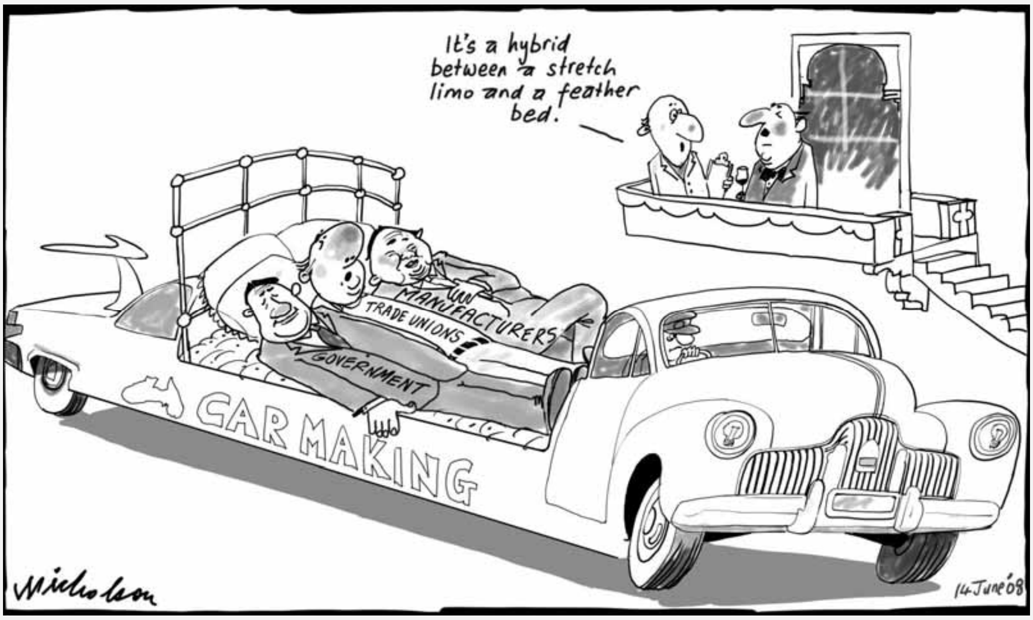
PART 1

STRUCTURAL REFORM: PAST ACHIEVEMENTS, FUTURE CHALLENGES

Australia's economy has been radically transformed from the high-cost, inward-looking economy of three decades ago. This is the result of a wide-ranging program of structural reforms, in which the Commission and its predecessors have played a significant part. These reforms and their impacts are discussed here, as well as further reforms needed to secure Australia's prosperity into the future.



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

Structural reform Australian-style: lessons for others?*

> *'The Government's commitment to reform, its willingness to commission expert advice and to heed it, to try new solutions, and to patiently build constituencies that support further reforms, is ... something that other countries could learn from.'* (OECD, *Economic Survey of Australia*, 2004)

Introduction

Australia has undergone sweeping structural reforms over the past two decades that have helped transform its economic performance. To most economists, the reforms themselves would no doubt appear unexceptionable. They typically apply conventional prescriptions for improving growth by removing policy-related distortions and impediments to a well-functioning market economy. However, given the magnitude of the reform requirements in Australia, and the entrenched political obstacles to reform, the manner in which the reforms were introduced and sustained may be of wider interest and relevance.

My purpose in this paper therefore is not to focus on the why of reform, which I shall take to be understood in this company. Rather, I will briefly outline what reforms were undertaken in Australia and provide some indication of their outcomes, before focussing on aspects of how we went about it. I will look in particular at some institutional innovations that appear distinctive to Australia and which have attracted the attention of a number of other countries — both developed and developing — as well as within international organisations concerned with promoting economic development.

Paradise lost — and (partly) regained

Economic reformers in Australia often observe that our country had the highest per capita income in the world at the dawn of the twentieth century. Like some

* Based on presentations to the IMF and World Bank (Washington DC, 26–27 May 2005) and OECD (Paris, 31 May 2005).

others in that privileged position (Argentina, New Zealand), Australia's position on the global income ladder steadily declined in succeeding decades.

In retrospect, the causes of our relative decline seem fairly clear. As the respected Australian journalist Paul Kelly has chronicled, Australia's structural policies following Federation in 1901 were shaped by a social compact known as the 'Australian settlement' (Kelly 1992). Trade barriers fostered domestic manufacturing activity. Relatively generous wages and conditions were determined Australia-wide by the Industrial Relations Commission. Those states of the Federation most disadvantaged by this were compensated over time through fiscal redistribution from the Australian Government. Statutory government monopolies were created to provide public utility and other services at 'fair' prices to the expanding populations. The regime was highly regulated, anticompetitive and redistributive: captured nicely by the expression 'protection all round'.

For many years the economic costs of this regime were masked by the performance of our broad-acre agricultural and mining industries. Until the early 1970s, the terms of trade favoured our primary commodities, and we had benefited from a world-wide expansion in demand following World War II. Australians enjoyed close to full employment with incomes still higher, on average, than those in most other OECD countries.

But we were riding for a fall. During the 1970s, the prices we received for our commodity exports commenced a long decline, while the costs of imports began to rise. The resulting terms of trade deterioration (figure 1) would, in turn, expose the underlying problem of Australia's poor productivity performance. Even in the post-war boom years, Australia's productivity lagged. Between 1950 and 1973, our annual productivity growth averaged 2.5 per cent, compared to 3.5 per cent for OECD countries as a group (figure 2).

The reasons for our relatively poor productivity performance, given the policy environment just described, are not hard to find:

- a fragmented, high cost manufacturing sector, focussed on the domestic market
- indulgent, inflexible work practices, powerful unions and lack-lustre management
- outmoded technologies, low rates of innovation and skill development
- high-cost infrastructure services like power, transport and communications, which effectively taxed business users, while cross-subsidising households.

Australia's poor productivity performance, together with the declining terms of trade, translated into what seemed an inexorable slide in our comparative living standards. Whereas Australia was still ranked 5th in the world in 1950 in terms of GDP per person, we had fallen to 9th by 1973 and to 15th by the late-1980s.

Figure 1 **Australia's terms of trade**

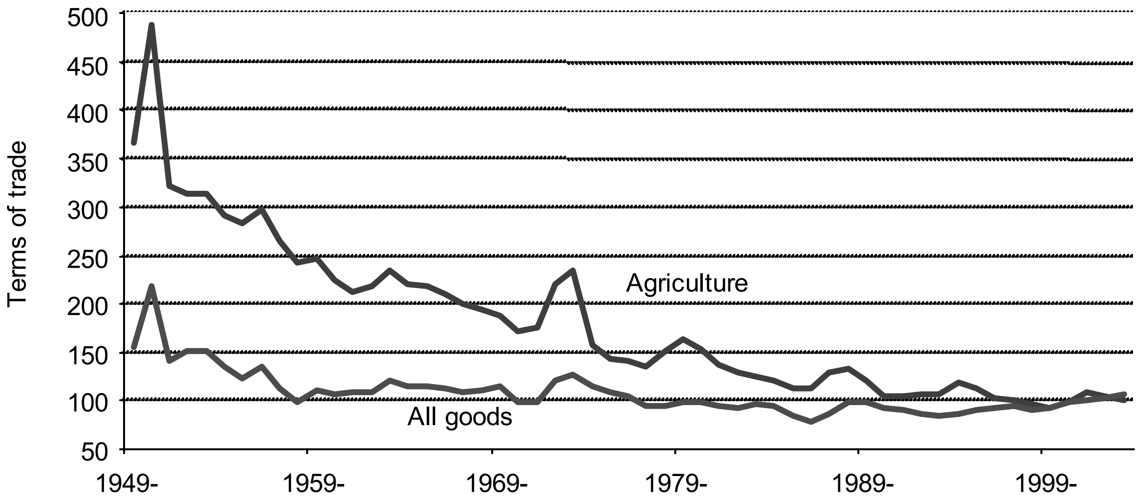
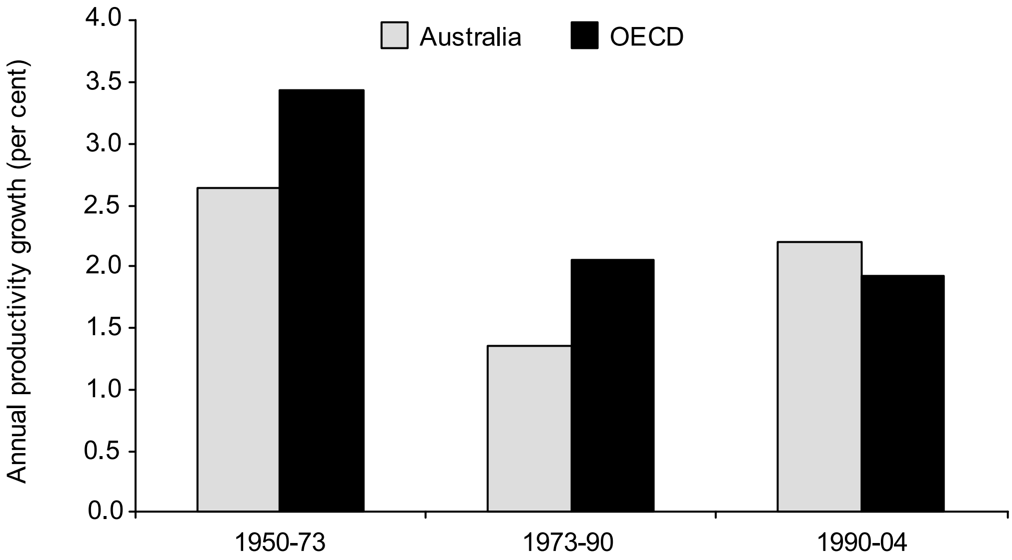


Figure 2 **Australia's relative productivity performance**



Wide-ranging 'microeconomic reform'

Structural reform could be said to have commenced with a false start in 1973, when the Government introduced a dramatic 25 per cent across-the-board tariff cut. However, the measure turned out to be a one-off. In conjunction with other events, the cut precipitated a backlash against reform and there were only 'piecemeal' further reductions in tariffs for over a decade.

Following the election of a new government in 1983, the reform of border protection arrangements was reinvigorated — with the conversion or elimination of import quotas as well as reductions in tariffs themselves. At first, these reforms were introduced on an *ad hoc* industry-by-industry basis. Then in 1988, the Government introduced the first in a series of phased reductions in tariffs across most industry sectors such that, by 1996, virtually all tariffs (other than for the automotive and textile, clothing and footwear (TCF) industries, which were on their own liberalisation paths) had fallen to 5 per cent or less.

The early 1980s had also seen the floating of the Australian dollar (facilitating subsequent adjustment to tariff liberalisation) followed by significant liberalisation of the finance sector, including the removal of exchange and interest rate controls.

Increased international competition in Australia's traded goods sector led to pressures for reductions in input costs, notably in labour markets and (non-traded) public utility services. In turn, pressure mounted for the reform of government policies and institutions that were impeding these changes, and an increasingly broad-ranging program of domestic microeconomic reform was hatched (box 1).

If any single indicator could convey the extent of structural reform in Australia, it would be that essentially Australian measure of relative net protection levels, the effective rate of assistance (ERA). The ERA for manufacturing has declined from 25 to 5 per cent over the past two decades, while agricultural assistance has also fallen (figure 3).

Equally, it would be hard to find more striking illustrations of consequent structural and behavioural change than the coincident rise in the trade intensity of Australia's economy, from 27 per cent in the mid-1980s to 44 per cent in 2003, and the sharp increase in business R&D spending as a share of GDP (figure 4).

Box 1 **Two decades of economic reform**

Trade liberalisation — reductions in tariff assistance (that began in 1973) and the abolition of quantitative import controls — mainly in the automotive, whitegoods and textile, clothing and footwear industries — gathered pace from the mid-1980s. The effective rate of assistance to manufacturing fell from around 35 per cent in the early 1970s to 5 per cent by 2000.

Capital markets — the Australian dollar was floated in March 1983, foreign exchange controls and capital rationing (through interest rate controls) were removed progressively from the early 1980s and foreign-owned banks were allowed to compete.

Infrastructure — partial deregulation and restructuring of airlines, coastal shipping, telecommunications and the waterfront occurred from the late-1980s. Commercialisation, corporatisation and privatisation initiatives for government business enterprises were progressively implemented from around the same time.

Labour markets — the Prices and Incomes Accord operated from 1983 to 1996. Award restructuring and simplification, and the shift from centralised wage fixing to enterprise bargaining, began in the late-1980s. Reform accelerated in the mid-1990s with the introduction of the *Workplace Relations Act 1996,* further award simplification and the introduction of individual employment contracts.

Human services — competitive tendering and contracting out, performance-based funding and user charges were introduced in the late-1980s and extended in scope during the 1990s; administrative reforms (for example, financial management and program budgeting) were introduced in health, education and community services in the early 1990s.

'National Competition Policy' reforms — in 1995, further broad-ranging reforms to essential service industries (including energy and road transport), government businesses and anticompetitive regulation were commenced by all Australian governments through a coordinated national program.

Macroeconomic policy — inflation targeting was introduced in 1993. From the mid-1980s, fiscal policy targeted higher national saving (and a lower current account deficit) and, from the mid-1990s, concentrated on reducing government debt, primarily financed through asset sales (privatisation).

Taxation reform — capital gains tax and the dividend imputation system were introduced in 1985 and 1987, respectively. The company tax rate was lowered progressively from the late-1980s. A broad-based consumption tax (GST) was implemented in 2000, replacing the narrow wholesale-sales-tax system and a range of inefficient state-based duties. Income-tax rates were lowered at the same time.

Figure 3 **Falling effective protection**

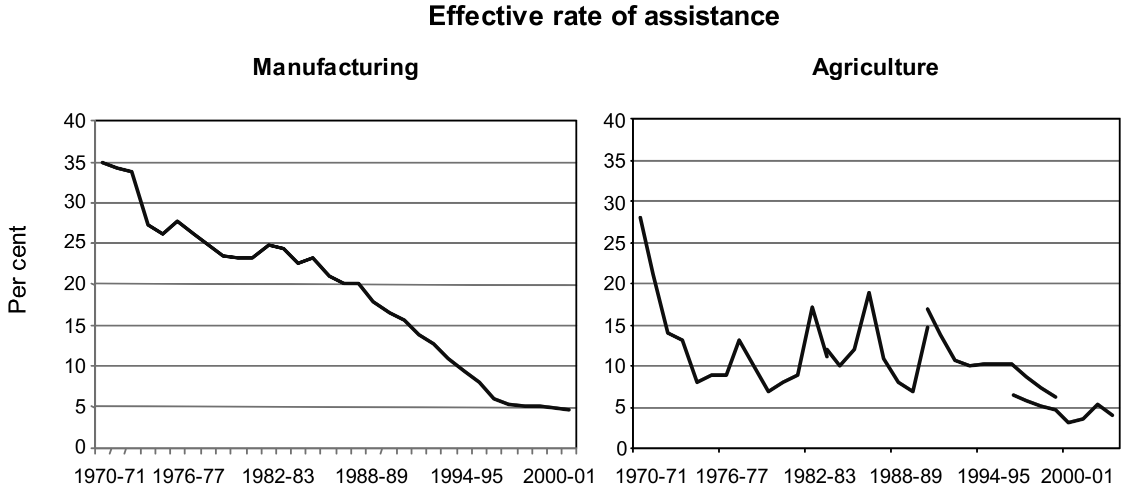
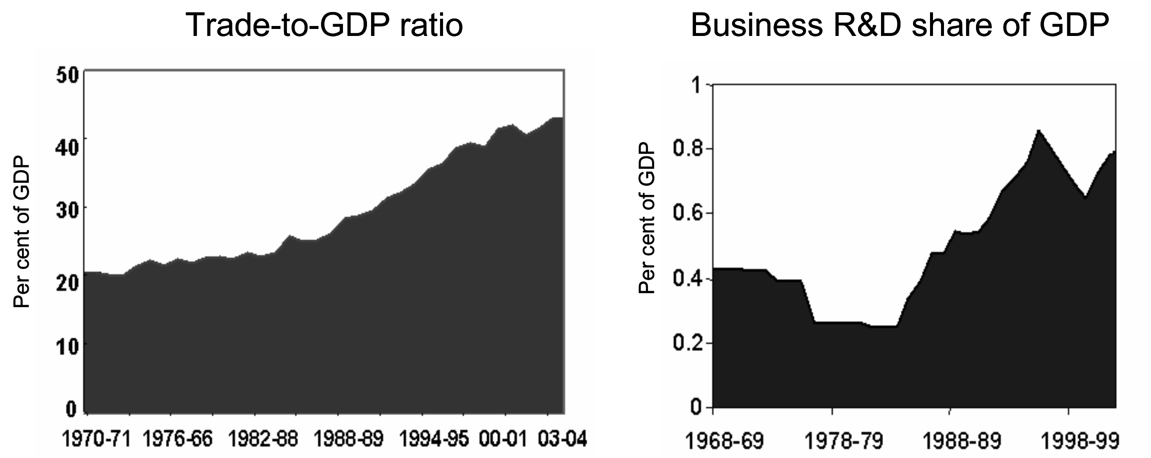


Figure 4 **Increased trade and R&D intensity**



A more productive economy

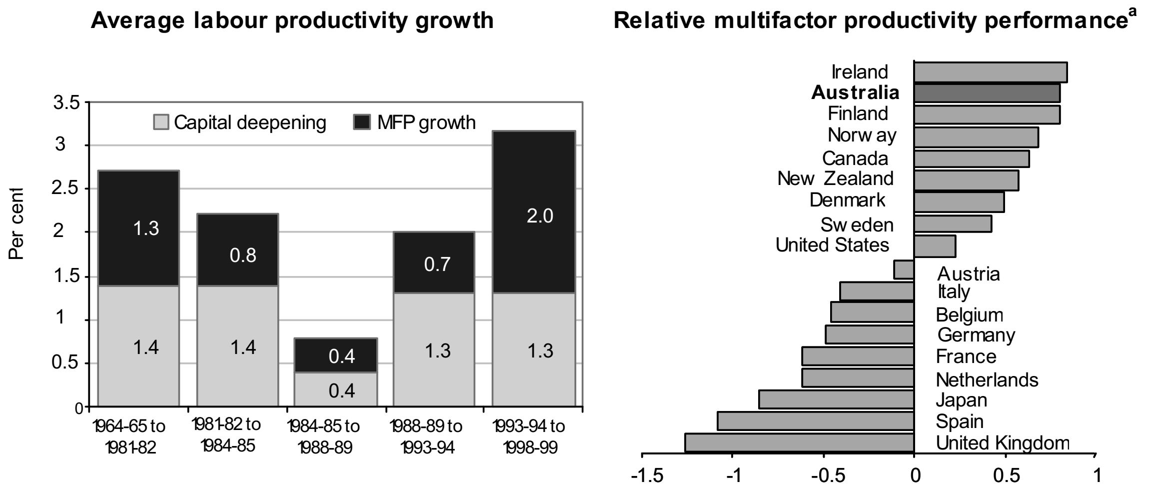
As a consequence, important changes have been wrought in each of the areas previously identified as contributing to our poor productivity performance. For example, there has been:

- a marked decline in high-cost, labour-intensive or standardised manufacturing activities and a rise of 'elaborately transformed manufactures' (PC 2003g)

- major changes in work practices in all sectors, including to accommodate new technology
- a rise in the intensity of business R&D, and increased innovation generally, with Australia having one of the highest rates of ICT uptake among OECD countries in the past decade (OECD 2004a).

These and other forces are reflected in the productivity performance of a range of industries. At the aggregate level, Australia experienced a surge in multifactor productivity (MFP) growth during the 1990s, averaging almost 2 per cent, more than double its previous rate (figure 5). Australia's MFP performance was also among the best in the OECD and its labour productivity growth exceeded even that of the United States (OECD 2004b).

Figure 5 **Australia's productivity turnaround**



[a] Percentage points change to average annual MFP growth 1980-1990 to 1990-2000.

Accompanied by rising labour utilisation, this translated into annual growth in per capita incomes of around 2.5 per cent in that decade, well above the previous average and that for the OECD as a whole (1.7 per cent). As a consequence, Australia has seen its position on the international per capita GDP scale rise again from 15th to 8th over the past decade or so.

Some (unusual?) features of the reform program

While Australia's structural reforms could be said to have followed standard economic prescriptions, the way the reforms were implemented had some distinctive features.

'Opening the boarders' became the first domino

For example, the literature on the 'optimal sequencing' of reforms generally argued in favour of addressing domestic distortions and inefficiencies before exposing an economy to international competitive pressures — in order to minimise adjustment costs. The Australian approach effectively turned this sequence on its head. Opening the borders to foreign goods, services and capital played a critical role in exposing 'upstream' inefficiencies, generating political pressure for reforms in government utility service provision and in labour markets. In particular, it is difficult to imagine that industrial relations reforms could have gone as far as they did without the increased discipline that international price competition placed on unit labour costs. In political economy terms, therefore, a lesson from Australia's experience is that external liberalisation has distinct advantages as a first-mover strategy.

We liberalised unilaterally

Unlike other OECD countries, most of Australia's trade liberalisation has been undertaken unilaterally, rather than in exchange for reciprocal concessions by other countries. This has not reflected any failure to engage in or support the then GATT (now WTO) system, but rather the reality that multilateral trade negotiations for many years did not encompass agricultural trade — which at that time was Australia's main export interest. This meant that there was little incentive to do reciprocal deals.

We hastened slowly

Another issue that has exercised reformers is the optimal breadth and pace of reform. For example, some economists have advocated a 'big bang' approach of rapidly introducing substantial reforms across an economy, to offset distributional impacts in any one sector and bring forward gains that might otherwise be delayed or forgone as 'reform fatigue' or opposition set in.

Australia adopted a more incrementalist approach, though ultimately with a broad reach. The 25 per cent tariff cut was an abrupt change that was not pre-announced by the Government. In hindsight, this bold initiative probably set back the case for tariff reform. Later tariff liberalisation programs involved pre-announced and graduated reductions.

Likewise, in the 'sensitive' sectors, including steel, autos and TCF, 'industry plans' were devised to provide incremental reform. For instance, under the first auto industry plan, which commenced in 1985, quotas were initially converted into tariff-quotas and then abolished, and the tariff of 57.5 per cent was phased down to 35 per cent in 1992. Subsequent plans have involved gradual, pre-announced tariff reductions, such that auto tariffs fell to 10 per cent in 2005 and are scheduled to decline to 5 per cent in 2010. Industry plans have also variously included export, investment and R&D subsidies and, in some of the early plans, specific restructuring targets and incentives.

We acted on a broad front

While Australia's structural reforms could be said to have begun sequentially and were incremental in nature, the program evolved in a cumulative way to encompass reforms across much of the economy. This brought many of the benefits attributable to 'big bang' approaches, but without all the costs. Potential losses in some sectors from reductions to protection were at least partly offset by benefits derived from reforms in other sectors, thus avoiding undue adjustment and making reform more 'palatable'.

We 'oiled the wheels' in sensitive sectors

In the main, Australia used the phasing of reforms to minimise adjustment costs, relying on general retraining schemes and the (relatively generous) welfare safety net to address the needs of displaced workers. However, particularly in sensitive sectors, governments also introduced some specific measures to deal with adjustment issues. The industry plans often entailed specific retraining schemes or assistance for displaced workers. In other cases, reform has been accompanied by direct compensation for the economic losses entailed. Governments have also provided specific support for regions in which the costs of reform were concentrated.

Two institutional innovations in Australia's reform story

Structural reforms of the kind Australia has implemented have long been recognised as economically desirable by most economists, but have faced strong political obstacles in all countries. This reflects the fact that many of the policies or regulations that have efficiency costs also have pronounced distributional effects. Reform (by definition) is intended to benefit the wider community. But in doing so it typically threatens the privileges or perceived entitlements of a minority.

The inherently adverse political calculus of structural reform is made worse by the front-loaded timing of the losses relative to the benefits. Given the three year electoral cycles that obtained in all Australian jurisdictions until very recently, this almost guaranteed that an incumbent government would experience more of the pain than gain from reforms that it introduced — while potentially seeing the reverse occur for its successor. The bicameral nature of most jurisdiction's parliamentary systems provided a further obstacle to reform, particularly at the wrong end of the political cycle.

Finally, in some countries, including Australia, there are the additional challenges for nationally beneficial structural reforms posed by a federal system of government. In Australia, the six states have regulatory powers and responsibilities in all relevant areas. In areas that require national systems, such diversity can manifest itself as productivity-sapping fragmentation.

International surveys and case studies have identified a range of other conditions conducive to reform. These include strong and well-motivated political leadership, 'technocratic' capability within government, 'good timing' and the emergence of pro-reform lobbies. Where Australia appears to have differed is in fashioning domestic institutional arrangements expressly to promote and sustain reform. The two institutions most distinctive of the Australian approach in this respect are the Productivity Commission (and its direct forebears, the IAC and the Industry Commission) and the inter-jurisdictional framework for National Competition Policy (NCP).

The role of 'the Commission'

Paradoxically, the institution most identified in Australia with the microeconomic reforms of the past few decades, had its origins in an institution that had underpinned the protectionist side of the Australian settlement for much of the preceeding 50 years.

The Tariff Board was created by statute in 1922 as an independent inquiry and advisory body on tariff making. At the Government's request, it would examine the claims of particular industries for increased protection through a public inquiry process, and issue public reports with formal recommendations. Reflecting the consensus of the time, the Board's recommendations were essentially designed to offset local industry's 'margin of cost disadvantage' against imports (while avoiding 'excessive' protection).

When the socially reformist Labour Government swept to power in the early 1970s, it created a new organisation, the Industries Assistance Commission (IAC), to provide a more wide-ranging institutional vehicle for arms-length advice in the national interest about the costs and benefits of tariff and other assistance to industry. This was predicated on the (then) radical notion for the political left that the fiscal requirements of social programs depended on having an efficient and productive economy.

There are three features of the organisation's design that have collectively distinguished its contribution:

- *Independence*. The Commission was established by Act of Parliament. Its role was purely advisory, having no judicial, executive or administrative functions. Members of the Commission were appointed by the Governor-General for up to five years and could not be removed by the government of the day.
- *Openness*. By statute, the government was obliged to obtain advice from the Commission before changing any tariff or financial assistance to industry. The Commission was required to hold public hearings and release draft reports before finalising its recommendations to government. The Commission was also required to prepare an annual report covering its operations and analysing the structure of assistance to Australian industry and its effects. And the government was obliged to release publicly all Commission reports within a specified period.
- *Economy-wide mandate*. Guidelines in the legislation stated that the Commission should be concerned with improving the efficiency with which the economy uses its resources and take account of the interests of consumers and users of products affected by its proposals.

With some variation, these three features remained fundamental to the role and operations of the two organisations that succeeded the IAC; namely the Industry Commission (from 1990 to 1998) and today's Productivity Commission, which was established in April 1998. The main differences between the organisations have been in their coverage, which has been progressively extended beyond industry assistance matters to cover structural reform issues across all sectors of the economy, and in social and environmental as well as economic spheres.

How has the Commission assisted reform?

The Commission has been able to assist reform in a number of ways.

Firstly, it has provided government with a source of well researched advice on structural reform that is impartial and concerned with the longer-term interests of the community as a whole. The Commission's processes also ensure that the arguments of vested interests will be subjected to rigorous scrutiny, weakening their influence if they do not hold up. For example:

- Claims by opponents of NCP that depopulation and other problems in regional Australia were attributable to the policy were examined in a 1999 inquiry. The Commission found that longer-term factors — including technological advances, changing consumer tastes and lifestyle preferences, and declining prices for agricultural commodities — were primarily responsible. Further, modelling undertaken as part of the inquiry indicated that NCP was likely to increase net income in all but one region (PC 1999b).
- To help justify the proliferation of gaming machines during the 1990s, gambling industry interests (and some state governments) promulgated a number of studies, incorporating 'multiplier analysis', that suggested that growth of the industry created significant additional employment. These and other claims were examined in the Commission's 1999 inquiry into Australia's gambling industries. It showed how gambling industry expansion had largely displaced other forms of economic activity, with little net effect on job numbers. Claims of major employment benefits appear to have been made less frequently (and treated more sceptically) since (PC 1999a).

Second, the Commission's findings and recommendations to government generally have the advantage of having been shaped in the light of extensive public input, and feedback on a draft report. This means that they are more likely to have taken into account all relevant considerations and thus be more robust and reliable. Recent examples include the Commission's report on the regulation of third-party access to gas pipelines, where it changed and refined its proposed criteria for using more light-handed regulation; and its report on an assistance program for the pharmaceuticals industry, where it changed its position from recommending termination of the scheme to re-focussing it as an R&D support measure (PC 2001b, 2003b).

Third, the Commission's processes — including public submissions, hearings, draft and final reports — provide governments with an opportunity to gauge at arms length the likely reactions of the community and interest groups to different policy approaches. This can reduce the prospect of unanticipated responses which could ultimately force policy reversals. For example, the Commission's 1997 inquiry into private health insurance led to changes to the community rating system. This system — which prevented health funds discriminating on the basis of age — was thought 'fair' by many and seemed politically off limits. However, the Commission showed that it led to adverse selection problems and ultimate inequities, with younger people not contributing to the pool causing premiums for remaining (generally older) members to spiral up, resulting in further exits. The Commission's recommendations that people entering insurance late pay higher premiums than those who enter early, gained more support than expected and were eventually adopted by the Government (to considerable effect) (IC 1997b).

Fourth, governments can use the Commission's reports and analyses in making the case for policy changes, or in resisting pressures to introduce policy measures that would be costly nationally. Thus, for example, the Commission's analysis of the effects of NCP on regional Australia, together with modelling indicating that the program would generate significant net benefits, blunted attacks on the NCP and contributed to its renewal and extension in 2000 (see below).

Finally, the Commission's public inquiry processes and reporting can in themselves engender a wider awareness within the community of the costs of existing policies and the benefits from reform. The Commission's detailed analysis of the costs borne by the mining and agricultural sectors as a consequence of manufacturing protection is perhaps the clearest (and most significant) example. The evidence it produced helped to galvanise those sectors as major political forces for tariff liberalisation in Australia.

The Commission's role in perspective

These observations should not be interpreted as suggesting that the Commission has been the sole driver of liberalisation. At various times other review bodies have been used to perform a similar role. Moreover, as for all such bodies, the Commission's role is informational and advisory. It is reliant on others to help take up its message and, ultimately, to implement reforms — a process which has not always delivered, or sometimes taken a considerable time.

The Australian press has often played an important part in promoting the Commission's findings to a wider audience, as well as in encouraging governments to implement its recommendations. But ultimately political leadership has been crucial, both in selling reform and implementing it. Australia has been fortunate over the past two decades in having leaders who were willing to expend short-term political capital in pursuit of the longer-term benefits of reform.

The National Competition Policy

A second distinctive institutional innovation in Australia's structural reform story has been the mechanisms for the national coordination of pro-competition reforms across the nine jurisdictions of the Australian federation.

Faced with political pressure from businesses increasingly exposed to international competition, some state governments began to reform their public utilities and other infrastructure service provision from the mid-1980s. While some progress had been made over the next decade, it was variable across jurisdictions.

In October 1992, an independent review (the Hilmer Review) was established to devise a framework for progressing pro-competitive structural reforms across all jurisdictions. Following further discussions and analysis, the NCP — comprising a comprehensive program of reforms — was agreed to by government leaders (through what had by then become the Council of Australian Governments) in 1994.

Again the identified reforms, while having some special features, were for the most part not novel. What *was* new and unprecedented in Australia, was the manner in which the reform program was implemented and adhered to across jurisdictions. A recent review of the NCP by the Productivity Commission singled out a number of features that contributed to its success (PC 2005e).

Key success factors in the NCP

An essential condition was the acceptance by government leaders that reforms were needed and would yield net benefits. Broad agreement was achieved on some key reform principles, priority areas and policy prescriptions. Other design features of the NCP that contributed to its success in driving structural reform across different jurisdictions included:

- While establishing agreed principles and approaches to reform, it allowed for some flexibility in how individual jurisdictions met their commitments.
- The establishment of another independent statutory body — the National Competition Council (NCC) — to monitor reforms across jurisdictions, to report on progress and to identify where commitments had not been met or where actions fell short.
- Provision within the agreement for financial payments from the Australian Government to the states and territories. These 'competition payments' were calculated on the basis of projections undertaken by the Industry Commission, and amounted to an allocation of $5.7 billion spread over nine years. Whether

particular states received their payments in full depended largely on the assessments of their progress undertaken by the NCC.

Heads of Government agreed to renew the whole NCP process after five years, with only minor modifications, and it has held together now for a decade. It represents an achievement in inter-governmental economic reform that is without precedent in Australia (and possibly in other federations as well).

Further reform challenges for Australia

There remains considerable scope and indeed a pressing need for further reform if our country is to realise its potential, and successfully manage some major challenges that lie ahead.

While Australia's productivity growth has been among the highest in the OECD, this has reflected a need to catch up from a low base — we still have a fair way to go. For example, in terms of GDP per hour worked, in 2004 we were at 81 per cent of the US level, only slightly above where we were in 1950. Our manufacturing productivity in particular remains well below US (and other OECD) levels (OECD 2004b).

The biggest looming imperative for further reform is the pronounced ageing of Australia's population. Though not unique to Australia, and largely a consequence of beneficial increases in longevity, this will significantly reduce the potential labour supply relative to the population, and substantially increase demands on health and aged-care. Projections by the Commission suggest that, in the absence of policy responses, this will in turn cut per capita growth rates by as much as a half. At the same time, it will create a fiscal gap rising to some 6.5 per cent of GDP, which would imply a cumulative debt burden twice as large as Australia's GDP by the middle of this century (PC 2005b).

Recent major reviews of the structural policy landscape by the Productivity Commission have revealed considerable scope to achieve a more productive and sustainable Australia by building on past reform efforts in economic infrastructure and regulation, as well as by extending reform into areas of social infrastructure and national resource management (box 2).

Box 2 The Commission's proposed reform agenda, 2005

Priorities for future reform identified in the recent Productivity Commission reports on NCP and ageing include:

- strengthening the operation of the national electricity market
- enhancing water allocation and trading regimes to better address scarcity and negative environmental impacts
- delivering a more efficient and integrated freight transport system
- addressing uncertainty and policy fragmentation in greenhouse gas abatement policies
- improving the efficiency and effectiveness of consumer protection policies
- introducing a more targeted legislation review mechanism, while strengthening arrangements to screen any new legislative restrictions on competition
- re-energising reform in the vocational education and training area
- introducing incentives to improve labour force participation rates, especially among males
- increasing productivity in the health sector by improving flexibility, encouraging adoption of evidence-based medical practices, and enhancing coordination within and between jurisdictions
- deepening reform in other key policy areas, including industrial relations and taxation, and generally reducing regulatory burdens.

Source: PC 2005b, 2005e.

Lessons for others?

A number of features of the Australian reform story appear to resonate with other countries' reform experience. These include effective political leadership, opposition parties that were supportive of (or at least not strongly opposed to) key structural reforms, an economically literate cadre of political advisers and bureaucrats, mostly 'good timing' in terms of political or business cycles, and the emergence of coalitions in favour of reform.

If Australia has any special insights to offer from its experience of the past few decades, it is about achieving enduring reforms. Apart from the 'false start' of 1973, reforms have generally stuck, and reform programs developed under one government have largely been maintained by new governments. The tariff liberalisation program and the NCP are two important examples. Features of the Australian story that help explain its success in this respect include the institutions and implementation strategies detailed here that were devised to promote an awareness of the benefits from reform, to help build political support, weaken resistance and promote adjustment.

Political leadership is critical to structural reform, but its influence on policy in the longer term can be ephemeral. Its most enduring legacy may well come from more fundamental actions to entrench institutions and processes that can facilitate ongoing reform beyond the life of any one government.

Gaining from trade liberalisation: reflections on Australia's experience*

It has been almost 30 years since Australians woke up to discover that their government had initiated a 25 per cent cut in manufacturers' tariffs. This dramatic event was the opening volley in the reversal of protectionism in Australia. The path of trade liberalisation since then has been neither smooth, rapid, nor consistently downhill. However, we have ended up a long way from where we started, with limited tariffs and other import restrictions in most of our traded goods sector (and low barriers to most services trade).

Unlike most other countries, Australia undertook much of this liberalisation of its own accord, outside the formal bargaining processes of the GATT or WTO. Nevertheless, it got 'credit' for its reforms in subsequent multilateral trade negotiations and, through the non-discrimination rule, benefited from the reciprocal liberalisation of the larger trading powers.

Part way into the latest Doha Round of multilateral trade negotiations, the old paradigm is shifting in significant ways. The Round itself seems to be in trouble. That is not too unusual at this stage. However, the sticking points are the same ones that have diminished the value of past Rounds (including agriculture). At the same time, and partly as a consequence of the earlier Seattle debacle, there has been an acceleration in effort devoted to the negotiation of bilateral or regional preferential arrangements.

The United States has been at the forefront of this, but we are now also seeing other traditional multilateralists like Japan, and even brand-new multilateralists like China, making similar moves, as well as other countries in Asia. This 'third wave' of preferential agreements goes well beyond barriers to merchandise trade, to include investment and various services-trade issues, as well as more contentious domestic regulation. Whether these agreements will prove to be building blocks or stumbling blocks for wider liberalisation remains hotly contested. What seems clear

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in the meantime, however, is that countries excluded from such agreements face considerable risks.

These developments bring obvious challenges, but also opportunities for Australia. The most significant of these relate to the current negotiation of a bilateral trade agreement with the United States, a new direction in Australia's own approach to liberalisation.

It is therefore timely to ask what lessons we can learn from the Australian liberalisation of the past that might help us plot the course ahead. What has been the effect of trade liberalisation on the Australian economy to date? Are there still benefits in proceeding unilaterally with reform? And what traps should we be aware of when negotiating trade deals, particularly bilateral or other preferential arrangements?

Australia's economic transformation

The liberalisation initiatives by Australian governments over the past two decades have contributed to the transformation of the Australian economy (Banks 2003a). Australia's exports and imports as a proportion of GDP are now one-third higher than they were in the mid-1970s. Domestic manufacturing based on import-replacement strategies has increasingly made way for export-oriented and globally-integrated production. Notwithstanding increased import penetration in manufacturing, the sector's real output has not decreased (although much employment has migrated to the services sector). Production and trade in services have also grown rapidly, as have commodity exports (at least prior to the current drought).

Over the 1990s, Australia's productivity growth accelerated to rates exceeding even the boom post-war years, with labour productivity growth almost doubling to over 3 per cent per year during the period 1993-94 to 2002-03. Further, Australia's growth performance was maintained despite the crisis which enveloped several of our major markets in Asia in the late-1990s, and the slowing of other OECD economies.

Australia became the fastest growing economy in the OECD during this period, and by 2001 we had climbed back from 15th to 7th highest of the 22 OECD countries, in terms of GDP per person.

Multiple benefits of trade liberalisation

While various factors, including sound macroeconomic management, played a part, research by the Commission and others suggests that the microeconomic reforms of the last two decades have been a major contributor to the strong productivity growth, and to our economy's increased flexibility in the face of economic disturbances. Trade liberalisation has been only one element in this transformation. But it has played a pivotal role, some key aspects of which are not generally recognised.

Consumers gain

First, and most obviously, tariffs are a (distorting) tax on consumption. They inflate not only the price of imports but also the price that domestic producers can charge for competing products. Reducing or removing that tax means that, over time, consumers can buy the same quantity of goods and services for less of their income, which leaves them with more to spend on other goods and services. They typically also have access to a greater variety of products.

More competitive firms and industries also gain

Second, lower tariffs for one industry generate benefits for businesses in other industries. One reason is that the extra consumer spending power can act to lift demand for other goods and services. But more directly, lower tariffs mean lower *input* costs for many businesses. For example, every business that uses passenger motor vehicles — from taxi owners to tourist operators to Telstra — has benefited from the significant reduction in tariffs and quotas on imported vehicles over the past two decades.

Exporters have been particular beneficiaries of lower tariffs. For example, when tariffs were lowered on farm machinery, our farmers' costs declined, making them more competitive on export markets — and better able to survive in the face of declining commodity prices. Further, high tariffs had tended to prop up the Australian dollar, which in turn pushed up the price of our wares on world markets. These are some of the reasons why economists say that 'a tax on imports is a tax on exports', and explains why export growth has broadly matched the more rapid import growth in the era of trade liberalisation.

For these and other reasons, reductions in protection for particular industries can be expected to create an expansion in the production and sales of many other industries across the economy. Understanding these inter-industry ramifications has been aided in Australia by the development of economy-wide models based on input-output data. For example, the Commission's ORANI model was used in the development of the 1988 program of general reductions in protection. The modelling projected that, while there would be a contraction in some industries such as transport equipment (7 per cent), TCF (5 per cent) and chemicals (2 per cent), price reductions and resource flows would mean that most sectors would expand. Mining output was projected to expand by 5 per cent, and output across agriculture and a number of manufacturing and service industries was also projected to expand, leading to an overall increase in employment, with real GDP rising by some $1.2 billion.

Increased flexibility and 'dynamism'

As well as these static allocative benefits, there are dynamic gains to an economy that opens up to import competition. The precise nature and magnitude of these gains are difficult to predict beforehand, or to model mathematically, yet Australia's experience suggests that they can be pervasive.

At one level, increased import competition puts pressure on corporate managers to examine and improve their operating efficiency, product menus and pricing, as well as exposing them to international best practice. It can also help to break down old antagonisms between management and labour within the threatened industry, providing them with greater incentives to recognise their joint interests and to work cooperatively.

At a broader level, heightened competition from imports means that firms and industry organisations that might otherwise have remained complacent about entrenched work practices, and the high cost of inputs and utility services, are no longer able to contrive to pass these costs on. This in turn can generate political pressure for reform in these other sectors of the economy. Thus the reforms to anticompetitive business regulations, government business enterprises and industrial relations, culminating in the National Competition Policy, can be seen as a logical outcome of the opening of the economy to international competition.

Managers are minding their businesses

Where the government sticks to a clear agenda of reform, such as the programs of phased reductions in tariffs that commenced in the late-1980s, there is a further benefit. It sends a signal to the business community not to expect special deals, thus releasing businesses' management and financial resources for managing rather than for lobbying. Unfortunately data on resources devoted to lobbying activities are not readily available. But casual observation of the Canberra scene over the past decade confirms a diminution and rationalisation of the lobbying armoury maintained by manufacturing firms and industries for protectionist purposes and a greater focus on seeking economy-wide reforms (for example, in taxation and industrial relations).

It is important to note that many of these gains were not achieved overnight. The reallocation of production and the introduction of new processes take time, and new investments of managerial effort as well as capital are needed. Similarly, attitudes and expectations formed in the era of government preferment take time to be redirected towards self-reliance. In the meantime, there are inevitably some dislocation and adjustment costs, particularly in more vulnerable regions, and these need to be taken into account. Nevertheless, the Australian liberalisation experience has been remarkable for the smoothness of the transition.

Unilateral reform has been the main source of benefit

Australia has not been alone in reducing barriers to imports. For example, average tariff levels for manufactured goods in industrialised countries have fallen from over 40 per cent after World War II to 4 per cent today. However, unlike the liberalisation efforts of the Europeans and North Americans, most of Australia's liberalisation has been *unilateral,* undertaken voluntarily rather than in return for reciprocal concessions from other countries.

This is partly because Australia was essentially precluded from being a conventional participant in multilateral trade negotiations. For many years our main export interest, agriculture, was off-limits in the GATT, providing little scope for trade bargaining, so we were forced to think about the domestic implications of reducing our own trade barriers (and we pioneered tools of analysis, such as the 'effective rate of assistance', to help us with that).

This turned out to be an important advantage, as we were among the first countries to act on the recognition that a country gains most of all from reducing its own trade barriers, *regardless of what other countries do*.

Contrary to mercantilist notions, the main benefits of trade for a country come not from maximising export income *per se*, but rather from the improvements in domestic productivity, resource allocation and consumption that import competition brings. A country's own barriers to trade generally have a more distorting effect on the allocation of its resources and on incentives to be productive and innovative than the trade barriers of other countries.

Unfortunately, the time-honoured rituals of trade negotiation are predicated on the opposite presumption — that any domestic 'concessions' are costly and can only be countenanced as the price for gaining greater access to foreign markets. This can often lead to tortuous tactical manoeuvres that are largely self-defeating.

Foreign liberalisation can bring additional gains

This is not to argue that reductions in foreign barriers to Australia's exports cannot be an additional source of benefit. In the case of agriculture, the Commission has estimated that complete liberalisation of the protection regimes in North America, Japan and Europe would yield welfare gains to Australia of over $US1 billion, largely through higher prices on world markets (improved terms of trade) (Dee and Hanslow 2000).

Moreover, it is obviously also true that the lower a country's trade barriers become, the larger the relative gains from foreign liberalisation.

This point was reflected in modelling conducted by the Centre for International Economics (CIE) for the Commission's recent inquiry on the automotive industry. In the automotive sector where Australia's tariffs are still relatively high, the CIE found that, of the gains that Australia would enjoy were all APEC countries to reduce their automotive tariffs to 5 per cent, Australia could accrue 90 per cent of this gain by reducing its own tariffs unilaterally. However, when considering the case of reductions in all manufacturing tariffs (most of which are already at 5 per cent in Australia), the CIE found that the main gains to Australia come from 'terms of trade' effects associated mainly with foreign liberalisation, rather than domestic resource allocation effects (CIE 2002).

This is germane to the current debate about the Australia-United States Free Trade Agreement (AUSFTA). Putting the tricky services-related issues to one side for the moment, the scope for Australia to derive further gains from liberalising its own merchandise trade barriers will have been considerably reduced once the final protection peak (TCF) has been dealt with. On the other side of the ledger, US barriers to Australian exports, particularly agriculture, are significant and their reduction might be expected to yield significant gains. (That said, it is also the case that much US agricultural assistance is in the form of domestic subsidies and price supports, which could not be changed to provide any preferential advantage to Australia.)

Non-discriminatory liberalisation has been advantageous

A further consideration, much discussed, is that moving from traditional unilateral liberalisation to a bilateral agreement opens up the possibility that domestic gains from our own liberalisation may be eroded by imports being diverted to a higher-cost source. Australia's traditional non-discriminatory approach to protection and its (unilateral) liberalisation has to date largely ensured that we used the lowest-cost sources of imports — as well as having the benefits of administrative simplicity and avoidance of international frictions.

Recent research by Commission staff suggests that, in practice, trade diversion may have been a more dominant consequence of many preferential trade agreements (PTAs) than previously thought (Adams et al. 2003). How significant it might be in a particular agreement will depend on the preferential margin at stake and the competitiveness of the partner. For the merchandise trade component at least, Australia's tariffs are becoming relatively low and the United States is a pretty competitive supplier of many products.

This leads to the broader question of the potential economic gains to Australia and the United States of preferential access to each others' markets. While the magnitude of the potential gains to Australia is not entirely clear, but could be significant if agriculture were fully liberalised, the potential gains to the United States are likely to be miniscule (given that we account for only 1 per cent of their trade and are a relatively open market already). Much larger gains are potentially available to the United States from its *own* liberalisation, again especially in the case of agriculture.

Attention to adjustment has been important

While trade liberalisation can generate a range of benefits across the economy, its most immediate and obvious effect is to put pressure on local, previously-protected industries. As we have seen, many businesses will be able to respond by cutting costs, innovating, lifting productivity or entering new markets. Inevitably though, some businesses will need to cut-back production or even cease operations. Such rationalisation is occurring in the TCF industry at present, where Australia's large labour-cost disadvantage means that many local firms producing standardised clothing and footwear will not survive almost regardless of the tariff regime.

However, the way in which governments unfold liberalisation can affect the extent of the risks. Governments can also help to ameliorate the adverse effects on people when change occurs. And this can affect community support for liberalisation.

In contrast, to the one-off 25 per cent tariff cut of July 1973, the programs of phased reductions in assistance that commenced in the 1980s brought more gradual and predictable change. Their announcement in advance gave businesses and their workforces time to plan their responses, and the phasing of tariff reductions resulted in incentives for continuous improvement within a more manageable rate of change. The across-the-board approach to reform also meant that businesses that came under increasing competitive pressure in their output markets were assisted by lower costs on their inputs. And, in contrast to earlier piecemeal approaches to reform, across-the-board reductions also made it more difficult for individual industries to argue for exemption.

While tariffs have been declining, governments have provided other forms of assistance to industry, partly to facilitate adjustment. These have included retraining subsidies or redundancy packages for workers in some industries, and a range of budgetary measures tied to production, investment and R&D. Microeconomic reforms in other sectors have also been introduced in part to assist businesses to remain competitive against imports.

Adjustment programs that effectively facilitate rather than hinder efficient adjustment are notoriously difficult to design and implement. Their efficacy is also difficult to assess. Nevertheless in its PMV and TCF reports the Commission saw value in extending for a limited period the respective subsidy programs, conditional on achieving further reductions in tariffs (PC 2002e, 2003f). In the case of PMV this was no doubt central to the industry's acceptance of further tariff reform (the Government providing larger subsidies than the Commission had envisaged).

An informed public debate helps achieve durable reform

Australia has not been the only country to liberalise its trade unilaterally. But it has been one of a few to do so from such an entrenched protectionist base, without pressure from the IMF or World Bank, or in response to economic crisis. Moreover, unlike New Zealand, it has done so within a bicameral parliamentary system, which raises the hurdle for radical policy change.

So how did this come about? The short answer is 'with a lot of effort'! A satisfying explanation would require more time and space than I have available here. However, at the risk of oversimplification, a number of factors seem to stand out. First, I have already noted that the fact that our principal export interests were 'off limits' in the GATT negotiations was (perversely) helpful, because it meant that we were not distracted from focussing on the domestic costs of our own policies.

That domestic focus was in turn aided by theoretical and modelling developments in assessing the economy-wide impacts of trade restrictions (many of which were pioneered by Australian economists, Professor Max Corden being the pre-eminent example) and by institutional vehicles which enabled an economy-wide perspective to be brought to bear on industry-assistance decision making. Perhaps the most durable and systematic of these were the predecessors to the Productivity Commission, which in having a mandate to provide information on the wider costs of protection, were able to alert those industries who would bear the burden and act as a public-interest counterweight to the pressure from import-competing industries. A third important ingredient was the political leadership needed to translate reformist ideas into actions, and sell them to the Australian community. This came together under the Hawke-Keating Labor Government of the mid-1980s, facilitated by the support of the Liberal Opposition.

The upshot has been a more open and well-informed debate on industry assistance issues in Australia than is evident in most other OECD countries. And, while one cannot expect *consensus*, it is apparent that most industries have come to accept that their protection was not sustainable. The relatively muted public response to the Commission's reports advocating 5 per cent tariff rates for PMV and TCF, compared to the more hostile and defensive reactions in the past, is the most recent illustration of this. Such public acceptance has no doubt been aided by accumulating evidence of the economic dividends from reform.

Trade liberalisation shouldn't mean 'open slather'

Trade liberalisation should involve policy actions which, in facilitating trade and investment flows, yield gains in national welfare. Trade liberalisation is not an end in itself. There can be valid rationales for certain measures that restrict trade in some cases and these should not be automatically surrendered under the banner of 'free trade'.

Free markets can be powerful mechanisms for promoting economic efficiency. But well-targeted government regulations or other interventions can improve on market outcomes in some cases. What needs to be demonstrated is that some form of 'market failure', or 'inequity' exists that can be addressed most efficiently by the intervention.

In the case of restrictions on merchandise trade, such rationales are hard to find. Sometimes regulations that can have the effect of restricting trade, such as technical standards and product design rules, may be warranted on safety or environmental grounds. But even in these cases, it is usually possible to achieve the underlying social or environmental objective through standards that do not discriminate between domestic and imported goods.

Some restrictions have sound rationales, but …

However, the issues are more complicated in relation to negotiations on certain services and various 'trade-related' matters. Prominent examples include the Pharmaceutical Benefits Scheme (PBS), our quarantine laws, broadcasting content and ownership regulations, and the Foreign Investment Review Board. All these government interventions directly or indirectly restrict inward trade or investment flows; or, in the case of the PBS scheme, reduce the profits foreign companies can make by exporting pharmaceuticals to Australia. Some of these interventions have been raised as potential targets by US trade negotiators. Yet at least some of them appear to have defensible objectives, with discrimination against imports a requirement for their successful operation.

In such cases, there is a need to assess carefully the domestic benefits and costs of the interventions before offering to 'surrender' them as part of any trade deal, whether it be a bilateral deal with the United States or other countries, or as part of multilateral negotiations in the WTO.

In some cases, it may be that the underlying objective is either not warranted or does not require the particular restriction. For example, the Commission's 2000 inquiry into broadcasting found that sector-specific restrictions on foreign ownership of media outlets were not warranted on either economic or cultural grounds (PC 2000a). Similarly, in a number of reviews the Commission has concluded that the benefits of statutory marketing arrangements are likely to be outweighed by the costs. This is because of the limited scope for Australia to influence world prices, and also because many of the potential benefits do not necessitate a regulated monopoly (Gropp, Hallam and Manion 2000; PC 2000b).

On the other hand, the Commission's broadcasting inquiry was more ambivalent about local content requirements, concluding that they should be retained pending a more systematic evaluation in the new context of the digital era (PC 2000a). Similarly, in recent reports on pharmaceutical prices and assistance arrangements to the pharmaceutical industry, the Commission found that prices for drugs under the PBS are considerably lower than would otherwise prevail, partly reflecting (countervailing) buying power, yet this did not have sufficient adverse effects on the local pharmaceutical industry to warrant compensatory assistance for manufacturers (PC 2001a, 2003b).

In the case of quarantine, there are long-standing provisions within the WTO for restrictions that have a legitimate scientific basis and all countries have arrangements in place. Australia's quarantine regulation and administration has drawn flak for being more restrictive than some judge necessary. This is a view apparently shared by the United States and the European Union. Clearly for a country like Australia, which still depends on agriculture and has much unique flora and fauna, an effective quarantine administration is particularly important. And, as some recent scares and potential threats illustrate (such as foot and mouth, fireblight and wheat virus) some degree of risk aversion would seem justified. Whether any changes to existing arrangements may nevertheless be domestically beneficial as well as trade liberalising would require careful assessment.

Looking forward

Australia has derived substantial economic benefits from the trade liberalisation which eventually followed that 'opening volley' of 30 years ago. In this period, we could demonstrate that our high import barriers imposed large costs on our domestic economy and community — and that this was so regardless of what other countries chose to do. The gains from unilateral liberalisation accordingly dominated external trade policy considerations. Moreover, apart from agriculture, our external interests were effectively secured anyway through (mostly) non-discriminatory treatment and multilaterised liberalisation by our trading partners.

At the start of this new century, while economically fortified by our past reforms, we find ourselves in a more complicated trade policy environment. Most of our own barriers to trade in goods and services are relatively low, or soon will be, whereas overseas barriers to our agricultural, services and some manufactured exports, and in some markets to investment, remain high. At the same time, there has been a shift to regional or bilateral trade agreements by our trading partners, which seem to be generating more liberalisation of trade and investment in those countries than the more inclusive but unwieldy processes of the WTO. However, unlike multilateral initiatives, these preferential arrangements pose obvious risks for Australia: by excluding us, they serve to depress our exports and terms of trade and thus our national income.

While this new environment presents new challenges and requires some new approaches, I believe that Australia's past experience in reaping gains from liberalisation continues to provide guidance for the future.

Push on with domestic reform

In particular, it would be counterproductive for Australia to hold back from further beneficial reforms simply to provide it with negotiating chips in trade negotiations. The gains from domestic reform are gains that we can plan for and can benefit from, if we implement them well, whereas those contingent on the actions of other countries are much less certain. In any case, Australia's domestic market and its remaining barriers are unlikely to be large enough to exert much negotiating leverage on our major export markets. Finally, and of particular importance in the current environment, the lower are our barriers to trade and investment generally, the less scope there is for 'diversion costs' associated with any bilateral or regional agreements that we do decide to join.

Thus it is a positive development for Australia that the Government has committed to further reductions in automotive assistance. And it is important that we also proceed to complete tariff reform in the TCF sector. The Commission's preferred option in its inquiry position paper provides a balanced plan for achieving this, on which public hearings are currently taking place.

Bilateral negotiations may be a useful 'motivator'

A question remains, however, as to whether trade negotiations can nevertheless provide a useful motivator for Australia to undertake further, nationally beneficial reforms. For reasons already noted, the GATT/WTO had only a limited role in this respect. However the more concentrated pressure of bilateral negotiations may serve to expose issues which otherwise could not easily have been addressed.

For example, among issues identified in the context of the AUSFTA, I see no reason why we should not provide an undertaking to review our current arrangements for quarantine, government procurement, statutory marketing, anti-dumping, foreign investment and even the PBS. Indeed, I would be surprised if there were no ways in which we could make these arrangements work better for the benefit of the Australian community, apart from the external implications. I hasten to repeat that (most of) these are complex issues requiring careful analysis and public consultation before we could be confident about what changes may be required. Any such decisions should not be made lightly or quickly, or simply as a trade-off for potentially improved access to the US market or even to foster 'deep integration' between our economies. However, if any nationally beneficial reforms we identify could also help to secure us improved access overseas, so much the better.

It is worth noting that any reforms in most such areas would in any case need to be implemented in a non-discriminatory way. (This is most obvious in the case of quarantine regulations.) To that extent, there is a built-in safeguard against one potential source of loss in the context of a Free Trade Agreement (FTA).

While we clearly need to do our homework on any domestic reform initiatives we may undertake, we obviously also need to assess very carefully the national implications of offers made by the United States.

Modelling has limitations

The oft-quoted estimated gains from an AUSFTA are based on certain presumptions about the nature and extent of US actions. Modelling can only tell us so much — and is critically influenced by the choice of parameters. It would nevertheless be useful to model the implications of different scenarios as they emerge.

General equilibrium models typically understate the gains from liberalisation because they are unable to capture adequately the dynamic benefits. However, in the case of preferential arrangements they can also partly *overstate* the gains, because they cannot model the detailed rules of origin and contingent trade remedies which may in practice impede effective market access. This is one reason why recent econometric research by Commission staff, based on actual trade and investment flows following the formation of PTAs, found much less (net) trade creation than *ex ante* general equilibrium models had predicted (Adams et al. 2003).

The devil is in the detail

As is well known, the United States has devised quite detailed (and lengthy) rules of origin in its various bilateral agreements. Apart from their complexity, they have varying restrictiveness, depending in part on the domestic 'sensitivity' of the imports. For example, at one extreme, under the 'triple transformation' rule for TCF in the North American Free Trade Agreement (NAFTA), duty free access is permitted only if clothing is sewn in a NAFTA country from fabric made in a NAFTA country from yarn spun in a NAFTA country. This can serve to distort the partner's input sourcing decisions in favour of higher-cost NAFTA suppliers, such as the United States. (This diversionary effect can occur even if the country's own import barriers are negligible.)

Similarly, unlike Australia, the United States has traditionally employed narrowly-based 'safeguard' provisions in the administration of its trade agreements, potentially enabling restrictions to be re-imposed where a local industry suffers injury. For example, this has bedevilled Canada's attempts to export timber to the United States.

Clearly, Australia will need to ensure that rules of origin and contingent protection provisions are truly consistent with further opening markets. One avenue for 'deep integration' that could usefully be pursued, therefore, would be to align rules of origin and safeguard provisions in both countries with those of the most liberal partner. At the very least, we should seek to modify the arrangements used in previous FTAs by the United States, to minimise their protectionist potential.

As one 'spoke' on the US 'hub', Australia cannot overcome through an AUSFTA the perils of bilateral and regional arrangements among our other trading partners and competitors — including other countries attached to the US hub. At the same time, some of our suppliers, like New Zealand and China, will see their exports eroded to some extent and this may adversely affect our trade relations with them.

Multilateral progress is needed

It therefore seems clear that we must redouble our efforts to ensure progress in multilateral liberalisation within the WTO and APEC and, as mentioned previously, we should push ahead in lowering our barriers generally, wherever this yields domestic gains. The alternative of seeking to do a succession of bilateral deals, is fraught with difficulty (apart from the transaction costs) and may see us entering arrangements which favour particular Australian industries at the expense of others.

One avenue within the WTO for Australia to advance its interests, as well as the interests of global trade and development, is to seek to tighten the rules relating to FTAs, in order to reduce their potential to harm third parties. Stronger and clearer provisions relating to the need for elimination of barriers to 'substantially all trade' among the members of such an agreement would seem a good starting point. And, as has been argued previously, if such deals are truly to be building blocks rather than stumbling blocks for multilateral liberalisation, it would also be desirable to require that any such arrangements are eventually made open to other WTO members on the same terms.

The nub: understanding the domestic gains

The biggest problem that we face in any shift from our traditional unilateral-multilateral approach to liberalisation towards a 'regionally'-negotiated one, is that most countries (including the United States) understand their national interest through trade policy primarily in terms of the concessions they can wrest from other countries, rather than their own liberalisation. As a relatively small market, with few 'prizes' to offer, we are at an obvious disadvantage in such a world. This has always been so, but previously we got to share the spoils of larger countries' battles through most-favoured-nation treatment under the GATT/WTO. These spillovers are not available under preferential agreements.

How do we resolve this fundamental dilemma? The answers are not obvious, but the question deserves far more attention than it has been receiving. The task is to find ways through which the gains from domestic reform by our trading partners can be better recognised in their policy formulation. While each country needs to come to terms with this in its own way, Australia's beneficial experience with trade liberalisation may provide a useful role model.

Australia's economic 'miracle'*

Australia's GDP grew by 3.5 per cent a year in the 1990s; this was faster than even the United States' lauded performance and a third greater than that achieved by the OECD as a whole. Australia's strong growth performance was seemingly unaffected by the financial crisis that gripped our Asian markets in 1997 and, later, the bursting of the dot.com bubble. The strong growth exhibited by our country in the midst of the 1997 Asian crisis led the US economist Paul Krugman to label Australia the 'miracle' economy.

According to *Websters* dictionary, 'miracle' has two meanings. The first meaning given is 'A wonder or wonderful thing; a marvel.' I would not wish to disagree with such an assessment, as you will see. However, the second meaning — which has overtaken the first in common parlance in Australia and I assume in America too — is 'an event which cannot be accounted for as produced by any of the known forces of nature.' If Krugman had intended to be taken literally in this sense (which I doubt) then I must differ.

Australia's improved economic performance, and the productivity surge that underpinned it, *has* been a wonderful thing for Australians but it also has a rational explanation. Indeed, my central message is that the main cause of our improved economic performance over the past decade has been (rational) economic reform. However, both the need and scope for economic reform in Australia have not disappeared, and indeed remain important to our future prospects.

First, let me attempt briefly to put our recent economic experience in historical perspective. In doing so, I am going to focus largely on the productivity dimension. There is of course more to the economic and social wellbeing of a nation than output growth, but in my defence I shall call on Krugman again, who has boldly observed: 'Productivity isn't everything, but in the long run it is *almost* everything' (Krugman 1992). Indeed, productivity is the mainspring of material living standards. It is a necessary condition, even if not a sufficient one, for a more prosperous society.

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From growth laggard to leader

Australia's productivity growth in the second half of the 20th century can be segmented into three phases: relatively fast growth in the 1950s through to the mid-1970s; a slowdown through to the early 1990s; and a strong resurgence in the decade that followed.

To interpret these trends, we need to view them in an international setting. During the worldwide productivity boom of the post-war period, Australia's productivity performance — though stronger than in earlier periods — was poor by the standards of other similarly-developed nations. In contrast, during the 1990s, when the world productivity record was patchy, Australia's performance stood out. In other words, Australia's earlier productivity boom was not remarkable by international standards, but its resurgence of the 1990s certainly was.

The early post-war decades (the 1950s and 60s) are generally referred to as a 'golden age' for growth internationally — reflecting pent-up demand, reduced constraints on supply and freer international movements of capital, people and technology. In 1950, at the dawn of that era, the United States was the world productivity leader, while Australia ranked fifth, its GDP per hour worked being around 80 per cent of the US level. As the years unfolded, the performance of the United States dropped off somewhat (as might be expected of the productivity leader) while growth in Europe and Japan accelerated in a process of productivity catch-up. Australia, meanwhile, did not even keep pace with the United States and, by 1973, its ranking had slipped to twelfth.

During the subsequent global productivity slowdown, Australia continued to perform poorly even in relative terms and, by 1990, our ranking in per capita GDP and GDP per hour had slumped to 16th. (It was in those years that Australians became conscious that they were being overtaken in the income stakes by countries in Asia that many still thought of as 'developing'.)

The 1990s turnaround

All that turned around in the 1990s. Productivity growth stepped up again in the United States, while remaining sluggish in most other OECD economies and in Asia. However in this period, as noted, Australia's productivity growth *surged*, outperforming even that of the United States.

Australia's strong (labour) productivity performance in conjunction with better, if not ideal, employment outcomes — higher employment and lower unemployment, accompanied by a stable participation rate — translated into strong growth in average incomes. GDP per person (measured in US purchasing power parity dollars) grew by 2.5 per cent a year over the 1990s, compared with 1.7 per cent in the 1980s, and an OECD average in the 1990s of 1.7 per cent.

The result was that Australia's international ranking in per capita GDP rebounded from its low point of 16th in 1990 to 8th in 2002.

More importantly, that one percentage point boost in our growth rate translated into a substantial improvement in the average income of Australians. If we had not had the additional productivity growth in the 1990s, Australian households would have been around $7000 worse off on average by now.

Increases in the average level of GDP per capita are one thing; how the income gains are distributed across the community is another, and arguably just as important for a society's progress.

- At the aggregate level, labour and capital have shared evenly in the income growth. Moreover, productivity gains were not simply appropriated by enterprises in higher wages and profits. The evidence is that the productivity gains in the best performing industries were predominantly passed on in the form of lower relative prices.
- At the personal and household levels, disparities in market incomes continued to widen in the 1990s. But this was largely offset by redistributions through the tax and transfer system. The distribution of disposable income remained stable or showed a modest increase in disparities — depending on whose figures you use — and the distribution of consumption remained constant. (But, as Melbourne Institute research reveals, these outcomes mask disturbing trends in poverty among jobless households with children, a point to which I return.)

Other considerations, apart from income and its distribution, also matter, such as social and environmental outcomes. Some commentators have recently returned to what at one time was called the 'growthmanship' debate, rightly questioning whether additional growth brings us commensurate increases in quality of life or happiness ('utility' in the jargon). That raises matters beyond the scope of this talk. I might just observe that at least we are in the relatively comfortable position of being able to debate such an issue. This is not the situation in many poorer countries. Moreover, those countries often have the greatest environmental degradation and social upheaval — and can afford to give very little attention to safety nets for their citizens.

What caused the 'miracle'?

If we take as a first approximation, therefore, Krugman's maxim that productivity 'in the long run is almost everything', it is important that we understand and learn from Australia's productivity turnaround. At this point I should perhaps make clear that while I have hitherto been talking mainly in terms of *labour* productivity, its rise has been almost wholly accounted for by increased '*multifactor* productivity'. Both grew at record rates in the 1990s, but it was the acceleration of multifactor productivity (MFP) growth (from 0.7 per cent to 1.8 per cent annually over the last two productivity cycles) that generated nearly all the action. This is significant because multifactor productivity is the more telling indicator of how effectively a nation's human *and* capital resources are being used.

Not the usual suspects

Australians have an ingrained sense of (healthy) scepticism, and the economics profession is *trained* to be sceptical. The first reaction by some to a surge in the productivity growth numbers was that the statistics were probably in error or that they were being reported in a misleading way. Successive ABS revisions and methodological improvements have not changed (indeed have strengthened) the underlying story, however, and more detailed examination of individual industry performance has generally confirmed it.

With the aggregate productivity growth numbers beginning to look unassailable, some have sought to find explanations other than policy reform. However, most of those do not stand up to scrutiny as credible *principal* causes of the turnaround. I can say that with some confidence, because of research undertaken at the Productivity Commission (Parham 2002, PC 1999c).

- First, as already noted, unlike the experience of the 1950s and 60s, Australia could not be said to have been carried along by any international productivity boom in the 1990s.
- Second, the surge in productivity cannot be dismissed as the normal result of recovery from the early 1990s recession. The improved performance has been both longer and stronger than in previous recoveries. Besides, the relevant ABS measures abstract from cyclical influences.
- Third, higher skill levels in the workforce could have pushed up productivity. But there appears to have been no significant acceleration in workforce skills in the 1990s. In fact, the evidence shows a faster increase in skills in the 1980s.
- Fourth, there have been claims that the productivity surge has been produced on the backs of workers through increased 'work intensity': increased hours of and

pace of work. Again, some compelling counter arguments have been made (for example, that productivity measures already take into account additional labour input). But the key prediction — that higher work intensity by the mid-1990s would mean that the measured improvement in productivity could not be sustained — has not been borne out. The level of productivity has not slipped back. In fact, we have had 7 or 8 years of almost continuous *further* improvements in productivity since then.

As an aside, I should clarify that the 'work intensity' issues raised in this context relate to whether productivity estimates are mismeasured or unsustainable. They should not be confused with other live issues in community debate about job security and the ability for people to make appropriate work/life choices. All I might say on those important issues is that increased productivity — through working 'smarter' — is the friend, not the enemy, of the work/life tradeoff.

- Finally, Australia has not been favoured by any special technological leap forward. Indeed, on a number of indicators such as business R&D spending, Australia is below the OECD average. Other countries, including the United States, derived some benefit from rapid advances in the *production* of information and communications technologies (ICTs) in the 1990s. Australia produces little in the way of ICTs and so we have not accessed that source of productivity gain. But what about productivity gains from *use* of ICTs? This seems relevant given that Australia moved toward the top of the ladder on the uptake of ICTs in the 1990s (second or third in the OECD on major indicators). Commission research suggests that *use* of ICTs did indeed contribute to Australia's productivity pick up, but not by much at the aggregate level — around 0.2 of a percentage point (Banks 2001, Parham et al. 2001). And even then we are left to ask: why was it that Australia moved from being slow on the technology uptake in earlier decades to a frontrunner in the 1990s?

Microeconomic reform has made the difference

The answer is in large part the same as the answer to a wider question: what were the 'home grown' factors that saw us part company with international trends — factors that had held us back in earlier decades?

Adam Smith observed that 'there is much ruin in a nation', meaning that an economy is potentially quite resilient to shocks and mismanagement. However Australian government policy throughout much of the 20th century had almost systematically, if unwittingly, undermined the economy's productive potential, by distorting price signals and protecting producers from competition. It is not surprising that those policies took their toll. Equally, it should not be surprising that their reversal has yielded the benefits that economic theory would anticipate.

As you know, the reforms really began with the lowering of barriers to foreign competition in goods and financial markets in the 1980s. As tariff reform and takeover pressure began to bite, managers began to devote more attention to improving the performance of their business. They needed to reduce their costs and improve their flexibility to respond to mounting competitive pressures. Two major impediments to those objectives were the high costs of energy, transport and other services provided by inefficient public utility monopolies (engaged in cross subsidising households), and a centralised system for 'fixing' wages and conditions, irrespective of the diverse circumstances of individual enterprises.

Reforms in these areas followed. A presumption of competition being in the public interest found ultimate expression in the National Competition Policy — the systematic program agreed to by all Australian governments in 1995 to extend competition throughout the economy.

I should not give the impression that any of this was easily or quickly achieved. Reforming anticompetitive policy is generally a lot harder than implementing it. For one thing, producer interests (including employees) become rather attached to it and they fight hard to retain what they perceive as their entitlements. The story of economic liberalisation in Australia thus has as much to do with politics and institutions as with economics. That said, the economics profession in Australia has played an important role both in identifying necessary reforms and demonstrating the likely payoffs, and in selling reform to governments and the wider community.

Evidence of reform's effects

The liberalisation of the Australian economy has coincided with important structural and behavioural changes which are consistent with the observed step-up in productivity performance. These include:

- a sharp increase in trade intensity, with the ratio of exports and imports to GDP rising from 27 to 44 per cent since the mid-1980s
- the decline of high cost manufacturing activities and the rise of elaborately transformed manufactures (for example, while textile, clothing and footwear production has fallen in real terms by about 40 per cent since 1985, manufacturing production as a whole has risen by 40 per cent)
- the growth in enterprise agreements, involving substantial variations in previously prescribed employment conditions and work practices

- a rise in business expenditure on R&D and other indicators of innovation (in production, distribution and marketing) including, as noted previously, increased uptake of ICT.

If we trace the productivity performance of individual industries over time, we can also observe some strong linkages with earlier microeconomic reforms. These are most apparent for those industries previously dominated by public sector monopolies, following wide-ranging reforms. For example, MFP growth in electricity, gas and water jumped by 60 per cent in the 1980s, while in the 1990s MFP growth rates in transport/storage and communications doubled.

The performance of the 'traditional' sectoral contributors to aggregate productivity growth was mixed, with agriculture surging in the 1990s, whereas mining had its burst in the second half of the 1980s and slowed thereafter, and manufacturing slumped in the mid-1990s when the market aggregate was rising most strongly.

Given the focus of trade liberalisation and other reforms on manufacturing, one might have expected to see its productivity growth do better. There are a few points to note. One is that there has been much stronger *labour* productivity growth in manufacturing in the 1990s, reflecting (hi-tech) capital deepening. Second, the MFP performance generally appears to have been much greater in particular industries (whitegoods in the 1980s, automotive from the late-1990s) where trade pressure increased most. Third, we are now also seeing aggregate MFP growth rates for manufacturing accelerate; in 2000-01 and 2001-02 they recorded their highest rates for 17 years.

However, the stand-out contributors to the productivity surge of the 1990s were the wholesale trade and finance and insurance industries. At first blush this might not seem in tune with a microeconomic reform theme. But Commission research indicates that both industries achieved a significant uplift in productivity primarily through the innovative use of ICT. For example, developments like scanning and bar coding and IT-based inventory systems helped transform wholesaling from a storage-based activity to fast flow-through logistics systems. But it was the *reorganisation* of the businesses that generated the productivity gains — from reduced warehousing and handling — rather than the mere acquisition of ICT. These organisational changes were, on the one hand, prompted by competitive pressures downstream (for example, as the hard-pressed auto industry sought cost reductions all along the value chain) while, on the other hand, being facilitated by work practice changes that could not have happened under the prescriptive and inflexible arrangements of the old industrial relations regime (Johnston et al. 2000).

This is supported by recent OECD research for their 'Growth Project'. OECD researchers found that product market regulations and employment protection legislation had a negative impact on MFP growth across countries in the 1990s. They found that countries with decentralised bargaining systems and less stringent employment protection were better placed to innovate in industries characterised by multiple and rapidly-evolving technologies.

Sustaining the 'miracle'

In sum, much of the so-called 'miracle' of Australia's transformation from economic laggard to leader can be attributed to simply removing the lead from our saddlebags. Mancur Olsen likened the potential gains from such reform to finding $100 bills on the sidewalk. Easy pickings for economists, if not for those who must implement the necessary reforms.

Indeed it could be said that the most miraculous thing about Australia's economic turnaround was that the necessary policy reforms took place at all! As a much earlier economist Vilfredo Pareto first demonstrated, the natural forces of political economy are not conducive to reforms that potentially provide diffuse benefits to the many at the concentrated cost of the few. Even from this perspective, however, it is apparent that considerable groundwork was laid over many years across different governments to create a climate of receptiveness to the need for change. Australia's proclivity for systematic inquiry and public debate in policy development has been part of this. The OECD alluded to this feature in its most recent report card on Australia's economy:

> The Government's commitment to reform, its willingness to commission expert advice and to heed it, to try new solutions, and to patiently build constituencies that support further reforms, is … something that other countries could learn from. (OECD 2003)

As I noted earlier, economists in various capacities — academics, consultants, public servants and political advisers — have been at the centre of this process and should be proud of their contributions. But I began this presentation on a hopeful note for current post-graduates and it may appear that there are no challenges left.

Reasons for seeking further improvement

Returning to the productivity window on our overall performance, it is clear that while we have been in catch-up mode internationally, there is still some catching up to do. For example, in terms of GDP per hour worked, in 2002 we were at 83 per cent of the US level, which was only slightly above where we were in 1950. Our manufacturing productivity in particular remains well below US levels.

Whether or not aspiring to US levels of productivity is realistic, the need for us to realise our productivity *potential* has not diminished. Taking Australian society and its regions as a whole, it would be difficult to argue that standards of living should not be any higher. And it seems clear that that cannot be achieved in any sustainable way without productivity growth. As the Australian National University's Professor Ross Garnaut has put it:

> Effective measures to promote distributional equity make large demands on a country's fiscal resources. Economic growth is therefore a necessary underpinning of progress towards distributional equity. For these reasons, it remains likely that Australia will have all of productivity-raising economic reform, progress towards greater distributional equity and stronger economic growth, or none of them. (Garnaut 2002)

Moreover there are both external and domestic challenges to our living standards which would make it unwise to rest on our laurels.

For one thing, the ongoing external pressures of globalisation and the reforms which have unleashed the competitive strength of other countries, like China, mean that we have to continuously improve our performance.

Compounding these (positive) external challenges, is the gathering international retreat from multilateralism in trade policy and the rise of discriminatory liberalisation. To the extent that Australia is excluded from such preferential deals, we are exposed to terms of trade and income losses. However in engaging in such deals ourselves, we may be exposed to other negatives through trade diversion and increased transaction costs. In other words, in terms of our external trade policy, we potentially face a no-win situation: this sharpens our need to take any measures that can enhance unilaterally our economic performance and competitiveness.

On the domestic front, we face two looming challenges that add to the productivity imperative. One is environmental sustainability. Dealing with the legacy of (unwitting) environmental mismanagement will demand additional resources in rectification, and policy reforms which will involve adjustment costs, much of which may be concentrated in regions that are already 'doing it tough'.

Secondly, while Australia has benefited from a relatively high engagement of its population in work, the demographics of our ageing society — with a doubling of the proportion of people over 65 years of age by 2040, as people live longer and procreate less — will reduce per capita income growth for given productivity growth, while potentially raising the costs of health and other services.

So plenty of challenges lie ahead for a new generation of economists to tackle. In some areas, past reforms will provide useful guidance, and indeed there remain parts of the existing reform program that need to be completed. These include remaining industry protection (including some contentious non-tariff issues raised in the current AUSFTA negotiations), the National Competition Policy (water reform being particularly important) and industrial relations reform.

However, there are a number of critical areas for the future which present new complexities for reformers and few 'off-the-shelf' or 'tried-and-true' solutions. These include:

- getting the best out of Australia's 'social infrastructure' — health, aged-care and other community services — which account for a sizeable and growing share of GDP and are key to future living standards
- raising the performance and accessibility of our education and training systems — primary, secondary and tertiary — particularly given their importance in deepening Australia's human capital, on which innovation and economic growth will increasingly depend
- raising the participation in employment of the Australian working-age population, including by reducing long-term unemployment (the major contributor to poverty) and premature 'retirement' from the workforce
- related to this, devising better mechanisms to ease social hardship, including from job losses associated with policy change, without detracting from economic performance
- devising better mechanisms for redressing and avoiding adverse environmental side-effects of economic activity.

Such areas are difficult to deal with because of the blend of social and economic objectives that arise, but they are problems for which an economist's training — in systematically analysing the role of incentives on human behaviour and the necessary tradeoffs in all policy choices — is apposite.

Industry policy for a productive Australia*

'I might tolerate theoretically the infant-industry case, but theoretical toleration is unwise; people will soon go beyond it.' (Colin Clark, from an interview with Chris Higgins, 1989)

Introduction

I am grateful to have been invited to give this address in honour of Colin Clark, one of Australia's foremost economists. Many years ago, when studying economics at Monash University, I had the pleasure of hearing some lectures from Professor Clark himself. I remember being greatly impressed by his casual references to discussions 'with Lord Keynes on the steps of the (British) Treasury'. More recently, in researching for this lecture, I found that while Clark agreed with Keynes on much, he had opposed the great man on the issue of industry protection. He saw this as Keynes' 'real blind spot'; and considered that 'he enjoyed being on the popular side' (Higgins 1989).

Clark himself was rarely on the popular side, especially in the protection debate. What's more, he was severe on his fellow academic economists who, he said, 'floated happily with the current of popular protectionist sentiment and have avoided the unpleasant task of having to educate public opinion out of its prejudices' (Clark 1962). Clark generally came to his own policy conclusions, based not just on theory, but careful statistical evidence and acute observation of the world as it was. This no doubt led him towards the end of his life to make the observation that I have chosen as the header quotation for this lecture.

This introduces a theme that for me is of wider and continuing relevance. Industry policy measures assume an important place in any government's policy armoury. But where they potentially deliver benefits to particular firms or industries, they are commonly the subject of much lobbying and self-interested claims. Moreover, where selective assistance to industry is involved, it is never costless, although the nature and incidence of the costs are often hard for the public to understand. It is therefore crucial that such policies not only have a sound rationale, but are carefully

* Colin Clark Memorial Lecture, University of Queensland, Brisbane, 6 August 2008. (Co-authored with Tom Nankivell.)

designed and implemented in keeping with it. This lecture in honour of Colin Clark provides a timely opportunity to consider these issues.

The broadening of industry policy

Writing in the early 1960s, Colin Clark was beginning to despair at the prevailing protectionist policy for Australian manufacturing and its deleterious impacts on work incentives and economic performance. He observed:

> Australia in the future — if Australia is to have a future — will have to be more competitive in every way. (Clark 1962, p. 28)

Fast forward to today and, clearly, Australia *did* have a future. Our economy also is more competitive in every way than it was then. However, if we had been making this assessment in the early 1980s, Clark's warning would have remained apposite. For it was only in that decade that the first real steps were taken to reverse the protectionist conception of industry policy that was largely responsible for Australia's secular decline in world economic rankings.

The steadfast commitment to opening Australia's markets over the subsequent 20 years or so has yielded gains much greater than conventional modelling could have projected. Reform is a process, not an event. Reducing tariffs — an umbrella sheltering inefficiencies well beyond the traded goods sector — set in train further 'behind the border' reforms that have in turn brought further substantial benefits to our economy.

In particular, under pressure from increased import competition in their output markets, businesses began to lobby for the reform of government policies and practices that were unduly increasing their production costs, as well as for alternative forms of assistance to enhance their competitiveness. This 'second wave' of reforms included measures to improve the efficiency of government utilities, changes to industrial relations to enable more flexible workplaces, and broad-ranging reforms to remove regulatory impediments and engender greater competition, where appropriate, throughout the economy.

At the same time, there has been an increased emphasis on industry assistance directed at overcoming market failures, notably in the area of R&D. And industry-specific assistance has increasingly been targeted at facilitating adjustment and structural change.

In sum, over the last twenty or so years there has been a move away from the previous narrow and defensive conception of industry policy. Taking its place has been a growing recognition that there is a need to get the economic environment right for all firms, and to facilitate adjustment to market pressures rather than resisting it. As such, industry assistance has come to be recognised as just one facet of industry policy, which itself is increasingly seen as encompassing the broad range of policy-related factors that bear on the performance of industry generally.

Notwithstanding the significant reforms in this period, considerably more needs to be done. Thus we are now embarking on a 'third wave' of reform, extending beyond cost impediments, to also addressing industry's human capital needs and encompassing all jurisdictions (Banks 2008).

Industry assistance nevertheless remains substantial

Despite the reduction in tariffs, and even with many omissions in coverage, Australian Government assistance to industry was estimated by the Commission to exceed $15 billion in 2007. State and territory assistance programs, which are less transparent, would add a few billion on top of that (PC 2008g).

In the early 1960s, when Colin Clark was raising concerns about Australia's future, tariffs accounted for virtually all the assistance received by the manufacturing industry. Today, average nominal tariff rates are about a tenth of what they were in the sixties, and tariff assistance accounts for three-quarters of measured (net) assistance to the sector. The other quarter involves various forms of budgetary assistance.

Although strictly comparable estimates are not available, measured budgetary assistance for manufacturing appears to have roughly doubled in real terms since the 1960s. Assistance tied to specific manufacturing industries and businesses has increased at a faster rate than generally available manufacturing assistance. Nevertheless, financial support has not compensated for the loss of tariff assistance, even in the textile, clothing and footwear (TCF) and passenger motor vehicle sectors, which absorb a large share (over 40 per cent) of estimated budgetary assistance to manufacturing. Moreover, more of the industry-specific assistance today is at least notionally tied to the performance of R&D or other activities, rather than simply supporting production.

New policy forces and influences

Ongoing pressures from globalisation and emerging exporters have prompted calls for new measures to provide relief against imports or other assistance.

The innovation impetus

In addition, increased recognition of the central importance of innovation to industry productivity and competitiveness has led to a renewed focus on how government can support it. The previous Government commissioned the Productivity Commission to undertake a major study, *Public Support for Science and Innovation* (PC 2007b), which included a focus on the rationale for and design of business programs. The Rudd Government has commissioned its own separate review of the national innovation system, expressing an intention, 'to ensure that business has better access to new ideas and new technologies and to bridge the divide between industry and research' (Carr 2008a).

Moreover, the current reviews of automotive and, especially, TCF assistance were designed to link into the wider review of innovation policy, with the enhancement of the innovation performance of these industries being seen as crucial to their future sustainability.

The greenhouse challenge

Greenhouse policy is another potentially significant new driver of industry assistance. A plethora of budgetary and regulatory initiatives have already been taken with the goal of reducing Australia's emissions, including energy efficiency targets and subsidies for alternative energy sources.

While the need to address the effects of global emissions is now widely accepted, some of these programs seek to achieve reductions in emissions by favouring certain industries, technologies or activities, simultaneously providing *de facto* industry assistance. This may also make it politically difficult to rationalise those schemes that are rendered redundant by a (well-designed) Emissions Trading Scheme (ETS) (PC 2008h).

Yet, as currently proposed, the ETS looks set to have its own substantial industry assistance component, with hotly debated exemptions and compensation for some industries or enterprises potentially amounting to several billion dollars. Further, some 20 per cent of the revenue from this *de facto* tax is to be set aside for the promotion of greenhouse-related R&D.

When account is taken of other policies relevant to management of the environment, such as the large subsidies provided to water users, the implicit industry assistance stemming from such policies may, in the future, dominate other measures of business support.

Ensuring a productive outcome

These emerging influences could potentially see an expansion again in support for particular industries and technologies relative to measures of more general application. It will be important to ensure that any such schemes enhance overall economic performance. Indeed, contemporary pressures and challenges — including labour shortages and capacity constraints, the need to address the effects of an ageing population, and climate change itself — have increased the imperative to ensure that any new industry support programs promote efficiency, and to terminate existing programs that do not.

How the Government responds and the sort of industry policy that emerges is of considerable importance to Australia's economic future. It is timely therefore to take stock of the principles that should guide the development and application of industry policy.

The ultimate objective must be *economy-wide* benefits

Devising and assessing any policy obviously requires a clear understanding of what one ultimately wishes to achieve. It is particularly important when assessing policy proposals directed at particular industries or sectors. The reason for this, of course, is that what is good for a particular part of the economy or community need not be good for other parts — and in the case of industry assistance often isn't. Tradeoffs will generally be involved and the community would want some assurance that the benefits of an industry policy initiative will exceed the costs across the economy as a whole.

Even as many people have come to accept that tariffs and other regulatory barriers to competition are not a good idea, they often do not recognise that other forms of support could be (almost) as problematic or costly. It is of course unlikely that anyone would be properly informed about this by the potential recipients, or sometimes even by those government departments most closely involved. That indeed is the original rationale for the Commission's existence.

Governments ultimately are there to serve the wider community, and need such information to do their job. Thus, for example, in its recent auto report, the Commission spelt out that current assistance to that industry placed a burden on consumers and taxpayers of $2 billion each year; that each job thereby 'saved' costs the community some $300 000 annually, and that there would be a net welfare gain of some $0.5 billion each year in perpetuity (equivalent to a much larger figure in NPV terms) from halving its tariff assistance, with gains in the mining sector alone outweighing the auto industry's losses (PC 2008b).

The 'materialist fallacy'

The goal should not be to promote any particular industry or sector as an end in itself. This was what our old-style protectionist industry policy was about, which promoted manufacturing at considerable costs to our economy and community. That policy ultimately failed even on its own terms.

It is important to recognise that the manufacturing sector, though declining in relative size, is larger today than it was twenty years ago, notwithstanding significant reductions in government support. The secular decline in manufacturing's *share* of GDP is mainly due to the expansion of services; not mining.

The shift in the structure of economic activity from manufacturing (and agriculture) to services is a common phenomenon internationally. It is generally associated with economic advancement and thus to be celebrated. Meanwhile, the fact that the manufacturing sector has a smaller share of the economy in Australia than in some other OECD countries principally reflects our relatively abundant resource base.

The key point, though, is that the relative decline of manufacturing has not held back living standards in Australia. On the contrary, once we began to reduce manufacturing protection, and the burden it placed on more efficient and productive activities — within manufacturing itself, as well as other sectors — Australia's exports took off and per capita incomes have risen faster than the average for the OECD, taking us back to 6th in world rankings from 18th in the late-1980s.

Other problematic pretexts

Just as maintaining particular industries or sectors should not be an end in itself, so there are other problematic pretexts for government assistance that treat economic activities that are means to ends, as ends in themselves.

Exporting is a prime example, and currently the subject of a policy review encompassing consideration of support programs such as the Export Market Development Grants (EMDG). Exporting obviously brings benefits — and in recent years has contributed greatly to income growth in Australia flowing from rising world mineral prices. However, the production, marketing and delivery of goods and services for export all employ resources and thus have opportunity costs. For Australia to gain from any particular exporting activity, the benefit received needs to exceed the value that could have obtained by using the embodied resources to supply the domestic market. Hence it cannot be presumed that additions to exports, particularly if induced artificially by assistance, will yield a net payoff to the community.

Sometimes assistance is seen as addressing the 'problem' of trade imbalances in particular sectors or product categories. But such imbalances are simply a manifestation of the gains from trade. We need to specialise in what we do well and import what we do not. Industry policy should complement trade policy in supporting this effective use of our scarce resources, not resist it.

In a similar vein, nor should the goal of industry policy be merely to achieve an expansion in small business, large business, jobs (in particular sectors) or even innovation. The objective should be to enhance the performance of the Australian economy, so as to enable living standards and community wellbeing to realise their potential, given the resources available and their alternative uses. What those industry policies that target particular industries, activities or groups need to demonstrate is how they can achieve this.

What policy rationales *meet* the economy-wide objective?

The key efficiency-related rationales for government intervention involve various forms of 'market failure', where private agents responding to market signals are led to make the 'wrong' investment or production decisions, detracting from economic welfare. Technically-speaking, market failure can arise where there are spillovers, public goods, information deficiencies or asymmetries, or where cognitive limitations detract from appropriate decision making. Most of these have given rise to industry policy interventions at one time or another.

Market failures are pervasive, but in order for them to become a rationale for intervention ('policy relevant') they need to be substantial and amenable to government action, without giving rise to even larger costs.

Innovation in perspective

Spillovers provide the core rationale for a major strand of industry policy directed at R&D or, more broadly, innovation. The latter is becoming the predominant focus of industry policy.

The evidence suggests that the keys to encouraging innovation are not government assistance, but rather competitive markets that provide strong incentives for firms to innovate, combined with a regulatory environment for doing business that readily allows them to do so (OECD 2007). These are precisely what the microeconomic reforms of the past two decades have been directed at. In particular, lowering tariffs and other barriers to foreign goods and capital has not only heightened competitive pressures, it has been a conduit for greater exposure of local firms to new ideas from abroad.

It follows that, for much of the innovation that needs to take place within Australian firms, there is no market failure that needs addressing (or can sensibly be addressed), once government's regulatory failures have been rectified. This is important to emphasise, since not all government regulatory failures *have* been rectified and there is always the danger of new regulatory obstacles emerging or past reforms being reversed.

Spillovers can inhibit R&D

This is not to deny the case for some 'reinforcing' industry support for innovation based on clear market failures and, in particular, spillovers related to research activity. Often research undertaken by businesses, as well as that in universities and public sector research agencies, generates ideas that can be used, mimicked or adapted cheaply by firms or others without payment to the originator. Public support to encourage innovative activity that would not otherwise proceed because the private returns to the originator are too low, has the potential to enhance community wellbeing.

As noted, much government support is predicated on such spillovers, as well as on the need for public research to underpin public sector activities. In 2006-07, government direct and indirect support for business R&D alone amounted to nearly $2 billion, or one quarter of measured assistance, and a further $4 billion went to research conducted within universities and other public sector bodies.

With spillovers assuming greater significance under an innovation-policy approach to industry policy, it is important to have greater clarity about the concept than has sometimes been the case. For example, spillovers are very different from multiplier effects that simply reflect (priced) linkages between different sectors of the economy and which do not provide a justification for government support even where the beneficiaries are research-rich activities. And, as the Commission argued in its report on public support for science and innovation, the spillovers arising from research activity in universities and public sector research organisations are often likely to be higher than for business R&D, much of which involves incremental, catch-up research (PC 2007b).

A faster changing and more tangled web?

Governments will also have to confront the argument that new industry policies are required to address the changing nature of innovation and the 'new world order' brought about by globalisation and climate change.

Innovation is increasing rapidly and models of innovation are evolving. It is not clear that such changes will significantly alter the basic menu of market-failure-related industry support, but they could alter its composition. For example, industry-extension support might be focussed more heavily on helping businesses to leverage finance off intellectual property and on dealing with information asymmetries impeding the uptake of more fuel efficient technologies. There may also be a case for shifting the balance of R&D support more towards promoting collaboration and clustering/networking, rather than paying individual firms for R&D activity, most of which they would have undertaken anyway.

The growing pace and evolving nature of innovation, and its role in responding to the challenges of climate change, may also create pressures for 'enhancements' to government procurement processes. Improving procurement processes is an intrinsically worthwhile policy goal. But it can clearly be a slippery slope, if promoting innovative technology becomes a goal in itself for the procurement process, with *de facto* industry protection being a not unlikely outcome. Those of us old enough to remember the 'offsets' arrangements and their many problems and costs (IAC 1989a) would not want a case of 'back to the future'.

The environment–innovation interface

The growing intersection of environmental policy and innovation/industry policy has great political appeal, but can lead to confusion about ends and means. It is important to separate genuine rationales for government intervention from convenient environmental pretexts for supporting particular industries or activities. For example, the implementation of an effective ETS would generate a market-based price for carbon emissions that should render many pre-existing emission-reduction schemes redundant. Stripped of this environmental rationale, schemes such as the Mandatory Renewable Energy Target would simply become very costly industry support vehicles (PC 2008h).

That said, the emerging price signals may not bring forth sufficient innovation in adaptive or low emissions technologies due to spillovers or other market failures. This may warrant supplementary measures. However, such measures would need to take account of the (extensive) existing support for R&D and be targeted at areas where market failures are likely to loom large — such as in basic or strategic research, rather than commercialisation of existing technologies or in picking green technology ‘winners’. For example, the $500 million Green Car Innovation Fund would be unlikely to yield significant innovation or greenhouse benefits if it were all allocated on a similar basis to the first $35 million instalment (PC 2008b).

Other rationales

Industry policy has traditionally also had some justification on ‘second best’ grounds, in compensating industry for excessive costs or other impediments to their performance associated with various government policies. Indeed, tariff policy itself commenced as a rough *quid pro quo* for regulation that raised the unit costs of labour (not only through higher arbitrated wages, but also constraints on work arrangements).

Second best rationales are harder to find these days than in the past, following the extensive reforms under the National Competition Policy and successive waves of industrial relations reforms since the late-1980s. Moreover, as Australia’s microeconomic reform record demonstrates, distortions are generally best tackled directly, rather than being compensated for. There is also the problem of designing effective policies on second-best grounds that would be effective.

One aspect of today’s policy environment does appear to provide a genuine rationale for industry policy intervention on ‘second best’ grounds. Specifically, the asymmetry in the treatment of profits and losses under Australia’s corporate tax system can inhibit relatively risky investments, at some cost to the economy. Since it does not seem feasible to address this problem through (‘first best’) changes to tax law without significant risk of abuse, alternative assistance arrangements may be justifiable (PC 2007b).

A more active ongoing rationale for certain industry policy measures is *distributional*. Such considerations most obviously arise in cases where government decisions lead to a loss of pre-existing ‘property rights’, where an element of compensation may be called for. The assistance arrangements put in place for dairy farmers, following the abolition of quotas as part of the deregulation of their industry in 2000, are a case in point.

But again, reminding us of Colin Clark’s insight, we find this theoretical justification being pushed to the limits. Thus, in the context of the current debate about ETS, there is the prospect that some more highly emission-intensive businesses will in some way be compensated for the impacts on their profitability and shareholder value. ‘Sovereign risk’ considerations are clearly relevant where major policy changes come out of the blue. But the prospect that government action might one day be taken to address greenhouse gas emissions is hardly news — the Commission conducted the first inquiry into the costs and benefits of doing this, in the lead-up to the 'Rio Earth Summit' almost two decades ago (IC 1991). Moreover, depending on how such compensation is paid, it could delay the adjustments in economic activity that the ETS is designed to drive.

The bigger issue that lies behind this, though, is the extent and timing of action by Australia to tax greenhouse emissions. There is much to be said for starting with very low effective prices for carbon until major global emitters also take action (PC 2008h), but to signal to business that future prices are likely to climb steeply. This would provide clear guidance for businesses making long-lived investment decisions, reduce adjustment costs and smooth the distributional implications. It would also provide a transition period in which government can learn about the most effective institutional approaches without posing too many risks for business.

Ensuring a payoff: policy design and review are crucial

Having a sound rationale is a necessary condition for industry policy interventions to yield a net payoff for the economy. But it is not a sufficient condition. Intervention brings its own costs and problems, which need to be taken into account in making a judgement about what specific policy approaches should be followed.

I used the term 'judgement', because even the most rigorous policy evaluation won't always provide a definitive answer. Lack of certainty about the exact outcome should not preclude some policy experimentation, provided there is a subsequent (robust) review of the outcomes.

That said, once in place, policy measures that deliver assistance to particular industries or activities can create *de facto* entitlements, with pressures for their retention that can be politically difficult to overcome. This can be seen in the ETS debate, where the renewable energy industry is strongly advocating the maintenance of direct support measures even under effective economy-wide pricing of carbon.

The difficulty in reversing policy measures is exacerbated by the understandable reticence of governments to 'admit' that a new policy has not produced the hoped-for outcomes. This is no doubt partly a reflection of the keenness of political opponents and the media to label such outcomes as 'failures'. A more constructive approach would recognise that some policy experiments of this type are worthwhile.

Some key design features

That said, there are a number of features that are central to effective industry policy design which, if met, would significantly limit the risk of policy misfires (PC 2008g, 2007c).

The most fundamental is the need to target measures at the problem. It is surprising how often this does not happen. Even where there is a genuine rationale for intervention, policy measures often fail to achieve a positive result because either the problem is poorly defined, or the measure does not adequately address it, or both.

Where a program is targeted at increasing a particular activity — such as R&D, investment, staff training or the use of energy-saving technologies — another critical hurdle for program designers is to ensure that the scheme really does add to the total amount of the targeted activity that is undertaken, rather than simply transferring public funds to the businesses for little or no public benefit.

The risk here is that some firms will receive assistance for things that, on commercial grounds, they would have done anyway. This has been a well known problem with the basic R&D tax concession (PC 2007b). But there are other documented instances. For example:

- around half of the subsidies for R&D and value-added activity under the (former) Pharmaceutical Industry Investment Program were estimated to have represented a 'free lunch' for the recipients (PC 2003b)
- two thirds of EMDG recipients surveyed by the Centre for International Economics indicated that the scheme had little or no influence on their export marketing (CIE 2005).

Of course, some payments for things that would have happened anyway are inevitable. The challenge is to design schemes in a way that achieves a sufficient rate of inducement to yield a net social benefit, remembering that this also can give rise to additional costs through increased program complexity and monitoring of firms.

Properly reviewing the outcomes

Withholding policy initiatives in the face of any uncertainty would amount to policy paralysis. However, the fact that a degree of uncertainty is inevitable, and that circumstances will often change over time, make it imperative that industry-policy initiatives are periodically reviewed. In practice, this has not been seen as an integral feature of industry policy (or, indeed, of most policy areas). Reviews tend to be partial, spasmodic and often not very rigorous.

They are not assisted where the rationale for action or the program's goals have not been well specified. Programs should make explicit provision at the outset for progressive evaluation and review, including ensuring that the data needed for assessment purposes are generated as a by-product of the programs, if not otherwise attainable.

For reviews of major programs, with significant distributional and efficiency implications, it is highly desirable that those conducting the review (including their secretariats) be independent of the program administrator and key stakeholders.

Summing up

Australia's approach to industry policy has evolved considerably from the protectionist regime that so concerned Colin Clark, and our economic performance has been much the better for it. With strong pressures emerging for new industry policy initiatives, it is important that these too undergo rigorous evaluation. As the Minister for Innovation has observed:

> It's easy to assemble a shopping list of initiatives … but not quite so easy to produce a program of support which is both affordable and internally coherent. (Carr 2008b)

Translating this insight into good policy requires governments to be active in areas where there are genuine market failures that intervention has good prospects of correcting. It requires careful attention to the design of programs up front, and evaluation after the fact. And it requires that governments rebuff any claims for assistance that, while couched as being in the interests of the economy or environment, result principally in transfers from taxpayers to the recipients, with little or no public benefit. These requirements can be technically demanding and politically challenging. But they are integral to achieving the productivity performance that this country must aspire to if it is to meet the challenges that lie ahead.

Riding the third wave: some challenges in national reform*

'The National Reform Agenda is aimed at further raising living standards and improving services, by lifting the nation's productivity and workforce participation over the next decade' (COAG 2006).

Introduction

Australia's economic performance over the past decade and a half is an undoubted success story. While in more recent years this owed much to external events — notably China's economic take-off, and the (related) pick-up in our terms of trade — the reversal of our fortunes predates this. Described for rhetorical effect as an 'economic miracle' by the MIT's Paul Krugman, it is now generally recognised as the deliberate outcome of a program of economic reforms, which gathered pace from the early-1980s.

The microeconomic reform process essentially began with (unilateral) reductions in import protection and barriers to foreign capital. But the consequent competitive pressures on Australian firms soon shifted attention to the policy-related domestic impediments to their performance. From this, a second wave of 'behind the border' reforms began in the late-1980s, focussed on improving the efficiency of public utility services and the flexibility of labour markets. This culminated in the National Competition Policy (NCP) in the 1990s, with recognition that the imperative of forging a national market required a more coordinated approach to promoting competition across jurisdictions (Banks 2005).

The NCP was a landmark reform initiative, involving an unprecedented degree of cooperation across our federation over a decade. It brought substantial benefits which are still being felt. But any tendency toward complacency (or reform fatigue), has been overtaken by the realisation that Australia faces major further challenges to its hard won prosperity in the years ahead, not least the ageing of our population. Accordingly, a 'third wave' of national reform has been agreed to by COAG. While

* Presented to the opening plenary session of the Melbourne Institute Economic and Social Outlook Conference, 'New Agenda for Prosperity', Melbourne, 27 March 2008. This speech benefited from contributions by several colleagues.

partly directed at completing unfinished business from the earlier reform programs, the new National Reform Agenda (NRA) pushes the boundaries of national reform to encompass the drivers of workforce participation and productivity. Its emphasis on human capital development is a natural and necessary extension of Australia's reform efforts, going to the heart of what is required to meet the challenges of an ageing population. But while the potential gains are great, the challenges facing policy in a number of key areas are also substantial and will require sustained effort.

Lifting productivity and participation

Population ageing will significantly reduce workforce participation and per capita income growth. At the same time, it will push up health and aged-care expenditures, creating major fiscal pressures for governments. While this demographically driven scenario will unfold progressively over the next half century, its influence is already occurring.

Given the demographic causes, some have advocated demographic solutions. But neither pro-natalist nor pro-migration policies can realistically make much difference. For example, the recent increase in fertility rates in Australia (from 1.7 to 1.8) will yield only a marginal reduction in aged dependency over the next 40 years and will actually raise *total* dependency (children take a long time to grow up). Feasible additions to this rate could do little more. In any case, fertility is notoriously hard to influence through public policy. Commission research suggests that the recent increase in the fertility rate is mainly attributable to increased prosperity and the fact that older women are catching up on their previously postponed births. In contrast, the 'baby bonus' is likely to have been a much weaker 'aphrodisiac', affecting the timing of some births more than their ultimate number (Lattimore and Pobke 2008).

Similarly, feasible *increases* in migration (from what is already an historically high intake) can have only minor affects on the age structure of the population. The main reason for this is that migrants age too.

Participation and productivity are the key objects of policy directed at meeting the economic challenges that lie ahead. Both are amenable to policy influence and they provide a dual focus for COAG's NRA.

Labour force participation: keeping it up

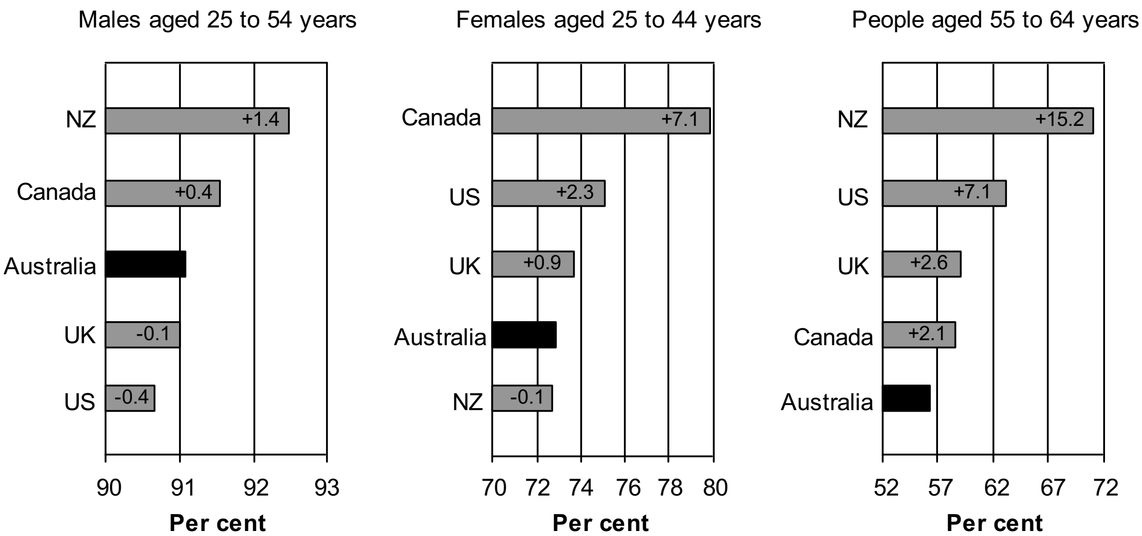
Increasing the participation of Australians in the labour force is not an end in itself. Policies directed at raising participation are only worth having when they yield benefits to society that exceed the costs. Determining this is not always straightforward. For one thing, people value leisure. Further, many are involved in caring for family members or in volunteering. Policy directed at raising participation needs to focus on the reasons why it may be lower than it should be, taking into account peoples' innate preferences and potential societal spillovers.

Scope to do better

The fact is that Australia's overall participation rate is higher today than ever. This has been due to the increased participation of women; male participation has fallen significantly over time.

While Australia's aggregate participation rate is above the OECD average, it is relatively low for some key age groups: particularly men and women aged 55 to 64 years, and women in the 25 to 44 ('child bearing') age bracket (figure 1). A significant gap in participation rates, relative to countries we regard as broadly comparable to our own, is indicative of scope to do better. As noted, whether that scope is real or not depends on the causes, and the costs and benefits of specific policy initiatives to address them.

Figure 1 **Australia's participation rates are lower in key age groups**
Differences between countries in selected participation rates, 2005



There are five broad areas for potential policy attention. Two of these — education and training, and health policy — relate not only to personal development and wellbeing, but also to the inherent contribution of people to the workforce. A third relates to the incentives they face to seek employment and perform well in a job. A fourth is the capacity of workplaces to employ people in ways that fit with their abilities and the needs of the firm. And a final one is support systems for helping people into work, where such assistance is needed.

Most of these are encompassed by the NRA. The Commission's analysis of the options suggests that work incentives — particularly those related to the interaction between the tax and welfare systems, and retirement income provisions — are likely to be the most influential (PC 2006b).

Large *potential* gains from the NRA

There are three reform streams within the NRA: a *competition* stream, directed at enhancing the operations and efficiency of infrastructure markets; a *regulatory* reform stream, focussed on reducing 'redtape' burdens on business; and a *human capital* stream, which is aimed at enhancing workforce participation and productivity, through policies that improve health and education outcomes and reduce disincentives for work.

The Commission's modelling and other analysis in its recent report for COAG suggest that the benefits from reforms in the areas identified are potentially large, and at least as great as those from the NCP (table 1) (PC 2006b).

Table 1 **Potential 'outer envelope' GDP gains from the NRA**

	$billion	*Per cent of GDP*
Competition stream	4	0.5
Red tape reduction	13	1.33
Health service productivity	4	0.5
Workforce participation	60	6
Workforce productivity	25	3

The greatest projected benefits related to the potential economy-wide impacts of reforms directed at enhancing human capital. The Commission found that there was potential to increase labour force participation by up to five percentage points over the next 25 years — potentially offsetting the projected impacts of population ageing — while workforce productivity could be raised by up to 2 per cent.

The impacts of participation and productivity on GDP appear to dominate those from the other reform streams. However, as the Commission emphasized in its report, the human capital numbers are not comparable with those from the other reform streams. Apart from the longer time frames involved, they exclude the (potentially large) program costs that may be called for, and they are far more speculative and exploratory in the methodologies used (PC 2006b).

The policy challenges are becoming more apparent now as COAG focuses more clearly on specific policy areas, with seven Working Groups having explicit work agendas and timeframes. In what follows, I focus on some key issues in each area.

Health and aged care

Health and aged care are arguably the most challenging areas for national reform. While our health system does not perform at all badly by international standards it is experiencing growing problems. Not least among these are rising costs, falling accessibility, and workforce shortages. The cost pressures and capacity constraints will soon be compounded by population ageing, with total health spending projected to rise from 10 to around 18 per cent of GDP over the next four decades.

In its 2005 review of the NCP and emerging reform priorities, the Productivity Commission argued that there was an urgent need for nationally coordinated reform (PC 2005e). The agenda we identified included financing issues (including the roles and responsibilities of the states and the Commonwealth), coordination of care (including informal care and aged care), the interface between the public and private sectors, the balance between prevention and treatment, and information management.

While the Commission's recommendation for a major independent public review of the health system as a whole was not taken up, a number of the issues were subsequently included in COAG's NRA.

Prevention better than cure?

Particular emphasis has rightly been placed on health promotion and disease prevention activities. These focus on seven chronic diseases accounting for around 80 per cent of the total disease expenditure burden.

The challenge for policy makers is to determine how, and by how much, the personal impacts and productivity losses resulting from chronic diseases could be reduced or avoided by better health policies. The Commission's early analysis indicates that we should not underestimate the difficulties of producing benefits that materially exceed the costs of intervention (PC 2006b).

For example, COAG's nominated priority, type 2 diabetes, is closely linked to obesity, as are cardiovascular and other chronic diseases. Targeting the growing incidence of obesity therefore has obvious attractions. However, the causes of obesity are difficult to remedy, being intimately connected with modern lifestyles as well as genetic makeup and other individual circumstances. Studies repeatedly reveal the difficulty for many people of maintaining weight loss. Moreover the costs of information campaigns and other strategies can be substantial.

The critical need is for hard-headed analysis of the effectiveness of specific interventions, as well as a willingness to experiment with new approaches, including pilot testing.

Just do it?

In contrast, there are some health issues where policy solutions seem clear, having benefitted from detailed reviews, but progress has been impeded by political pressures. Two which stand out are health-workforce arrangements and aged-care funding.

The first is bedevilled, among other problems, by a silo mentality and protection of professional territory. What is needed is a culture of teamwork and innovation in scopes of practice and models of care, and the institutional structures to support it. The Productivity Commission's review for COAG strongly argued for national accreditation and registration boards that span the professions (PC 2005a). Despite resistance from the AMA and after some delay, it is pleasing to see that COAG is now pushing on with establishing these — an important step.

As currently structured, the aged-care system is not well equipped to deal with an ageing society. The key lies in the reform of funding/charging arrangements. In particular, there is a strong case for unbundling accommodation from care costs. Personal care also needs to be delivered on an entitlement basis, with targeted subsidies, rather than through provider-based funding.

Human capital development

The second COAG Working Group is primarily focused on education and training or, in economists' jargon, the development of 'human capital'.

This has traditionally been a relative strength for Australia, but there is considerable scope for improvement. For example, in the core skill areas of literacy and numeracy, average schooling outcomes for Australia exceed OECD averages, but there is a relatively long tail of poor achievement, with one-third of 15 year olds rated below international benchmarks.

COAG's goals in this area primarily focus on young people, which is appropriate. There is abundant evidence that literacy and numeracy skills are influential in the extent to which children complete school and go on to higher study or well paid employment.

Teachers are instrumental

Much policy effort and resourcing over the years has been directed at reducing classroom sizes. But the evidence suggests that this has not yielded significantly better outcomes. The key to better learning is quality teaching and teachers, but this has arguably been the most neglected area of education policy.

It is fair to say that contemporary society values teachers less than did any previous generation. Taking the economist's measure of value, female teachers' pay fell from 114 per cent to 103 per cent of non-teachers' pay between 1983 and 2003 and male teachers' pay fell from 108 per cent to 91 per cent of non-teacher pay (Leigh and Ryan 2008). Widening income disparities can be expected eventually to have an effect, both on the average quality of those entering the profession and on how their contribution is perceived by the public.

Recent evidence shows that, unlike other professions, there appears to be no relationship between the aptitude of teachers and their pay — which is exactly what you would expect in a system characterised by uniform salary schedules. These problems are compounded within government schools in some jurisdictions by restrictions on the ability of principals to appoint the best person for a particular vacancy. Schools must be the only part of the public sector where merit-based appointments are constrained, despite their particular importance in this field.

Progress is being made in some of these areas in individual jurisdictions. COAG's new education Working Group is ideally placed to initiate an assessment of what approaches to Australia's education workforce would best meet future needs.

Climate change and water

The Working Group on Climate Change and Water is concerned with the two 'sustainability' issues that loom largest for the future wellbeing of Australians. While related, they pose quite different policy challenges for governments. In the case of climate change, the problem is global; Australia is a relatively small contributor, and our rate of contribution has generally reflected efficient use of abundant fossil fuels. In the case of water, the problem is domestic, and largely the result of our inefficient management of an increasingly scarce resource.

A cost-effective climate change policy

The objectives of the COAG Working Group are to 'ensure an effective national response to climate change' based on a national Emissions Trading Scheme (ETS) and nationally consistent complementary measures. The move to a national approach is of fundamental importance. The emergence in its absence of a multiplicity of measures was a growing source of cost in its own right. The focus on a regime based on a market price for carbon is also essential, to ensure that any emission reduction target can be achieved at least cost.

The facts are that any abatement action by Australia will be more costly than that by most other developed economies. That simply reflects the reality that the structure of our economy has been shaped by the abundant availability of low-cost fossil fuels. Our total contribution to global emissions is very small (around 1.4 per cent). That means that a negative cost-benefit outcome for Australia is assured unless the major emitting countries ultimately take comparable actions. It underlines the need for our mitigation actions to be carefully designed and implemented to avoid incurring unnecessary costs.

This is the biggest regulatory challenge Australia has ever faced. There is the potential for poor regulatory design to generate costs at least as great as the economic impact of raising energy prices. This puts a particularly high premium on good regulatory process. While Australia could be said to have an impressive track record overall in policy development, our performance has not been so good in the more practical art of regulation making. One of the main deficiencies has been lack of understanding of the compliance burdens of regulation on business. These could loom very large here.

What 'complementary' measures?

The great advantage of a national ETS is that it should in principle enable the market to price allowable carbon emissions such that abatement occurs in least-cost ways. However, to be successful in this, there will need to be some rationalisation of the many and varied schemes previously devised to reduce (net) emissions in the absence of such a price signal. Many of these will make no *additional* contribution to abatement, but simply reshuffle the existing contribution and raise its costs. This task is on the Working Group's agenda.

A preliminary assessment by the Productivity Commission has identified a range of programs deserving particularly close scrutiny. One of the more significant ones is the Mandatory Renewable Energy Target (MRET). An MRET has been in place since 2000, with the Australian Government planning to increase the target nearly five-fold, so that 20 per cent of electricity would be drawn from renewable sources by 2020. In replacing multiple state-based regimes, it will lower the overall costs of such an approach to emissions reduction. However, it would effectively cut across an ETS and impede its ability to deliver least-cost abatement through carbon pricing. While it would be unlikely to achieve extra abatement, it would constrain the choice of abatement options (which could potentially cost billions of dollars) and reduce the incentive to use other new low-emission technologies (PC 2008h). The apparent special status accorded the MRET needs to be rethought.

A more promising area for complementary policies is in programs to support R&D. Knowledge spillovers are likely to be particularly marked in this area and thus enterprises may require more support. There is a balance to be struck between technology-neutral support and support aimed at areas in which Australia has strategic interests, due to our energy resources and existing industries.

Water, water everywhere?

COAG's objective of 'sustainable water use across Australia' is best interpreted as achieving outcomes that maximise the net benefits to society from this country's water resources over generations.

Underpricing and over allocation of water resources have encouraged excessive demand and a system ill-equipped to deal with emerging scarcity. The best solution to scarcity is a market. Prices revealed in well-functioning markets can provide a coordinating role to achieve an efficient allocation of water among competing uses. They can also provide signals to guide investment in water supply augmentation.

Reforms to create water markets began in rural areas. While there were some earlier state-based initiatives, the need for a scheme embracing the Southern Murray Darling Basin, and the jurisdictions that draw water from it, became obvious. The issue has rested with COAG since 1994. Progress has occurred, but slowly. The 'market' remains fragmented and distorted by constraints on trade, excessive transactions costs, and incomplete arrangements for environmental allocations. The move towards a single governance arrangement is fundamentally important to resolving these problems.

From country to city

In contrast to developments in rural areas, markets do not exist for water in our cities. Most capital cities and urban centres have for several years dealt with lower catchment rainfall by imposing severe restrictions on use. The hidden cost of these restrictions for many households outweighs the charges they actually pay for the water they use, and nationally could amount to billions of dollars a year (PC 2008f).

Introducing market mechanisms for urban water has the potential to generate substantial efficiency gains, both through enabling available water to reach the most valuable uses and providing better signals to investors about the need to augment water storage capacity or develop other sources.

Equity or ethical issues are often seen as problems when the question of pricing water is raised. However, price structures or rebates can deal with the need to ensure that all households can afford basic needs.

In moving to more efficient water markets, there are two issues that require attention. One is the dominance among water utilities of old style vertically integrated monopolies. Structural changes to enhance commercial pressures and promote competition, including through third-party access to networks, offer the prospect of significant efficiency gains.

A second untapped opportunity to get better outcomes, at least for some cities, is to breach the artificial divide that exists between urban and rural water systems. Some 60–70 per cent of Australia's water is consumed by agriculture; only 10 per cent by households. Even small diversions could make a significant difference to urban supplies.

Efficient national infrastructure

Efficient economic infrastructure is clearly fundamental to Australia's economic performance. Over the past two decades, the performance of much of our infrastructure has greatly improved. This was achieved mainly through reforms that introduced commercial disciplines and competitive incentives to a sector that had long been dominated by inefficient statutory monopolies.

The Productivity Commission's 2005 Review of NCP found that prices of infrastructure services had generally fallen significantly, at least where that was needed, and had been rebalanced to more closely reflect (lower) costs (PC 2005e). We estimated that the observed productivity gains during the reform period had boosted Australia's GDP by around 2.5 per cent.

However, the Commission also identified considerably more that needed to be done, including to achieve more competitive, nationally integrated markets in energy, transport and water (as well as, within the Commonwealth domain, telecommunications and broadcasting). These have become subject to ongoing attention by COAG under the NRA. In addition, since the federal election, particular focus has been placed, via the relevant Working Groups, on the goal of improving the coordination and streamlining of infrastructure planning and investment processes, and undertaking a national audit of infrastructure. A new Infrastructure Australia Council has been created to assist in this.

Better evaluation of public investments is needed

Assessing the adequacy of national infrastructure, particularly in a forward-looking context, is a very complex undertaking. The intention is to help guide priority-setting for public infrastructure investments, but there would still be the need for detailed cost-benefit analysis of particular projects. Such analysis has typically not been done well in the past.

Periodic audits of the regulatory and, for public infrastructure, governance arrangements within which infrastructure investment and management decisions have been made could prove particularly useful. The Commission's annual review of the financial performance of government enterprises has found that the aggregate return on their assets has slowly improved, but over half of GTEs still do not earn a commercial rate of return (PC 2007a).

In an across-the-board review of GTE governance arrangements, the Commission detected many ongoing deficiencies, including a lack of clarity (and even transparency) in corporate objectives, a need for greater independence of boards and generally greater accountability. When it comes to investment decision making, problems include undue political influence, ill-defined or unfunded non-commercial obligations, constraints on pricing and restrictions on borrowing (PC 2005c).

Private provision requires balanced regulation

This underlines the importance of periodically testing the case for public ownership of infrastructure assets. Private ownership and control avoid many of the incentive and governance problems that bedevil public assets, and only private ownership involves the additional discipline of competition from within the capital market. By the same token, private owners tend to be single-minded about making profits, and this has meant that in areas where market power or equity issues loom large, governments have regulated heavily to keep prices down.

Price regulation almost inevitably becomes rate-of-return regulation, which can undermine incentives for productive efficiency and innovation. In the end, the regulator effectively becomes the arbiter of new investment. Concern that regulatory truncation of ‘above-normal’ returns was diminishing incentives to invest in long-lived assets, was at the heart of a number of recent Commission reviews of competition regulation of infrastructure introduced under the NCP. While some changes have been made as a consequence, it has been raised again as a key contributor to the export bottleneck problems experienced over the past few years (Exports and Infrastructure Taskforce 2005).

Reform of road freight infrastructure is a priority

The Commission’s analysis suggests that some of the largest gains from further reform are likely to come from achieving more efficient provision and charging for land freight infrastructure (PC 2006e). Efficient freight is especially important for Australia, given its dispersed population and production centres.

Road infrastructure is likely to continue to be largely provided by government, given its public-good features, but there is a need to get a closer relationship between user charges and usage costs, and a better basis for investment, both of which are subject to heavy political influence.

The challenge is to find solutions that yield unambiguous gains and would achieve community acceptance. To this end, the Commission recommended COAG adopt a carefully sequenced approach in progressing towards direct location-based charging, with each step preceded by detailed examination of costs, benefits and distributional impacts. This was largely adopted by COAG and is now on the agenda of the Business Regulation and Competition Working Group.

Enhancing business regulation and competition

The first waves of microeconomic reforms were directed at reforming anticompetitive regulations that assisted some businesses at the expense of others. With considerable progress in that area, the emerging priority is to reform regulation that is unnecessarily costly to *all* businesses.

In its 2006 report *Rethinking Regulation*, the Regulation Taskforce found that much regulation suffered from unclear or questionable objectives, lack of targeting, excessive paperwork requirements, undue prescription and complexities, and inconsistency, overlap and duplication, particularly across jurisdictions (Regulation Taskforce 2006).

Harmonising 'hot spots' is challenging

Many of the worst inter-jurisdictural problem areas have now been picked up by COAG as 'hotspots' for priority action. For most, there is a strong case for achieving at least harmonisation, if not national uniformity.

For many of these regulations, the potential benefits of harmonisation from the perspective of a particular state or territory may not appear sufficiently large to offset the loss of sovereignty over issues that can involve local sensitivities. The fact that the Australian Government is willing to provide reform-contingent transfers to the states may therefore represent the best chance yet for a break through.

That said, it will be important that a strong case is made for any proposed national standard, demonstrating a national payoff from reform. National uniformity or harmonisation is only worth having if it involves the best rules, not merely the lowest common denominator.

Of all the regulatory 'hotspots', perhaps the hottest from a business perspective is occupational health and safety and this will be the litmus test for whether moves for regulatory harmonisation can be successful generally.

Addressing the causes of bad regulation

Bad regulation — regulation which is ineffective or for which the costs are excessive — has proven easier to make than reform. The problems are deep-seated and need to be tackled on a number of fronts. However the absolute priority is to improve the processes and institutions responsible for making regulation in the first place.

COAG has made a useful start in agreeing to some 'best-practice regulation reforms'. However, concrete commitments need to be made to strengthen the obligations on policy makers and regulators, and to ensure that regulatory proposals satisfy those requirements. For example, the Australian Government now requires that regulatory proposals with non-trivial impacts on business include an estimate of those impacts. It has also mandated that a regulatory proposal which fails to meet the Government's 'best-practice' requirements cannot proceed unless the Prime Minister grants an exemption (in which case a 'post-implementation review' is required within one to two years). Such requirements need to be extended to all jurisdictions.

Competition still needs support

In the specific area of competition, NRA has a significant role in completing and extending the agenda of the NCP. As noted, this includes further refinements to pro-competition regulation of infrastructure markets. There is also unfinished business from the NCP's review of anticompetitive regulation. Many of the gaps or deficiencies in that program — which required a public interest case to be made for retaining such regulations — have involved considerable political sensitivity. Examples include remaining statutory monopoly controls over exports, and regulatory constraints on competition in such small business heartland areas as pharmacies, newsagencies and taxis.

The states and territories provide billions of dollars in assistance to industry. The extent to which the costs and benefits of the assistance programs have been scrutinised varies. From a COAG perspective, there is a particular need to review progress in reducing subsidies and tax exemptions designed to influence enterprises to locate in particular jurisdictions. These 'bidding wars' generally involve negative sum outcomes for Australia as a whole. Moreover, in the few instances where programs have been properly reviewed, most have been found to yield little or no benefit even to the 'winning' jurisdiction itself.

Understanding the economy-wide implications

The opportunity cost of helping particular firms or industries to operate at higher levels of activity looms largest when the economy is stretched to capacity. A job gained or retained in an industry as a result of government assistance is a job lost to another, particularly in an environment of labour shortages.

Economy-wide (general equilibrium (GE)) modelling is a powerful tool for analysing the impacts of policy changes across the economy, but it has limitations and cannot encompass all the forces at work. In the past, GE modelling has found net gains to the economy from reducing tariffs, but it has generally underestimated those gains. For example, the Commission's 2002 review of automotive assistance found that steadily reducing tariffs had provided a major spur to innovation, yielding productivity gains that the industry itself had not anticipated (PC 2002e).

Accordingly, there is merit in the government's review of innovation policy being undertaken concurrently with the automotive and TCF reviews. It should help reinforce the message that any change to the established assistance regimes for these industries should be directed at enhancing the scope for innovation, not weakening the competitive incentives that help motivate it.

The strong link between competition and innovation is underpinned by the reality that (technological) R&D is only a small part of the total innovation that occurs within industry. That said, R&D can be relatively costly, and incentives for firms to undertake it can be weakened by the difficulty of withholding its fruits from market rivals. Government support can help address this ‘market failure’. However, as the Commission’s recent report *Public Support for Science and Innovation* showed, such support needs to be carefully designed and targeted, with robust analysis of its cost effectiveness in generating (additional) social benefits (PC 2007b).

Further candidates for review?

Current resource constraints within our economy, and pressures on government budgets, strengthen the case for undertaking reviews of other industry assistance programs. In 2006-07, Commonwealth assistance to industry monitored by the Commission totalled nearly $16 billion, with budgetary assistance amounting to some $6.5 billion (PC 2008g). While a proportion of this will represent a good investment by the community, some of it will not.

In deciding which programs to examine, relevant criteria include whether:

- areas receive relatively high assistance, or involve multiple measures offering scope for rationalisation
- programs appear to lack a strong rationale or were devised without robust analysis
- a review has not been undertaken for some time, or market circumstances appear to have changed (or previous recommendations for reform failed to be implemented).

Some candidates for early review could include defence procurement, drought assistance, biofuels subsidies and assistance for tourism. Given the complexity of the issues and the various interests involved, such reviews should be independent and properly resourced, with adequate opportunity for public participation and terms of reference that give priority to analysing the economy-wide implications of specific assistance measures.

Two other important COAG Working Groups

The final two COAG Working Groups — on housing and Indigenous reform — are outside the boundaries of the previously agreed NRA. But both deal with issues that are central to the wellbeing of Australians, with outcomes dependent on federal-state cooperation.

Accessible and affordable housing

In the case of housing affordability, there are two challenges that stand out, based on the analysis in our 2004 report on First Home Ownership (PC 2004a). Both are fundamental to affordability outcomes, but have been seen as politically too hot to handle.

- The first is the zoning and heritage laws that stop sufficient dwellings being built in the inner urban areas where people increasingly want to live.
- The second major influence is Commonwealth taxation, particularly income tax provisions that favour housing, and the concessional arrangements for capital gains taxation that were introduced in 1999.

While affordability problems are significant, for many people the main impact is to defer entry into home ownership, rather than preclude it entirely. Arguably, the more important social problem relates to the adequacy of accommodation for people on low incomes who will never own a home and have trouble affording rental accommodation. Again, the key to identifying policy interventions in this area that can make a difference is to understand potential ramifications in the wider market. This is not easy, but it would be helped by a more rigorous approach to reviewing existing programs.

Indigenous policy

The most extreme housing policy failures apply to Indigenous housing. Overcrowding in Indigenous households is much greater than anything observed in non-Indigenous Australia. This is a major policy issue. As the Commission's work for COAG's Government Services Review shows, poor housing conditions contribute to several facets of disadvantage and disfunctionality in Indigenous communities, including bad health, poor school performance and family violence (SCRGSP 2007). It is therefore encouraging that this has become a priority area for policy attention both at the Commonwealth level and within COAG. But much greater attention also needs to be given to the specific housing needs of Indigenous people — by actually involving them — as well as to the adequacy of related infrastructure services.

This is a particular manifestation of a much greater failure in Indigenous policy over the years. Despite the good intentions of successive governments, much Indigenous policy has not met even the most rudimentary tests of good public policy. Programs have lacked clear rationales and objectives, have been designed without effectively consulting those affected and, perhaps most damning of all, have not been properly reviewed to gauge their effectiveness. The result is that after three decades of policy experimentation, we have very little knowledge today about which of the myriad of programs worked best or why. Rectifying this — bringing a sustained evidence-based approach — is the most important challenge we face in seeking to realise COAG's aspiration to close the gap for Indigenous people.

Moving forward

It emerges that while the potential pay-offs to Australia from embarking on a new wave of national reform are large, there are also some major challenges in devising reforms that will yield the anticipated benefits. If anything, the challenges are greater than under the NCP, because of the additional complexities and uncertainties that confront policy development in the human capital area — where there is potentially most at stake.

The difficulties under the NRA were also initially made greater than under the NCP because of some compromises and deficiencies in the governance and other arrangements. However a number of these problems are currently being addressed.

One important development is that financial transfers from the Commonwealth to the states and territories, analogous to the NCP's 'competition payments', are being put back on the table. The payments had an influence disproportionate to their magnitude in encouraging states and territories to adopt an ambitious reform agenda under the NCP, and are likely to prove an equally good investment under the NRA.

Another positive feature is the strengthening of COAG oversight of the various reform steams, with Working Groups involving central-agency representation reporting on a quarterly cycle.

The introduction of three-monthly meetings for COAG is an important signal about the role that it intends to play, and stands in marked contrast to previous arrangements. It should enable closer monitoring of progress and provide a better basis for maintaining momentum. The main downside would be if a 'need for speed' began to take precedence over marshalling evidence and rigorously testing policy proposals where this is needed.

A key challenge for the NRA will be to ensure that reforms are actually implemented as agreed. In the past, it has often been difficult to achieve this, or at least to keep reforms intact over time. Under the NCP, the National Competition Council played a crucial role in monitoring reform implementation and advising on the related competition payments. Indeed this was integral to the overall success of the reform program. A similar role is envisaged for the COAG Reform Council. To be fully effective, it would need independence and adequate resourcing, as well as a clear mandate.

As a final observation, the benefits of the NRA will take a long time to be fully realised. In the meantime, governments will need to be willing to bear not only its financial costs, but also the political heat that major reform often generates. This is not assisted by short electoral cycles, which mean that more pain than gain will generally occur within a government's term. The move to four year fixed terms has ameliorated this at the state level. Now could be a propitious time to seek a similar change at the federal level.

Back to the future: restoring Australia's productivity growth*

The theme of this conference, 'Restoring Prosperity after the Crisis', has a similar policy message to the previous conference in this series, some eighteen months ago, but in rather different circumstances. That such a turnaround — from boom to bust to incipient recovery — could have occurred in such a short space of time is remarkable, if not unprecedented. But we have witnessed much else that has been unprecedented in this period, including the degree of commonality internationally in governments' fiscal and monetary responses to the crisis and in their pro-active interventions in financial markets.

Australia's own policy response has itself been unprecedented, involving a reversal of our budget surplus on a scale and speed never experienced before, with a fiscal stimulus amounting to 5.5 per cent of GDP, the third largest in the OECD. And we have been in new territory in the extent and nature of the stimulus spending, involving two rounds of lump-sum cash payments to households, targeted additional subsidies for first home purchases and home insulation, and two rounds of infrastructure spending.

Together with historically low interest rates and still buoyant demand for mineral exports from China (itself a consequence of fiscal pump-priming) Australia's economy has weathered the storm very well thus far and many Australians are already contemplating recovery. Whether it is realised remains to be seen, as our economic fortunes do not depend on us alone. It will be important, for example, that China's demand remains strong and (not unrelated) that the US economy regains strength in the months ahead.

Just as 'moving ahead of the curve' was seen as important to the success of our demand stabilisation policies, timely policy interventions to enhance the performance of the economy's supply-side will also be needed to underpin a sustainable recovery and growth in the longer term.

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* Presentation to the Melbourne Institute Economic and Social Outlook Conference, 'The Road to Recovery', 5 November 2009. This speech draws on PC 2009a and 2009e.

The recent unprecedented fiscal expansion and associated debt add to the pre-existing imperatives for higher productivity growth arising from demographic ageing, increasing globalisation and the costs of achieving greenhouse gas abatement and other sustainability goals. Productivity growth can help service the debt now accumulating from fiscal deficits, as well as offset the effects on incomes of withdrawal of stimulus spending.

Causes of the productivity slump

Australia's recent productivity growth record does not, at face value, look encouraging. Following the dizzy heights attained in the 1990s, the MFP growth rate dropped back to its historical average of 1.1 per cent in the next cycle to 2003-04 — which was not surprising — but has averaged small *negative* growth in the current incomplete cycle, which has been a surprise.

Given the importance of productivity growth to living standards, it has also been of widespread concern, prompting calls for policy actions to remedy it. This is fine, indeed important, but any such policy actions need to be informed by a close analysis of the causes of the decline.

Commission research to this end suggests that in fact much of the decline resulted from specific developments in three industries (PC 2009e). The most significant has been the impact on measured productivity in the mining sector of a lagged production response to the major capital investments needed to satisfy booming export demand, as well as some depletion in deposits. At the same time, agricultural productivity has suffered from drought, and the utilities sector has seen major capital investments coinciding with reduced output growth, reflecting in part demand management initiatives.

Once the influence of these events is removed from the estimates, MFP growth actually rises above trend in the last complete cycle and changes from –0.2 per cent to 0.7 per cent in the current period. Some 70 per cent of the decline since 2003-04 is accordingly accounted for by the unusual developments in these sectors.

That still leaves 30 per cent unaccounted for. However, it seems plausible that general capacity constraints throughout the economy over that period may have played a key role here. With buoyant demand and tight labour markets, efforts are likely to have been made to satisfy demand even at the expense of increased input costs, as long as additional profits could be made.

The lesson from a comparison of the 1990s and 2000s is that while productivity is obviously important to our economic future, it was not a driver of the high income growth in the most recent period. Indeed, it was partly a casualty of Australia's economic success.

With current policy discussions in mind, what should also be noted is that Australia's productivity slump was not caused by any lack of spending on education and training, R&D or even infrastructure — important though these may be in the long term. Indeed, infrastructure spending had increased significantly and, when adjusted for differences in industry structure, Australia's expenditure on R&D has remained near the top of the OECD.

In seeking policy guidance from our productivity history, the story of the 1990s boom is more instructive (Banks 2003a; PC 1999c). This new 'golden era' of productivity was preceded by a series of microeconomic reforms which, on the one hand, increased the incentives for enterprises to perform well by removing barriers to competition, while on the other, enhancing their capacity to respond to these market pressures through more flexible, enterprise-based work arrangements and lower prices for existing infrastructure services.

Post-crisis priorities

COAG's current Reform Agenda encompasses some unfinished business in these areas, as well as a new focus on reforms to enhance human capital development — thereby increasing the participation and productivity of labour in the years ahead. Taken together, COAG's agenda and that of the Australian Government, cover a lot of territory. In the current economic setting, there would seem to be particular merit in prioritisation. The 'sweet spot' for policy effort in the next few years is likely to be those reform areas which (a) can bring productivity gains in the short term, underpinning economic recovery, while (b) achieving this at little or no cost to the budget.

From this perspective, there are three policy areas that deserve particular attention: industry assistance, regulatory reform, and infrastructure. All three have regulatory dimensions and all present reform opportunities that could be implemented quickly (to borrow the metaphor, all are 'shovel ready').

It could also be said that these reform areas contain few surprises. Reforms have been stymied in the past through political resistance. However, one would hope that such resistance may be more easily overcome under crisis (or even post-crisis) conditions, as the old saying about 'not wasting a crisis' would have it.

Remove or reform ‘unproductive’ industry assistance

The policy response in most countries to an economic crisis has traditionally involved some government assistance to selected industries. This is perhaps politically inevitable. Its form and duration, however, are crucial to its impacts, both in the short term (on the market) and longer term (on productivity).

As is well known, escalation of assistance to trade-exposed industries in the 1930s was a contributor to the length and ultimate severity of the Great Depression. Empirical studies suggest that protectionism explains over 40 per cent of the drop in world trade in that period. This is one lesson that hopefully has been well learnt. The OECD warned in late-2008 that ‘keeping markets open will … be an essential condition for recovery and long-term growth’ (OECD 2008). And the G-20 communiqué from November 2008 stated: ‘ … within the next 12 months, we will refrain from raising new barriers to investment or to trade in goods and services’ (G-20 2009).

Nevertheless, in the past year the WTO has reported a rise in trade-restricting measures, outnumbering trade liberalising initiatives by at least two to one (WTO 2009). Unlike the 1930s, however, the scope for a broad protectionist break-out today is contained by a web of WTO rules and reciprocal agreements. Accordingly, most of the trade-related assistance actions have been temporary measures that are ‘within the rules’, or in areas where rules are either not present or not binding.

The net impact to date on global protection levels is not known, but the apparent early bottoming of the hitherto vertiginous drop in world trade volumes — in contrast to the pattern in the 1930s — suggests that the increase has been modest overall.

That is just as well, because Commission modelling suggests that even if countries chose to exploit only the ‘head room’ available to them within WTO tariff bindings, world trade would fall by around 8 per cent, with world output (and incomes) declining overall by some A$1 trillion (PC 2009a).

With unemployment levels continuing to rise in many countries, domestic political pressures to provide such assistance can be expected to increase. Keeping the potential costs in the public’s mind will be an important political responsibility if we are to build on the incipient recovery. History tells us that the discipline of individual G-20 countries will be crucial to their collective ability to hold the line.

One area where such discipline — in the absence of effective WTO coverage — has been lacking, is government procurement policies that discriminate against foreign supplies. At least 15 countries have imposed such measures over the past year.

Regrettably, Australia is among them. The New South Wales Government recently introduced a price preference of up to 25 per cent for locally-supplied goods and services. Other states have previously implemented similar, though less protectionist, measures. As the Commission observed in its Annual Report:

> Such policies not only risk reducing the value of government spending for taxpayers, but also provide a poor demonstration effect internationally, and are a liability when seeking to encourage other countries to reduce protection. (PC 2009a, p. 13)

A second focus for industry assistance initiatives worldwide in the past year has been that long-standing recipient, the automotive industry. Consistent with WTO rules, governments have generally not increased tariffs — indeed some, including Australia, have maintained planned reductions. Instead, many have provided subsidies in various guises. As all economists know, however, a given tariff can be replaced by a subsidy with equivalent protective effect. The impact on production, trade and global welfare is much the same.

The assistance to car assemblers announced by the Australian Government in November 2008 as part of its stimulus package, was reportedly the second largest among OECD countries, in per capita terms. While much of the $6.2 billion for producers leveraged off recommendations made by the Bracks review (2008), which pre-dated the Global Financial Crisis (GFC), top-ups to the Automotive Competitiveness Investment Scheme and the Green Car Innovation Fund were provided to help the industry cope with expected additional market difficulties. Removing these top-ups in what are now less threatening market circumstances, would yield a budgetary saving of at least $1.7 billion.

Government assistance to selected industries generally makes for poor 'crisis policy', because it comes at the cost of penalising unassisted activities. The net impact on jobs is hard to discern even in the short term. Recessionary forces are typically economy-wide and generally cannot be neutralised by industry-specific measures.

The main exception to this general rule, especially in the short-term, is the finance sector, given the contagion risks any major failures pose for the whole of the 'real' economy — as the unfolding of the GFC itself has demonstrated. Support for financial markets and institutions has been a strong feature of most governments' responses to the crisis. This has included guarantees of liabilities, the purchasing of illiquid assets (or accepting them as loan security) and equity contributions to troubled institutions. This support appears to have played an effective stabilisation role, and may have foreshortened the drawn-out recovery phase that typically characterises recessions originating in financial markets (IMF 2009).

That said, if maintained, some measures could inhibit desirable competition and innovation, and encourage undue risk-taking through moral hazard. For this reason, the Australian Government has designed its mechanisms of support to be temporary. However, withdrawing industry support — which is always difficult — could prove particularly challenging for the finance sector.

As the Commission has noted in various reports, there is also considerable scope to rationalise industry assistance that predates the crisis. The Commission's most recent estimate of total industry assistance at the Commonwealth level alone amounts to over $17 billion in gross terms, of which some $8.3 billion comprises budget expenditures. Much of this has not been reviewed regularly to determine whether it is generating net benefits to the community. On the basis of those reviews that the Commission itself has conducted, however, it seems likely that a substantial proportion could be withdrawn to positive effect both on the budget and on the economy (PC 2008g, 2009f).

In addition, Australian governments intend to spend some $23 billion to 2011-12 on programs to reduce carbon emissions, much of which takes the form of assistance to selected industries and technologies. The potential environmental payoff from such assistance is unclear, and the costs of achieving abatement benefits appear excessive in some cases. With the advent of the economy-wide pricing of carbon through the Carbon Pollution Reduction Scheme (CPRS), it will be important to rationalise this assistance. However, by then a sense of entitlement may have taken hold, and investments undertaken, which could make withdrawal difficult.

Remove regulatory burdens and avoid adding new ones

Regulatory reform is a key strand of the National Reform Agenda. In the current circumstances, it has the added attraction that it can enhance productivity — by reducing business costs and constraints, and improving production incentives — while involving little fiscal cost. Indeed, in many cases it will yield fiscal dividends.

Two dimensions of regulatory reform assume importance currently: one is removing existing burdens and distortions; the other is avoiding adding to these unduly through new regulations. The latter also raises more fundamental issues to do with the regulation-making process itself.

The first two waves of structural reform in Australia focussed on regulatory impediments to competition, both in the private and public sectors of the economy, which contributed to the surge in productivity growth in the 1990s. However notwithstanding two decades of effort, various anticompetitive regulations remain. These are all well known (PC 2005e). They remain in place not because they have been found to be justified in the public interest — on the contrary, most studies have found their efficiency costs to be unwarranted — but rather because of the political clout of their beneficiaries over the years.

A second category of identified regulatory reforms that could be expedited to assist with economic recovery is 'redtape' — business compliance burdens that exceed what is necessary to meet legitimate regulatory objectives. They were a 'sleeper' for many years, accumulating even as major advances were being made on the competition front. The Regulation Taskforce (2006) estimated in 2007 that they could be adding $8 billion to the costs of doing business, the removal of which, the Commission estimated subsequently, could boost GDP by nearly $12 billion (PC 2006b).

Repositories of 'reforms-in-waiting' at the Commonwealth level, include those in the Productivity Commission's series of reports surveying redtape burdens, including most recently, in important areas of social and economic infrastructure (PC 2009b). The Regulation Taskforce's initial wide-ranging stocktake, which preceded these, also still contains some recommendations waiting to be implemented.

Equally, while there is now a commendable focus on advancing reforms to some 27 regulatory 'hot spots' that add to the costs of doing business across jurisdictions, no reforms (other than wine labelling!) have yet been implemented. Less than half are on track for completion within the original timeframes. Nevertheless, it should be noted that these include such important areas as trade licencing, health workforce registration/accreditation, consumer policy, standard business reporting, and upstream petroleum regulation. Given the long history of resistance to reform in those areas, the progress that is being made is to be applauded. The challenge is to use the common imperative now facing all governments, to progress all the reforms within a time frame that can assist economic recovery.

Minimising new burdens

Under the heading of 'avoiding unnecessary new regulatory burdens', which could compromise economic recovery and inhibit productivity growth in the long term, are three contentious areas of regulation that will need close attention: industrial relations, carbon emissions reduction and financial markets. All three have pervasive effects throughout the economy and all inevitably require tradeoffs to be made between competing objectives, of which economic efficiency and productivity impacts are only one. Getting the balance right will be crucial both in the short and long terms.

In the case of industrial relations, legitimate concerns for workers' rights need to be balanced against the flexibility that firms need to implement the organisational changes and other innovations on which productivity growth ultimately depends. It will be important for industry performance and employment alike that enterprises preserve the ability to engage effectively with their employees, so as to implement work arrangements that best meet commercial imperatives. As the economy evolves, different firms and industries will face divergent pressures and needs that are not amenable to the enforcement of common conditions.

In relation to carbon emissions reduction, Australia faces regulatory challenges on an unprecedented scale. Abstracting from the (important) questions of initial scheme design and timing, it will be crucial to monitor CPRS implementation in a way that enables timely adjustments to the framework in the light of experience; and secondly, to rationalise the myriad of other regulatory measures directed at the same objective — which will serve mainly to raise the costs of emission reduction. Foremost among these, is the new 20 per cent National Renewable Energy Target.

The third area where we need to be careful to get the balance right in any new regulation is the finance sector. Regulatory failings in the United States were clearly implicated in the global financial crisis. While Australia did not share those failings — on the contrary — there is considerable pressure for us to impose 'stricter' regulation. There is much at stake in getting this right. Financial regulation needs to steer a course between the risks and costs of financial instability — and its potential contagion effects on the real economy — and the risks and costs of stultifying competition, innovation and ultimately the productivity of this key sector — and the adverse economy-wide impacts that these too would have.

Financial flows are the life blood of the economy. Prior to the liberalisation of financial markets in the 1980s, the system could be said to have been very 'safe', but credit was costly, hard to get and poorly allocated. The relaxation of credit controls and barriers to competition drove major innovations and cost reductions that boosted economic growth. Any response to the recent excesses and poor risk management in the United States should not overlook these benefits.

To illustrate the possible impacts of 'excessive' re-regulation among OECD countries, the Commission conducted some simulations using the GTAP model of the world economy (PC 2009a), which suggest that for every 1 per cent decline in the productivity of financial services, and 1 per cent rise in its cost, global output would be 0.5 per cent lower than otherwise (equivalent to $350 billion).

This underlines the importance of ensuring that any changes to the regulation of financial markets and institutions are made only with the benefit of a careful analysis of the problems being targeted and the likely costs and benefits of alternative options for addressing them. There is a particular danger in making changes to specific parts of the regulatory framework unless the likely ramifications on the system as a whole can be tested. There is no substitute for public consultation as a means of avoiding unintended consequences.

Good processes for testing the need for regulation and formulating it are going to be especially important in the fiscally constrained circumstances that lie ahead. There will be stronger pressure to resort to regulatory means of achieving policy goals that might otherwise be best pursued through budgetary measures. Are our regulatory assessment processes up to this challenge? It is still not clear that they are.

Rethinking infrastructure

Government spending on infrastructure has begun to acquire the status of a 'cure all' in the public consciousness. Before the financial crisis, it was seen as the key to reversing Australia's productivity slump. Once the crisis hit, it was seen as a key mechanism for stimulating employment. In reality, infrastructure spending is not and cannot be a panacea in either setting.

It is well known that major projects are not a good counter-cyclical spending vehicle because of their long lead times. Of course, as the IMF's Olivier Blanchard has observed, if sound projects had already been identified and were ready to go, this problem would be mitigated. But that was not the case in Australia, nor in most other countries. Instead, priority was given to many smaller scale, so-called 'shovel ready' projects, and the pre-existing processes for identifying beneficial larger scale projects were accelerated. Further impetus to government spending in the latter area was gained from reports of the drying up of private capital as the GFC took hold.

One of the attractions of public infrastructure spending for macro stimulus purposes, is that it involves once-off budgetary outlays, rather than recurrent expenditures. But it still has long-term economic effects (PC 2008e, 2009a). Projects that are well selected, with high benefit-cost ratios, should yield social returns that more than cover the financing costs over time — with a 'win, win' for the short and long terms. However, poorly conceived or executed infrastructure investments can impose a double burden on the community: with future generations having to service higher debts from incomes that are lower than they would otherwise be.

Indeed, it could be argued that any stimulatory spending on economic or social infrastructure that did not yield a net benefit would be inferior on efficiency (national productivity) grounds, to giving the money to households for discretionary spending. At least such payments are likely to end up being directed to valued goods and services (even if not all domestic in origin) at prices that reflect costs.

Scope to further modify existing plans?

One consideration, much debated, is how much scope there may be to recalibrate or defer existing spending plans in order to pursue a bigger productivity bang for the taxpayer's buck.

Among the infrastructure spending that is primarily stimulus-based, the main potential candidate is the school buildings program. This was designed to provide a relatively early boost to employment across the community, given ready access to school land and its dispersed location. A need for speed was met through a degree of uniformity in the type and construction of buildings permitted, rather than potentially drawn-out identification of projects attuned to the particular needs of each school community. Might there be more scope now to change tack? It would at least seem worthwhile to consider whether changes could be made wherever clear educational benefits could be demonstrated, such that any transaction costs of change would be worth incurring.

A second potential source of productivity gain, now that some of the pressure is off, are those larger scale 'nation-building' infrastructure proposals that were brought forward and selected without the opportunity to conduct adequate cost-benefit analysis (PC 2009a). It would be desirable to delay the progression of such projects, until this can be remedied.

There are two 'urban myths' about cost-benefit analysis (CBA) that appear to be gaining currency. One is that they need to be kept confidential because of commercially sensitive material. This conflates CBA with a competitive bidding process. An effective CBA can be conducted (and made public) in advance of seeking tenders. Once the tender is chosen it can be refined and made public again without disclosing commercial-in-confidence details. Taxpayers deserve to know on what basis their money is being spent and external scrutiny provides a useful discipline on the decision makers' calculations. The second myth is that CBAs cannot be conducted where there are non-financial costs or benefits (like environmental impacts). Such impacts will be implicitly valued anyway. CBA merely requires that those valuation judgements be transparently tested.

Removing impediments to private investment

While it is clearly important to ensure that publicly-funded infrastructure is well designed, and allocated where it can yield the highest social return, public spending is only a fraction of private spending and will face considerable budgetary constraints in the years ahead. A key issue, therefore, both for the short and long terms, is how to facilitate greater private investment in infrastructure and help ensure that it is efficiently allocated.

There is an established agenda of reforms here that have strong empirical support and could be implemented in the near term — without incurring any public expenditure.

- One is regulatory overreach that discourages and distorts private investment. One major example identified a few years ago in the Commission's airports inquiry is the need to legislate to bring back an adequate regulatory threshold for successful third party access to major infrastructure investments (PC 2006c).
- Another is the need to rationalise or simplify the complex, multi-tiered approval processes for major projects. For example, the Commission has estimated that, in the case of upstream oil and gas projects, delays can cut billions of dollars from the NPV of major projects (PC 2009d).

Getting more out of the 'stock'

While the flow of new investments in infrastructure is important to future productivity, even more important is the efficient utilization of the existing *stock.* Much of this is in the public domain (for example, water, transport and energy) and there is a further well-established agenda of productivity-enhancing reforms awaiting implementation (BCA 2009; PC 2005e, 2006b, 2007a, 2008a, 2008e). Two of the more important areas, which are not unrelated, involve deficiencies in the *governance* of government infrastructure businesses (including lack of independence, accountability and proper project assessment processes) and secondly, deficiencies in the *pricing of* infrastructure services.

These have been much discussed. I would just re-emphasise that without appropriate governance and pricing of public infrastructure services, existing assets cannot be used efficiently and new investments will often be mis-timed and poorly directed. Many Australians are having to cope with the consequences of this everyday in the water shortages and traffic congestion that detract from the liveability of our cities, with electricity black/brown-outs becoming more common. These problems underline the reality that infrastructure is not an end in itself, but a means of enhancing the wellbeing of the community. Policy makers need to act on the recognition that better outcomes cannot be achieved through government spending alone.

Other reform imperatives for future productivity growth

Reforms in the above three areas have been singled out because they would yield early productivity dividends without calling on scarce budgetary resources.

However, they represent only a sub-set of the wider suite of important reform areas under COAG's national reform agenda (PC 2006b, 2009a, 2009e). A crucial element for the long term is the 'human capital' agenda. As the name implies, this encompasses potential reforms to improve the population's health and skill levels, which are pathways to a more productive and participative workforce, as well as improved wellbeing. While, as the Commission has shown, this ultimately holds the promise of national welfare gains at least as great as those from the previous, competition-related waves of reform, realising much of it will take time and require higher levels of public investment. The scope for such expenditure has been reduced by the stimulus spending and the new challenge of restoring budgetary balance.

Even such tight fiscal constraints should not preclude spending on human capital investments with high net social returns, provided they are indeed genuinely high returns. However, this ups the ante on conducting rigorous assessments and trials before introducing any programs. Australia's record to date, like that of many other countries, does not inspire confidence. On the basis of many *ex post* evaluations, the eminent American sociologist, Peter Rossi, coined an 'Iron Law' that 'the expected value of any net impact assessment of any large scale social program is zero' (Rossi 1987). This should give us pause.

The fact is that human services already constitute a large proportion of the total outlays of governments in Australia, with health and education alone accounting for one-third (or some 15 per cent of GDP). How effectively is this money being spent? The answer is that we do not really know for sure, but there are a variety of indications of scope for productivity and efficiency gains that would not detract from service quality. One source of these is the annual Blue Book, commissioned by COAG precisely for this purpose, which reveals significant disparities in performance across jurisdictions for many human service areas (SCRGSP 2009). In its report on the National Reform Agenda, the Commission found potential to increase the productivity of health services that would alone translate to a $4 billion gain in GDP (PC 2006b).

The goal in striving for more cost-effective service delivery is not merely to achieve existing service levels at lower cost, but to improve both, thereby achieving better outcomes for the community and for the economy.

A further important issue for productivity going forward is the degree of 'churn' in taxation and transfers to households. The conception of what constitutes 'welfare' has changed over time to be far more encompassing of the population and its needs than anyone might have imagined at the dawn of the system. The taxation raised to support subsequent transfers back to households imposes productivity costs of its own, with recent estimates suggesting deadweight losses from taxation of $40–60 billion annually (excluding administrative and compliance costs) (Robson 2005). For every extra dollar in tax that is levied, there is a real resource cost of up to $1.30.

It is therefore both timely and appropriate that parallel reviews are underway of the welfare and tax systems. The only regret is that the latter has not been given scope to consider making better use of the Goods and Services Tax (GST). Changes in the coverage and rate of the GST, as part of a wider package of tax reforms, could see us getting closer to the ideal of broadly-based taxation at relatively low overall rates and creating few distortions in economic activity.

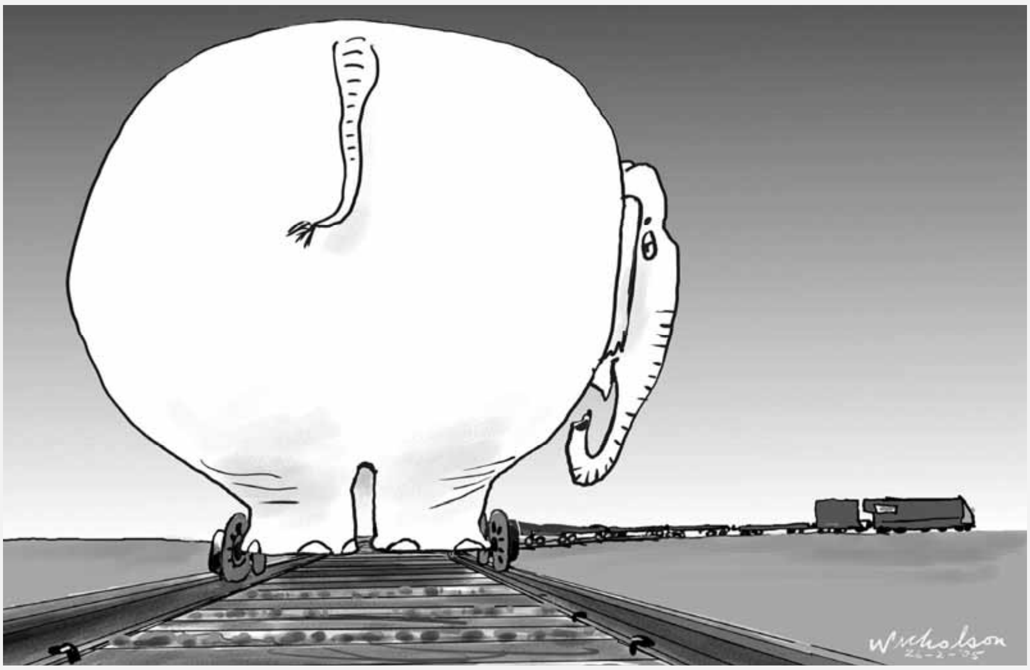
In sum

Australia's economy has once again proven highly resilient in the face of major global pressures. However the demand stabilisation measures to achieve that have left a fiscal legacy that will present additional policy challenges in the years ahead. Reforms that can reduce business costs and improve organisational flexibility and capability are needed to support recovery and generate additional productivity gains. Policy actions in this area over the past two decades have held us in good stead, but they will not be enough. Having grappled successfully with the major challenges of the past year, we now need to re-focus on a productivity agenda for prosperity into the future.

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.

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* 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

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* 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'

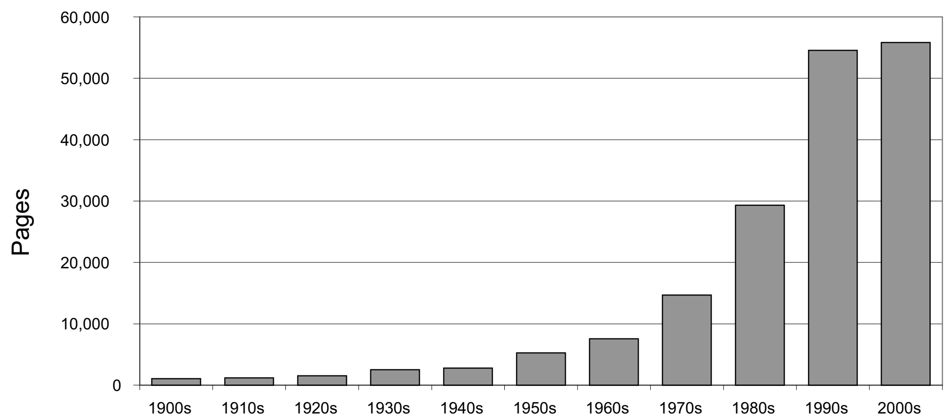
* Opening presentation to the Melbourne Institute Economic and Social Outlook Conference, 'Making the Boom Pay: Securing the Next Generation of Prosperity', Melbourne, 2-3 November 2006. (Co-authored with Ian Monday and Tom Nankivell.)

- 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.

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* 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

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* 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.

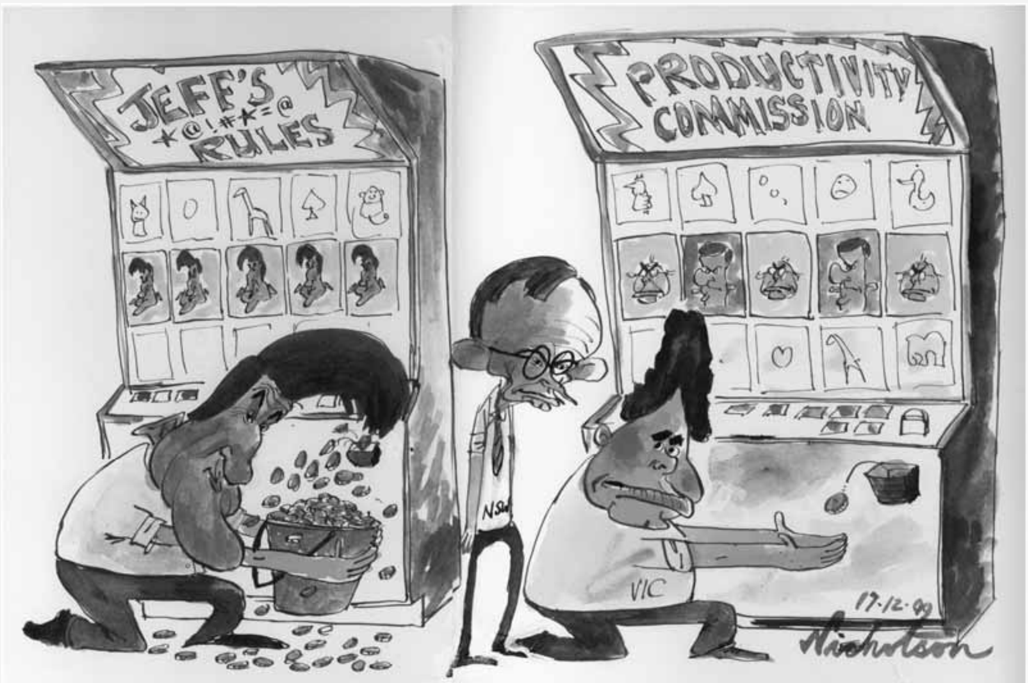
So far the steps have been modest. But they are in the right direction. They can be taken further. As in international trade liberalisation, the key to achieving a meaningful agreement is for each government to accept that it would be beneficial to its own jurisdiction. Some Australian states and territories 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.

PART 3

SOCIAL POLICY: SOME KEY REFORM ISSUES

Over the years, the Commission has increasingly been tasked with investigating key areas of social and environmental policy. One strand of work has been the provision of data for COAG on the efficiency and effectiveness of government services, and monitoring outcomes for Indigenous people. The diversity of the Commission's involvement is reflected in the following speeches, which also cover policy challenges in health, education and gambling.



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

Health costs and policy in an ageing Australia*

Australia has traditionally been regarded as having a relatively cost-effective health system. Per capita spending has been below the OECD average, and well below that of the United States in particular, for comparable or better health-system outcomes.

But there is a question as to whether this is likely to remain the case. Over the past decade, Australia's health expenditure has grown by about 70 per cent in real terms, with private sector growth outpacing that in the public sector in more recent years (though public expenditure is still two-thirds of the total). This rate of growth has exceeded that of the economy as a whole, leading to a 1.5 percentage point rise in the health sector's share of GDP to its present 9 per cent (AIHW 2007).

All components of health spending have grown. While inpatient and outpatient services still dominate total spending, there has been an acceleration in expenditure on pharmaceuticals and therapeutic appliances since the late-1990s.

This aggregate growth has been matched or exceeded by other countries, however, so that international relativities have not changed much (figure 1). For example, we remain a somewhat bigger spender than the United Kingdom and a much smaller spender than the United States.

This indicates that trends across countries are being influenced by similar forces. But it also suggests that some countries may have systems that can do better than others. Most are likely to be severely tested by developments in demography and technology in coming decades. It is important to understand how these forces are likely to play out, and their implications for health policy, given the size of the healthcare sector and its importance to community wellbeing.

The health 'market'

At a broad level, we can conceptualise the market for healthcare like the markets for other services in the economy, as being shaped by both demand- and supply-side influences.

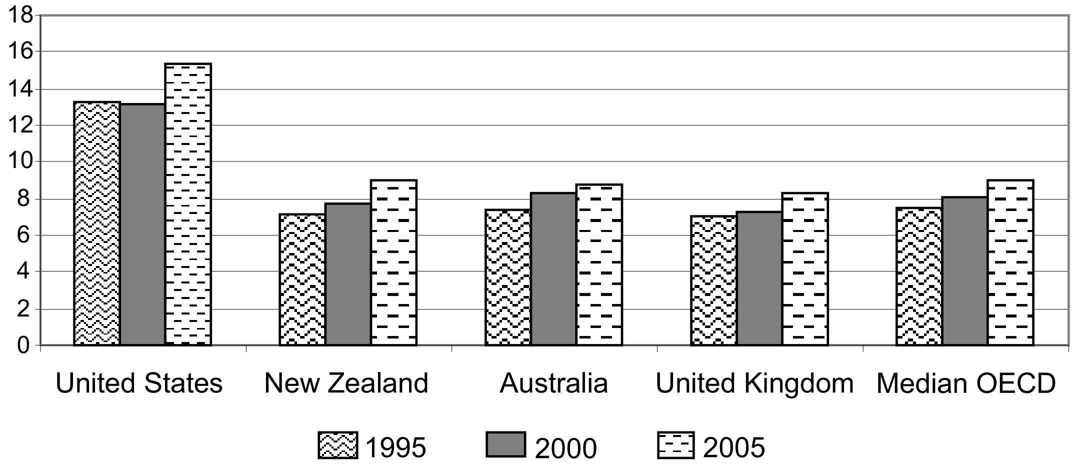
- On the demand side, the key determinants of expenditure growth are changes in the size and structure of the population, its overall affluence or purchasing power

* 'Public Health Oration', Menzies Centre for Health Policy, John Curtin School of Medical Research, Australian National University, Canberra, 26 June 2008. (Co-authored with Lisa Gropp and Ralph Lattimore.)

and — related to this — societal preferences or expectations and, of course, inherent healthiness.

- On the supply side, new knowledge and technical change have a strong bearing on the nature of health services provided, as well as on who and what can be treated. The implementation and diffusion of technology over time depends on the availability of, and access to, skilled people and capital resources.

Figure 1 **Health spending as a share of GDP (per cent)**



A creature of government

These dynamic influences are comparable to other markets. But unlike most other markets, there is a bigger role for governments and only a limited role for prices in balancing supply and demand over time. Much healthcare is funded by governments or insurers, rather than being bought directly by consumers, and the provision of healthcare is constrained by regulation and by the medical profession itself.

While there are some features in common with other markets, these are limited, and government policy is clearly influential in shaping healthcare expenditure. That said, the most critical underlying drivers of expenditure going forward will be further advances in medical technology, the ageing of Australia's population and the important interactions between them. These are complicated and contentious areas, posing significant challenges for public policy, and with much at stake for the community in 'getting it right'.

Technological change is a key driver of health costs

It is widely recognised that technology has a major impact on the health sector and on health outcomes, but there has been some debate about whether technological advances will, on balance, serve to reduce or increase overall health expenditure in future, especially in the context of an ageing population.

Assessing expenditure impacts is not straightforward, requiring an examination of the cost of the technology for each person treated; whether it is a new treatment; whether it replaces or supplements existing treatments; its uptake; and its effect on subsequent use of the health system.

Overall spending can increase — even if unit costs decline — when improvements in a treatment expands its use. New technologies can have beneficial flow-on effects in other areas of spending, however, such as by reducing rates of hospitalization or the duration of hospital stays, or by allowing the aged to remain in their own homes and thereby reducing aged-care costs. On the other hand — and probably only economists would point this out — if one disease is successfully treated, people may live on to develop other ailments, which can themselves require expensive treatment. (I hasten to add that this is not an argument for avoiding better treatments!)

Understanding technology's cost impacts

The Commission has measured the cost impacts of new technologies over a recent ten-year period (PC 2005d). The results of the main econometric analysis are depicted in figure 2**.** While the estimates depend to some extent on what is assumed about the sensitivity of demand to income growth, the results suggest that technology contributed around one-third of the increase in real health expenditure in the decade to 2003, with the (substantial) income growth experienced by Australians in this period being the other dominant contributor.

Some case studies that we conducted provided insights as to why new technologies were contributing to net cost increases. The story varied in relation to unit costs, with some rising and others falling, though on average they were greater. The decisive factor, however, was the expansion of treatment associated with new technologies.

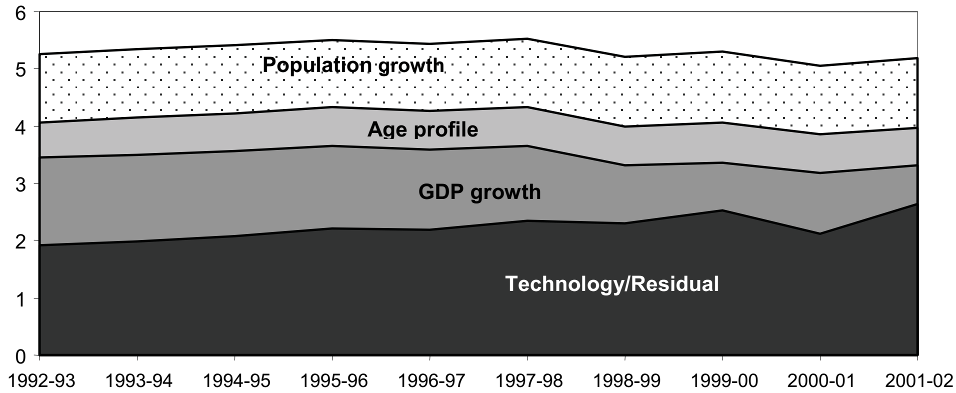
The outlook for technology

So what does the future hold? It seems safe to anticipate that further technological advances will transform our ability to detect or successfully treat diseases, and thus bring considerable benefits to many people. But such developments are likely to continue to increase, rather than reduce, healthcare expenditure overall. As in the recent past, the reasons are the high costs of development (particularly of biological medicines), the expansion of treatment possibilities, and more ongoing treatment.

Further, as noted earlier, such technological advances will require complementary investments in skill development within the health workforce, together with changes in modes of delivery of care. These have additional cost implications, the size of

Figure 2 **Drivers of past health spending**

Annual growth rate (per cent) in real expenditure



which will depend on the adaptiveness of the healthcare delivery system, including in relation to roles within the health workforce.

Population ageing will compound future cost increases

So it seems clear that rising demand fuelled by income growth, and increased service possibilities from technological advances will continue to be important into the future. But an emerging additional influence is the ageing of Australia's population. This inevitable, pervasive force will fundamentally change the outlook, compared with any simple extrapolation of the past.

Impacts of ageing

That we are today living longer on average than our forebears is a symptom of success — a cause for celebration! But this phenomenon also poses considerable policy challenges for governments, particularly in the financing of healthcare.

In short, the pronounced ageing of Australia's population will reduce the (per capita) growth capacity of the economy — by shrinking the proportion of the population in the workforce — while simultaneously expanding the rate of government spending. The second Intergenerational Report (Treasury 2007) projected that the resulting impacts on the spending of the Australian Government would amount to around 5 per cent of GDP by the middle of this century. Throwing in the spending pressure for state governments will push this to around 6 per cent (PC 2005b).

Further substantial growth in health expenditure will be the dominant cause of this fiscal blow-out, with population ageing being a key underlying contributor.

This view about the impact of ageing on health spending in the future is not universally shared, including among health economists and government officials, so I would like to spend a little time outlining the basis for our conclusions.

Health costs rise (sharply) with age

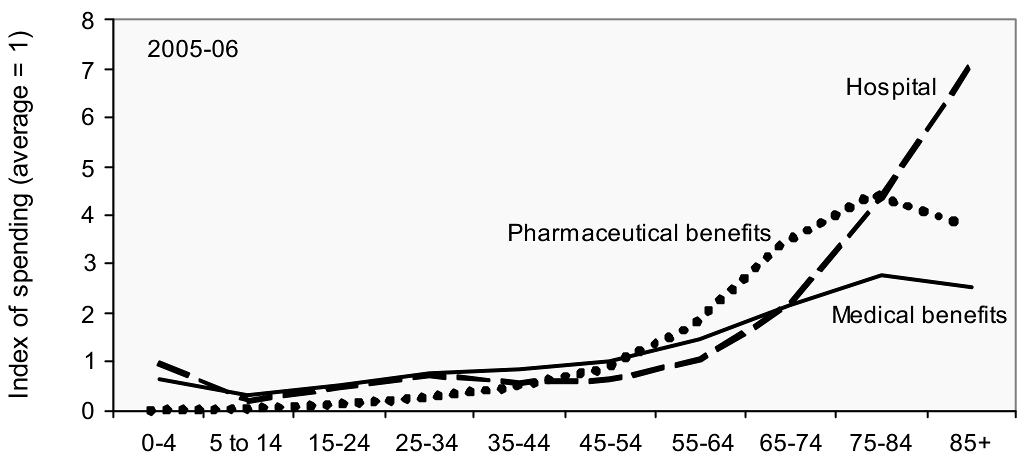
Perhaps the best starting point is what we already know empirically about how health costs vary by age groups. Cross-sectional data for public hospitals, the Pharmaceutical Benefits Scheme (PBS) and medical benefits are shown in figure 3. The escalation in costs for progressively older age brackets is striking.

For health services as a whole, average expenditure on those aged 65 and above in 2002–03, at around $5200 per person, was three times greater than for those aged under 65 (PC 2005b). And the ratio gets progressively greater for older age groups. When this age-cost profile is combined with the much higher projected demographic growth rates for older age groups to the middle of this century we start to get a sense of what lies ahead.

Counter arguments do not hold up

Against this interpretation, it has been argued that all such cross-sectional aggregate data is revealing is the higher incidence of deaths in older age brackets, and the relatively high proportion of lifetime health costs incurred in the period just before death. On this view, if people on average live longer, a large share of their health costs will simply be deferred, and lifetime costs won't increase much.

Figure 3 **Health costs rise steeply with age**



This hypothesis is logically appealing, but it is not supported by the evidence.

- While it is true that healthcare spending is relatively high towards the end of one's life, the bulk of costs still relate to people not at risk of imminent death.

- But even if a proximity-to-death phenomenon *did* explain most of the rise in age-specific expenditure, the projected ageing of the population would still lead to a major surge in future health spending as a share of GDP. The reason for this is that the ageing phenomenon is superimposed on the bulging demographic known as the post-war baby boom. As the boomers reach the end of their lives (in the period 2025–50) the incidence of deaths in the population will swell dramatically (PC 2005b). That in turn would see an escalation in healthcare spending in that period.

A second and related argument commonly made as to why population ageing would not greatly increase healthcare costs is based on the observed fact that older people are becoming 'healthier'. If this phenomenon continues, as it should, it is hypothesised that it will serve to flatten, over time, age-health cost profiles such as those shown in figure 3.

Again this argument is plausible. However, though the issues are complex, the weight of evidence (such as it is) is against it. While age-specific disability trends do seem to be improving (though the empirical evidence is not clear cut) there is an upward trend in various chronic health conditions. These include diabetes linked to rising obesity and age-related conditions, including diabetes again, Alzheimer's, hearing loss and Parkinson's disease. These are being managed by medical (and aged-care) interventions at significant cost.

The impacts of ageing could be understated

Recent trends suggest that ageing and technology are forming a potent expenditure cocktail that will, if anything, see a *steepening* of the age-cost profile over time. Indeed, the evidence suggests that this is already happening. For example,

- hospital 'separations' (figure 4) have been increasing faster for the oldest Australians (with the growth rate of private hospital usage exceeding that for public hospitals) (PC 2005b)
- this is reflected in the steepening age-profile of separations for both hip-replacement and cataract surgery in Australia
- in the case of hip-replacement surgery, the ageing-related growth is even more marked in US data (figure 5). This also reveals that in the 1980s, the incidence of hip replacements was similar across age groups, despite the need being greater for older people.

Projected health expenditure

In its own projections, the Productivity Commission has been relatively conservative. For example, we assumed an unchanging age-cost profile, together with a moderate projection of demographic structural change. Even so, it was projected that the combined health expenditure of governments in Australia would almost double by 2044-45, reaching just over 10 per cent of GDP (figure 6). While all components are projected to increase, the PBS share grows most — more than tripling — followed by hospital costs.

If the ratio of public to private health expenditure were maintained, total spending would amount to around 15 per cent of GDP by 2045 (greater than currently in the United States).

Indentifying the ageing-related component

The Commission unpacked the ageing component from population growth and demand/technology, to assess its separate contribution as an expenditure driver.

Looking firstly at the proportion of expenditure attributable to those aged 65 and over, we projected that this would rise from about 35 per cent today, to around 60 per cent by 2044-45; that is, to become well over half the health budget.

Of course, not all the increase in spending arises from ageing. So we conducted a thought experiment in which we froze the population age structure and allowed the other expenditure drivers to vary over time. Ageing alone is estimated to push up health expenditure from $170 billion to $210 billion by 2045, an increase of 25 per cent (figure 7). As a proportion of GDP, the increase is from 8.1 per cent to 10.3 per cent. Expressed differently, ageing is projected to account for one half of the total increase in (public) health costs as a share of GDP over the next four decades.

Figure 4 **Hospital separations are increasing fastest for older Australians**

Average annual increase (per cent)

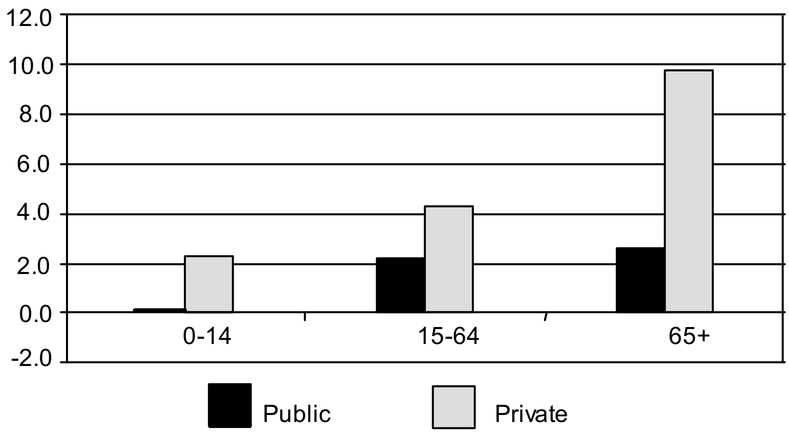


Figure 5 **Longer-term hip-replacement trends among America's aged**

Per 100 000 people

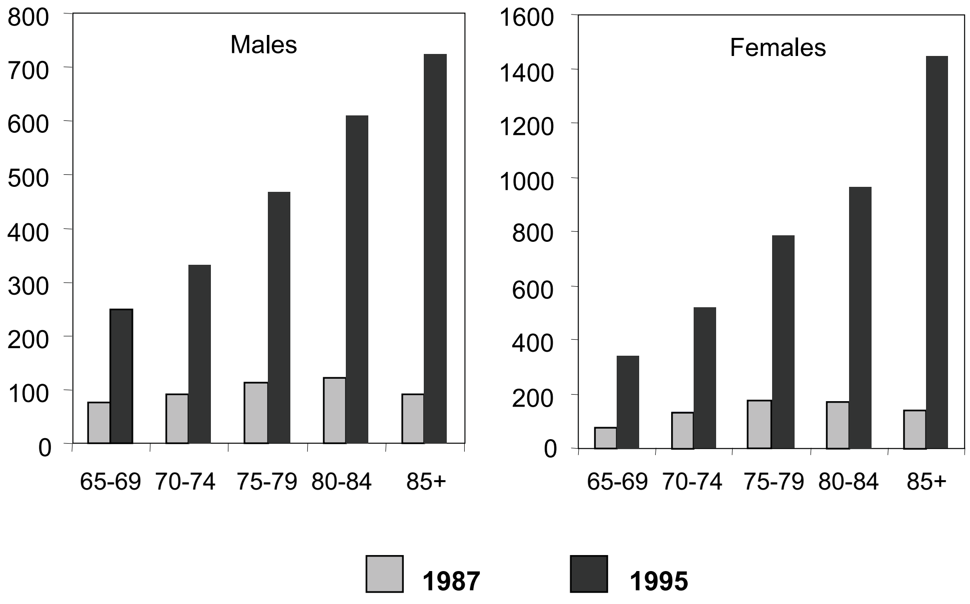
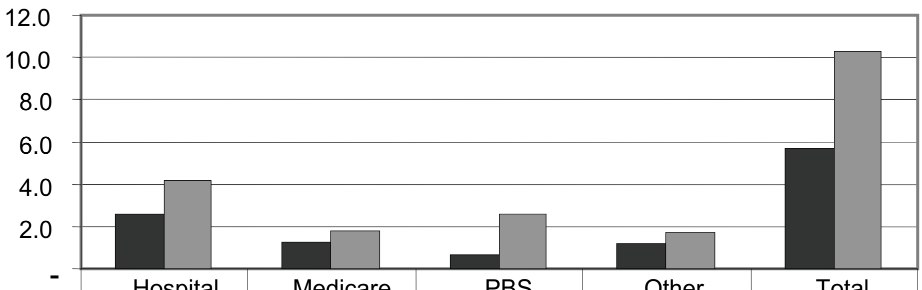


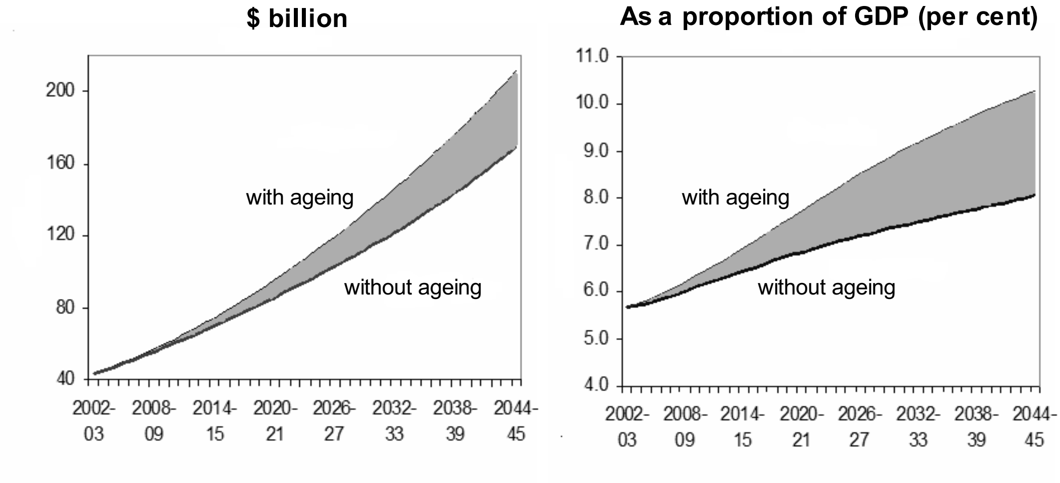
Figure 6 **Projections of government health expenditure**

Proportion of GDP (per cent)



	Hospital	Medicare	PBS	Other	Total
2002-03	2.6	1.2	0.7	1.2	5.7
2044-45	4.1	1.8	2.6	1.7	10.3

Figure 7 **What a difference ageing makes**
Projections of government health expenditure



Some policy implications

Projected health expenditure growth of this magnitude will clearly create a problem for governments, even if only because it will need to be financed. There are three broad policy choices.

Three broad options for governments

First, governments could take a *reactive* role, cutting services or inputs into the health sector (lower quality staff, older technologies, longer waiting periods, greater rationing of treatments). This might avoid a fiscal deficit, but it would soon create a *service* deficit — more insidious because it is less visible, with the potential to adversely affect people. It would also be pushing against the tide of demand for services generally.

At the other extreme, governments could adopt a *passive* role, simply accommodating expenditure pressures through public financing. This avoids any worsening of rationing, but as noted it creates a burgeoning fiscal deficit that must be financed. It can not realistically be financed by cutting back other budgetary demands — like aged care, education, infrastructure, and R&D. So addressing fiscal deficits implies the ‘T’ word — taxes now or later. Fully offsetting the health-induced fiscal pressure would require an increase in taxes of some 16 per cent. Apart from the politics (again) the costs and potential inequities of extracting more through our imperfect taxation system make this choice problematic.

The third, *proactive*, course — identifying areas for reform in the health sector that improve its financing or functioning — looks by far the most attractive.

Attaining the ideal: a 'market' analogy

When considering how to give effect to this proactive option it is useful to ask 'what would an ideal health system look like?'. Many would agree that both equity and efficiency would need to be integral, such that:

a) clinically required services would be available to all

b) only services for which the benefits exceeded costs would be provided

c) there would be no opportunities for producing more from existing inputs.

Fantasising for a moment that health services were like, say, the restaurant industry — supplied by a myriad of producers in approximately competitive markets and dealing with well-informed, demanding consumers — the above goals could be met by markets, supported by cash transfers to the disadvantaged (to meet goal (a)). Fully-informed consumers would buy services that were worth the cost (satisfying goal (b)). In such an ideal market, competition between private providers would drive them to be productive (satisfying goal (c)).

The reality, of course, is that health services are not like restaurants. And more 'market-like' systems, such as in the United States, produce outcomes that appear to be more expensive and less equitable than most universal systems. Even so, some of the features of markets that achieve efficiency and consumer empowerment might be emulated *within* a universal, largely 'free', publicly-financed health system.

Demand-side policies

A bigger role for 'pricing'?

Prices play a central role on the demand side of most markets. In health markets — whether private or public — full pricing for all services would never occur because consumers are willing to pay for insurance (through taxes or premiums) to avoid catastrophic risks. The issue is about the right level of insurance, and therefore, the right level of co-payments.

Co-payments can provide a valuable role in constraining inappropriate demand and, by marshalling private financing, relieving some of the fiscal strains for government from burgeoning healthcare costs. These days the choice is not really *whether* to have them — they are already here in GP services, pharmaceuticals and other services — rather, it is about the types of services to which co-payments should be applied, their level and their structure.

Figure 8 **Proactive policy choices**

Demand side	Pricing	Information and empowerment	Regulation
Supply side	Incentives	Decision-making processes	Health workforce
System wide	Roles of different funders	Coordination and interactions between parts of the system	Transitions: 'big bang' or incrementalism

‘Good’ co-payment design is not easy. And there are other potential problems with co-payments, such as diversion of demand to unpriced services. But there is also scope to extend their use, such as for services that are shown to have low cost effectiveness. The policy challenge is for us to learn more about where their further use could yield net benefits to the community.

Information and consumer ‘empowerment’

People’s lack of information and knowledge about health and treatment is the fundamental ‘market failure’ on the demand side that underlies many of the features of the public health system. But there is scope for policy to promote better informed consumers and thereby to achieve better outcomes at lower social cost.

One avenue is to provide information, and advertise information sources, that could enable consumers to be more discerning in their use of the health system. A second step might be to provide information on outcomes by hospital and doctor, and give consumers more choices about both. Choice of this kind, combined with funding premiums for higher-performing hospitals and recognition of higher-performing health staff can improve quality of services as well as empowering consumers.

Of course, such ‘league tables’ need to be designed carefully to avoid perverse outcomes such as discouraging surgeons from taking on high-risk patients. As in most areas of health reform, careful evidence-based change, supported by trials if possible, is the best way of proceeding.

Preventative action

A third step relates to encouraging changes in consumer behaviour to avoid or reduce health risks — ‘preventative health’. There is evidence that information can have powerful impacts. One of the biggest identified priorities in preventative health is curbing obesity, the incidence of which has grown rapidly over the past decade Obesity is a significant health and social issue. It is causally linked to higher prevalence rates of heart disease, stroke, diabetes II, kidney disease, arthritis and some cancers, as well as social marginalisation.

However, while achieving behavioural change to address this burden of disease is an appropriate goal, doing so effectively through information provision and social marketing alone is likely to prove demanding.

Regulatory options?

From a policy perspective, the obvious alternative approach is regulation. Many successful public-health interventions have in fact been based on regulation, rather than information provision. Well-known examples include safety-belt regulation and drink-driving penalties; smoking bans in workplaces; addition of fluoride to water; and removal of carbon monoxide from domestic gas supply.

However, regulation is potentially a more fraught route to societal improvement, to the extent that it overrides individual preferences. For example, rules about what foods can be advertised on television, made available in school tuckshops, or sold at supermarkets, involve progressive encroachment on an individual’s right to choose. In some cases that may be warranted, in others not. The calculations are not straightforward and political judgement will inevitably be called upon.

Therefore, as in the case of public education campaigns, it will be very important to subject all new regulatory proposals to careful analytical scrutiny in advance and subsequent formal evaluation following implementation. This is rarely done well; and sometimes the latter is not done at all.

Supply-side policies

When people think of the health system, they mostly think about the supply side; doctors, hospitals, chemists and pharmaceutical components, health bureaucrats and systems for public financing. This preoccupation with the supply side is in itself an indication of the currently attenuated role of the consumer.

Incentives and productivity

In normal markets, the costs for consumers are the rewards for suppliers. That price nexus is all but severed in the heath system. Instead, the most important incentives provided to suppliers come from governments.

A well-functioning health system should have strong incentives to maximise productivity as well as to attain appropriate quality (as occurs routinely in the business world). In its recent report on the National Reform Agenda, the Commission found evidence of sizeable productivity gaps in the supply of existing services around the country (PC 2006b). We estimated that the gains from even partly closing these could amount to nearly $2 billion a year.

As noted above, information about performance, combined with a degree of consumer choice and financial incentives, can stimulate performance improvement by competing services.

Nevertheless, Australia does not appear to be as innovative in its use of incentives as the United Kingdom (which in many other respects has similarities to our system). In May 2008, the UK Government outlined a system of payments to hospitals that would be linked to patient satisfaction and health outcomes. The experience with this could provide valuable lessons.

Better decision-making processes

In part, higher productivity may be achieved by simply adopting better processes, such as avoiding wasteful cost shifting between parts of the health system funded by different parties, and the application of evidence-based treatment protocols to reduce adverse events and unnecessary clinical variation. Structural changes, such as re-organising the system to realise economies of scale and scope may also offer gains.

The desirability of good processes also extends to 'technology assessment', which provides the basis for approving the (subsidised) use of new technologies, including new PBS drugs.

Health workforce, regulation and remuneration

Australia's health workforce is highly regulated. Much of that regulation is appropriate. Occupational certification of surgeons, general practitioners and other health professionals is an effective way of signalling their competence to patients.

But there are also some rigidities in workforce regulation and fragmentation in processes that frustrate innovation, raise costs and put strains on a system where workforce shortages are growing across the country (PC 2005a).

System-wide issues

Health provision *is* a system. The effectiveness of policy change in one area depends on policy settings in others. Indeed, the health system is more even than the resources and structures devoted to healthcare. The complex causal factors behind persistent Indigenous disadvantage provide a vivid illustration of this. Having a good health clinic in a remote Indigenous community is unlikely to achieve better health outcomes if there are barriers to access, if housing is overcrowded, diets are poor, and substance abuse is widespread.

The notion of health as an interconnected system is becoming better understood, both in the extreme case of Indigenous health policy and in the mainstream. This is illustrated by the piloting of coordinated primary healthcare. This has been suggestive of significant benefits through more integrated service provision; though it also has revealed considerable underestimation of the administrative complexities entailed (Department of Health and Ageing 2007).

In its report on private health insurance, the Commission advocated a major public review of the health system as a whole, and it has since reaffirmed that view (IC 1997b, PC 2005e). The most effective way of implementing changes to achieve system-wide improvement is likely to continue to be through incremental steps, rather than any 'big bang' reform. The challenge is to ensure that it is consistent with a coherent strategy for the system as a whole.

Any national reform plan needs to be cognisant of the emerging cost pressures related both to the demand (ageing) and supply (technology) sides of the healthcare market. Those pressures are inevitable and of major dimensions. They are best addressed proactively and there appears scope to do that. However this brief excursion through various areas that are seen as prospective is suggestive of caution. Ultimately, health policy reform is about changes that can lead to improvements in people's wellbeing. While greater cost effectiveness and efficiency must be an integral part of this, mere cost containment should not be the goal.

Reviewing the service performance of Australian governments*

Assessing the performance of government in delivering services for which there is (or can be) no well developed market, and where criteria such as access and equity loom large, is no simple matter. Individually governments can set objectives and collect information which can at least reveal trends in their individual performance over time, but how do they know what is potentially achievable or, to use an overworked expression, 'best practice'?

Federations provide constituent governments with an important mechanism for doing just that — to compare performance and learn from what other jurisdictions are doing and how they are doing it. That said, the ability to realise the potential for inter-jurisdictional learning depends on having access to consistent and comparable data. That is where the Review comes in.

The Review of Commonwealth State Service Provision was established in 1993 by Heads of Government in recognition of two things: the importance of government-provided services to community living standards, and the scope for different jurisdictions to learn from each other in improving service delivery and achieving better outcomes. The Review embraces services that together add up to over $65 billion in expenditure (or around one-third of total government spending). That's equivalent to around 10 per cent of Australia's GDP.

The Review was established in an era of reform. It was congruent with the other reforms taking place in the public sector as governments became more focussed on getting greater value out of taxpayers' dollars — more focussed also on what sort of outcomes they were looking for and whether they were being achieved. Heads of government saw an opportunity to learn from each other in improving service delivery and getting better outcomes. But at that time much of the data that existed were fragmented and lacking in consistency. More systematic comparative data were seen as essential, and the Review was set up to provide it.

* Presentation to the 'Measuring and Managing Government Performance Summit', Canberra, 20 February 2002. (Co-authored with Robyn Sheen.) Gary Banks has chaired the Steering Committee responsible for the *Report on Government Services* since 1998.

The Review has been carefully structured

A Steering Committee comprising senior representatives from central agencies in the Commonwealth, states and territories has overall responsibility for the Review. It is they who make the decisions about what will be included in the Report and have responsibility for signing it off.

Supporting the Steering Committee are working groups for each of the 12 sectors. They comprise representatives from the 80 or so relevant line agencies in all jurisdictions and form the 'engine room' of the Review. Many working groups also have observers from various statistical agencies — like the Australian Bureau of Statistics and Australian Institute of Health and Welfare — who provide much of the data in the Report.

The Industry Commission was originally asked to chair the Review and provide its secretariat, and the Productivity Commission has continued those functions. In both of its roles — that is, Chair and secretariat — the Commission brings to the Review the advantage of its statutory independence, the transparency of its processes, and a community-wide focus. As Chairman of the Commission, it has been my responsibility to assume the role of Chair of the Review's Steering Committee.

Its guiding principles and scope

The Review's task is to provide objective information relevant to assessing government performance. The aim is to facilitate well-informed judgments and sound public policy on government service provision.

There are three broad principles underpinning the work of the Review: a focus on *outcomes*; a concern for *completeness*; and a preference for information that is *comparable* across all jurisdictions.

Since the release of the first *Report on Government Services* in 1995, the scope of the Report has expanded considerably as more data have become available. The Review covers sixteen individual service delivery areas, which can be grouped under six broader categories:

- *education* — schools and vocational education and training
- *health* — public hospitals, general practice and key health management issues (mental health and breast cancer)
- *justice* — police services, court administration and corrective services

- *community services* — aged-care services, services for people with a disability, children's services, and protection and support services
- *emergency management* — fire and ambulance
- *housing* — public and community, plus rent assistance.

I am often asked why we cover some areas of government service delivery but not others — for example, why not include employment services or transport? The focus of the Review is on social services rather than economic infrastructure, so areas like transport, energy or communications are ruled out. As for including other possible services in the social domain, the Review has generally given priority to those services which are provided by all states and territories.

The performance indicator framework

For each sector that the Review reports on, a performance indicator framework has been developed. Within this framework, performance is reported in terms of efficiency and effectiveness.

What do these two concepts mean?

- *Efficiency* relates to how well organisations use their resources to produce units of services. The generally used indicator of efficiency is the level of (government) inputs per unit of output.
- *Effectiveness* relates to how well a service achieves its desired outcomes. Effectiveness indicators in the Report include: access and equity; appropriateness; quality; and actual outcomes.

As anyone in the public sector will know, service provision can sometimes involve a tradeoff between effectiveness and measured efficiency. A change in service delivery may increase the level of resources per unit of output (resulting in what might look like a decrease in efficiency) but lead to better overall outcomes. For example, the accessibility or quality of the service may improve, resulting in a more than proportionate benefit to the community.

The Review itself does not seek to analyse such trade-offs. Its role is to present objective information that allows closer analysis of this kind, but not to make judgements about how individual governments are performing.

The performance indicator frameworks are developed by the individual working groups. While the ultimate aim is to provide quality data that are comparable and timely, reporting in all service areas has been a journey of (continuous) improvement, sometimes from very patchy beginnings. Great importance is placed on developing indicator frameworks that will provide a picture of what performance information is needed to assess whether objectives are being met — even if all of that information isn't immediately available.

Some misunderstandings and criticisms

There is a common misunderstanding that the Report is a benchmarking report, which in some respects goes to different conceptions about what benchmarking is. For example, some people see benchmarking as a way of identifying best practice, while others see it as setting a minimum standard to be achieved. The *Report on Government Services* does not in itself purport to establish benchmarks of best practice.

Having said that, the Report has become a useful vehicle by which governments can determine their own relevant benchmarks. They may need to make adjustments for those differences which the Review is careful to set out in its caveats, but the data provide a good starting point. They may go about this task by looking at their performance in comparison to other jurisdictions which are of like size, or deliver kindred services; or the Report may lead them to ask questions about where and how they can do things better and to consult more closely with other governments.

While most participants in the Review accept that performance reporting and transparency of government spending is important, there are still some pockets of resistance to supplying the necessary data. The school education sector comes to mind, but it is by no means alone.

The school sector has made some progress towards comparative reporting of learning outcomes over recent years. But there is still a significant gap between what the Ministerial Council for Education, Employment, Training and Youth Affairs has agreed to report and what is being delivered. And there is a substantial time lag between collection and publication of results.

Most service areas in different jurisdictions see themselves as special. But claims that 'we are too different' or that the services are 'not amenable to quantification' have diminished over time as people, sitting around the table, have come to understand the more basic similarities.

However, it would be fair to say that the Review and what it stands for have attracted some vocal critics over the years. Clearly the Review's activities in shining light on the efficiency and effectiveness of government services are not always welcome!

The most recent public example of that is in the area of Court Administration. For example, the Chief Justice of the Supreme Court of New South Wales recently had this to say about the Review:

> All aspects of this process are being pursued with a single ideology and a single methodology. A system of performance benchmarking is established, pursuant to which performance indicators are developed and published. In the case of the judicial system, the terminology is misleading, perhaps dangerously so. The courts do not deliver a 'service'. The courts administer justice in accordance with law. They no more deliver a 'service' in the form of judgments, than the Parliaments deliver a 'service' in the form of statutes. (Spigelman 2000, quoted in Drummond 2001)

I would agree that the Review's processes derive from a common purpose, but it has no ideological basis. With eight governments involved that would be an achievement indeed! And with 12 different service sectors sourcing data from a range of providers, you could only say it had a single methodology in the very broadest terms.

Also, there is no system of establishing performance benchmarks. It is up to governments and their agencies to decide whether they want to use the Report for benchmarking purposes, and how.

But I do agree that it would be inappropriate and dangerous to consider legal judgments as a service, at least in the conventional sense involving a client or customer relationship. I'm not sure that many of those who lose out from a judicial decision would consider themselves well served. In a much broader sense, however, the justice system certainly does provide a service to the community. As I've previously observed, society could not function effectively without it.

In practice, as everyone knows, the Review does not report on judgements. But it *does* seek to report on court administration — how well the courts go about their business. Anyone who has found themselves attending the pleasure of the court system will understand why that is a worthwhile task. The value of courts to society lies not just in the quality of the judgements that are ultimately made, but also in the processes that produce them. Justice greatly delayed, or achieved at excessive social cost, has a diminished value to society.

The Judges' objections

Objections from sections of the judiciary to such performance measurement appear to be of two principal kinds. The first relates to its possible implications for the independence of the courts; the second, to the feasibility of obtaining meaningful and comparable information.

There can be no question as to the critical importance of judicial independence. Judges must be able to make unconstrained judgements. In order to do that, they not only need separate powers and secure tenure, but also adequate incomes and administrative resources.

The resources made available to courts need to account for what New South Wales Chief Justice Spigelman has described as the 'inefficiency' of justice administration compared with some other systems of decision making (Spigelman 2001, p. 7). But that does not negate the value of comparisons of the efficiency of the system in different jurisdictions.

Moreover, as already emphasised, the Review is concerned at least as much with measures of effectiveness as with costs of provision. While the separation of powers is fundamental to judicial independence, it is difficult to see how requirements to report on such matters as court delays, finalisations or lodgements could involve a significant conflict. Indeed, without adequate transparency and accountability, the stature of the courts could ultimately be eroded.

Thus the Chief Justice of Australia, Murray Gleeson, has made the following observation:

> The current emphasis on court management is natural and appropriate. The operations of courts involve the expenditure of scarce public resources, and governments are entitled to reasonable assurance that those resources are being applied efficiently and effectively, and are dealt with in a manner that responds to the demands of accountability. Those demands are not inconsistent with the imperative of independence; although the appropriate resolution of the two might occasionally involve some difficulty. (Gleeson 2001)

Gleeson concludes his discussion with what could be cited as the credo for the Review:

> Managers have a lot to teach us about how to be more effective in the application of the resources we are given. We have a lot to teach them about the demands of justice, and due process of law. The public will benefit if we learn from each other. (Gleeson 2001)

The second concern voiced by some judicial critics of the Review relates to what is perceived to be a lack of comparability in data from different jurisdictions. As noted previously, *perfect* comparability is typically unattainable and that is not a good reason for forgoing the reporting process.

There is a tendency for those jurisdictions that do not show up too well in the Blue Book's numbers to 'shoot the messenger'. One test of whether such criticism is likely to be valid is to observe how those who fare better treat the same results. To give one relevant example, Victoria's Chief Justice has recently and publicly endorsed the Review's performance indicators in arguing the need for additional appointments to the Victorian Supreme Court.

Courts need to be accessed by the poorest and most vulnerable people in our society, as well as by the richest and most privileged. That the services provided should be accessible, equitable and timely is broadly accepted — and embedded in the objectives. It is in everybody's interest that there be transparency in the courts' administrative performance, and accountability for the resources used. The 'quality of mercy' we rightly leave to the judges.

Indigenous disadvantage: assessing policy impacts*

Thanks largely to the economic policy reforms of the past twenty years, Australia has regained its position in the ten most prosperous countries in the world. Like other prosperous countries, we have policies and programs in place to assist the relatively disadvantaged within our society. In common with a number of those countries, the number of Indigenous people who are disadvantaged remains disproportionately high, despite longstanding policy attention. The contrast with our broader economic success is striking.

The widespread disadvantage among Indigenous people in Australia is reaffirmed in a new report released today. The report, *Overcoming Indigenous Disadvantage: Key Indicators* (SCRGSP 2003), forms part of a broader process of policy reassessment and reform that has the potential to redress this persistent failure in the midst of general economic success.

The report was commissioned by COAG and is the responsibility of a steering committee of senior officials from all governments within Australia, assisted by a secretariat drawn from the Productivity Commission. Its commissioning demonstrates a new resolve, at the highest political level, not only to tackle the root causes of Indigenous disadvantage, but also to monitor the outcomes in a systematic way that crosses jurisdictional and portfolio boundaries. In so doing, the report will also raise the transparency of governments' performance.

This report's purpose, therefore, is to be more than just another collection of data. It seeks to document outcomes within a framework that has both an agreed vision of what life should be for Indigenous people and a strategic focus on key areas that need to be targeted if that longer-term vision is to be realised.

The framework that distinguishes the report had its genesis in work undertaken by the Ministerial Council for Aboriginal and Torres Strait Islander Affairs. It has

* Melbourne Institute Economic and Social Outlook Conference 'Pursuing Opportunity and Prosperity', Melbourne, 13 November 2003. (Co-authored with Robyn Sheen.) Gary Banks was the initial convenor for the Working Group overseeing the *Overcoming Indigenous Disadvantage* report.

benefited from ongoing input from the Aboriginal and Torres Strait Islander Commission, the Australian Bureau of Statistics and the Australian Institute of Health and Welfare. It has also evolved considerably as a result of widespread consultations across the country, particularly with Indigenous people and organisations. It is fair to say that, while agreement on all aspects of the reporting framework would be too much to expect, it has received broad endorsement from all of these groups, and not least from COAG itself.

A strategic framework

This is obviously not the first report to assemble data on the social or economic status of Indigenous people. Its difference lies in the strategic framework within which the information is collected and presented. The reporting framework is based on a 'preventive model', which focuses on the causal factors that ultimately lead to disadvantage; areas where experience and logic suggests that targeted policies will have the greatest impact.

The vision

At the apex of this framework are three overarching priorities that were initially derived from COAG (see figure 1). They reflect a vision for Indigenous people that is shared by governments and Indigenous people alike:

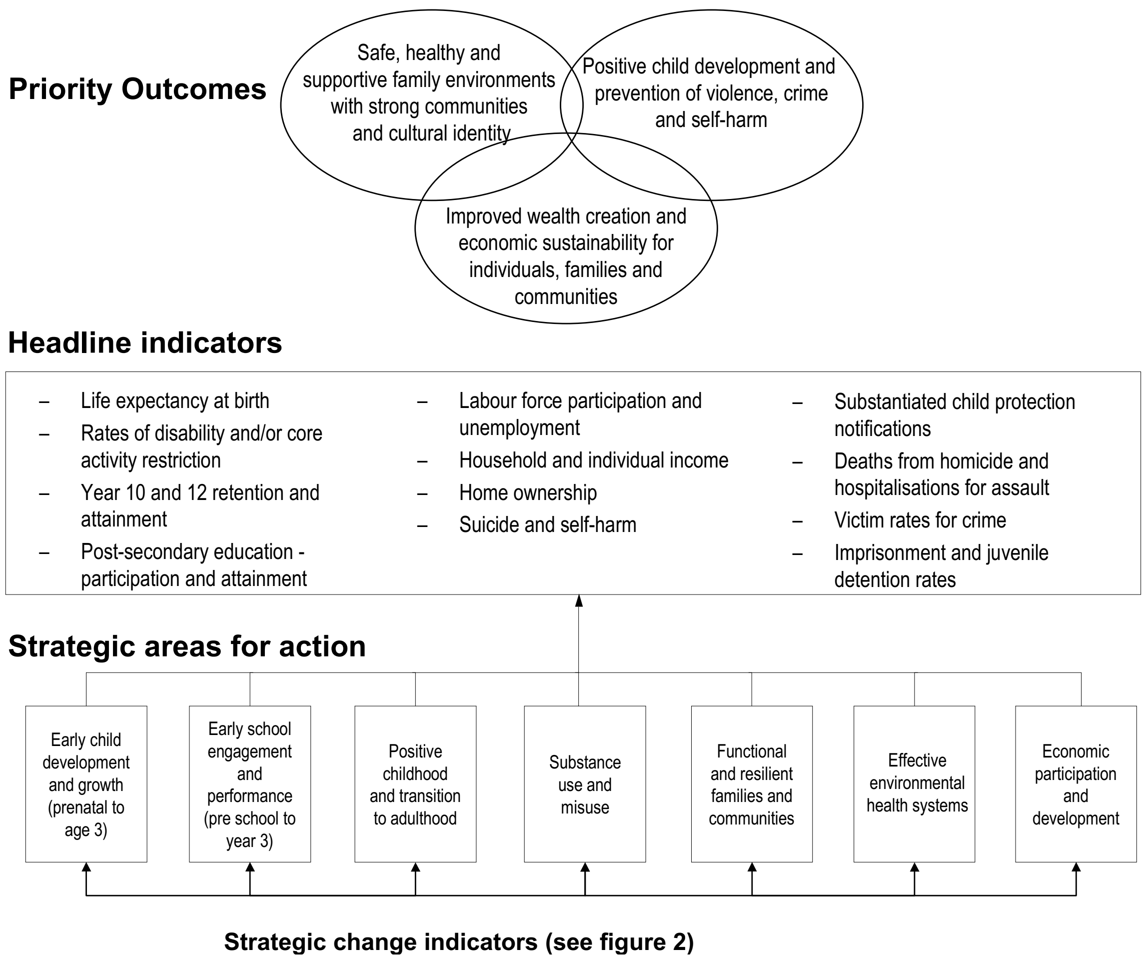
- safe, healthy and supportive families with strong community and cultural identity
- positive child development and prevention of violence, crime and self-harm
- improved wealth creation and economic sustainability for individuals, families and communities.

'Headline' indicators provide a snapshot

A first tier of 'headline indicators' has been developed to provide a snapshot of how actual outcomes for Indigenous people measure up against these overarching priorities. The choice of indicators, while subjective, has generally been accepted as meaningful by Indigenous people. Included are a dozen indicators of social and economic status of Indigenous people relative to other Australians.

The framework and report could rest there, as other reports have done. However, this would not do much for policy makers, or those who wish to monitor their impact. Headline indicators of this kind reflect desired longer-term outcomes and therefore are themselves only likely to change gradually. Because most of the measures are at such a high level and have long lead times (for example, life expectancy) they do not provide a sufficient focus for policy action and are only blunt indicators of policy performance.

Figure 1 **The strategic framework**



Indeed reporting at the ‘headline’ level alone can make the policy challenges appear overwhelming. The problems observed at this level are generally the end result of a chain of contributing factors, some of which may be of long standing. These causal factors almost never fall neatly within the purview of a single agency of government, or indeed a single government.

The innovation: ‘Strategic areas for action’

For this reason, the framework also contains a *second* tier of indicators under seven ‘strategic areas for action’. These have each been chosen for their demonstrated potential to have a lasting impact on (higher level) disadvantage, and for their potential to respond to policy action within the shorter term. They assist policy makers to concentrate on the causes of disadvantage, with the indicators providing intermediate measures of progress.

The strategic areas for action are not ‘rocket science’: they sensibly focus on young people, the environmental and social factors bearing on quality of life, and material wellbeing (see figure 2). They — and the indicators that relate to them — have been developed with advice and feedback from governments, experts in the field and, most importantly, Indigenous people and organisations. They meet COAG’s need for ‘indicators that are of relevance to all governments and Indigenous stakeholders, and that can demonstrate the impact of program and policy interventions’.

The report recognises that Indigenous people are as diverse as other sections of the Australian community. People in Arnhem land or central Australia have a quite different life experience to people living in say, Sydney or Perth. Wherever possible, within the data limitations, we have attempted to reflect such differences by presenting information by geographic region. Even then, it can miss variations. For example, Indigenous people living in remote coastal or island areas may have quite different circumstances to those living in remote inland areas.

It should also be emphasised that there are many good things happening at the local level, the results of which may not get picked up in national or even state data collections. And finally, of course, not everything that is important to Indigenous people can be quantified. In some cases, the report attempts to deal with this through case studies.

Figure 2 **Strategic areas for action**

Early child development and growth (prenatal to age 3)	Early school engagement and performance (pre school to year 3)	Positive childhood and transition to adulthood	Substance use and misuse	Functional and resilient families and communities	Effective environmental health systems	Economic participation and development
– Rates of hospital admission for infectious diseases – Infant mortality – Birthweight – Hearing impediments	– Preschool and school attendance – Year 3 literacy and numeracy – Primary school children with dental caries	– Years 5 and 7 literacy and numeracy – Retention at year 9 – Indigenous cultural studies in school curriculum and involvement of Indigenous people in development and delivery of Indigenous studies – Participation in organised sport, arts or community group activities – Juvenile diversions as a proportion of all juvenile offenders – Transition from school to work	– Alcohol and tobacco consumption – Alcohol related crime and statistics – Drug and other substance use	– Children in long term care and protection orders – Repeat offending – Access to the nearest health professional – Proportion of Indigenous people with access to their traditional lands	– Rates of diseases associated with poor environmental health (including water and food borne diseases, trachoma, tuberculosis and rheumatic heart disease) – Overcrowding in housing – Access to clean water and functional sewerage	– Employment (full-time/part-time) by sector (public/private), industry and occupation – CDEP participation – Long term unemployment – Self employment – Indigenous owned or controlled land – Accredited training in leadership, finance or management – Case studies in governance arrangements

Some ‘headline’ messages

So what are the facts as they emerge from this report? As noted, the 12 headline indicators provide a high level ‘stocktake’. They confirm that disadvantage is broadly-based, with major disparities between Indigenous and other Australians in most areas.

This is most fundamentally reflected in the 20-year gap in life expectancy for Indigenous men and women, relative to the rest of the population. Twenty years is just short of the standard measure of a generation. It represents a tragic loss and a waste, for Indigenous people and for Australia as a whole.

This was brought home to me most forcefully when, at the conclusion of an insightful discussion with one of Australia’s foremost Indigenous identities — a man about my own age — he said that on the basis of the averages, by the time the report was released he would not be around to discuss it further with us. (Fortunately, that has not transpired.)

The lower life expectancy of Indigenous people is bound to reflect a range of influences and patterns of behaviour that impact differentially on their health. But there are other contributors. The proportion of homicides in the Indigenous population is over 10 times that for other Australians. The suicide rate for Indigenous people was around three times higher than for the rest of the population, with an even greater disparity for 25 to 34 year olds.

The headline indicators relating to young Indigenous people are also cause for concern. While getting robust and meaningful data in areas of child abuse and neglect is hard, significantly more Indigenous children appear at risk. The statistics show higher rates of child protection intervention, particularly related to neglect. And, despite some improvement, Indigenous juveniles are still 19 times more likely than other young Australians to land in criminal detention. (By the time they grow up, the disparity falls only slightly, to 15 times).

Indigenous students are more likely to leave school when it is no longer compulsory, and have much lower levels of participation and attainment at senior school and post secondary.

The circumstances for Indigenous adults also involve major disparities with other Australians. For example, even with the many people engaged under the Community Development Employment Projects (CDEP) (effectively a form of voluntary ‘work-for-the-dole’) counted as employed, the overall labour force participation rate for Indigenous people is lower and the unemployment rate is nearly three times higher than it is for non-Indigenous people. It follows that

Indigenous people also have significantly lower incomes (at both the individual and household level). The difference is particularly marked in remote regions. And, while the incidence of Indigenous home ownership appears to have risen, it is still less than half that of non-Indigenous households.

Outcomes in the 'strategic areas for action'

These outcomes didn't happen overnight. They have been influenced by experiences in childhood, within families and communities and in the economic and physical environments of Indigenous people. And they are likely to differ in various ways for people in urban environments relative to those in more remote (including island) regions of Australia.

Young people

In the three strategic areas that focus on young Indigenous people, the potential for cumulative disadvantage is plain to see.

The first of these areas, *early child development to age 3*, is widely seen as pre-conditioning outcomes in later life, particularly in health and education. Whether there have been improvements is unclear from the data. What is clear is that there are some significant gaps. In particular:

- the Indigenous infant mortality rate is twice as high as for other Australian babies, reflecting in part, a higher incidence of low birthweight
- children under four appear to have a significantly higher incidence of infectious diseases requiring hospitalisation and, in particular, long-term ear infections and consequent hearing loss — a major inhibitor of early school performance.

The second strategic area, *early school engagement*, is critical to future educational performance, and all that follows from that, as well as for social development.

Unfortunately, crucial data on attendance were unavailable. School participation, a weak proxy used in this year's report, was found to be lower for Indigenous children. By year 3, Indigenous students already had significantly lower literacy and numeracy than other students. Among other things, this increases the likelihood of poor subsequent performance and early exit from school.

This was confirmed by indicators in the third area, labelled *positive childhood and transition to adulthood*, which revealed widening disparities in performance in years 5 and 7, and high drop-out rates once compulsory schooling ends in years 9 and 10. Indigenous people have argued persuasively that having more

Indigenous teachers and content in schools would make a difference in turning this story around. They have also suggested that this would yield benefits for non-Indigenous students. So far, however, Indigenous teachers are heavily under-represented in the mainstream system.

The transition from school to work is a critical phase for all young people. An educational attainment of Certificate Level 3 or above has been found to reduce significantly an Indigenous person's chance of being unemployed. However, Indigenous people aged 15 to 24 years were much less likely than non-Indigenous people to be in either school or work.

Families and communities

Families and communities are the bedrock of any society. Indigenous leaders have argued, and research confirms, that dysfunctional families can undermine the potential for individuals to enjoy good health, educational attainment and employment. That said, the functioning of families and communities is a subjective and 'private' matter, for which reliable data or meaningful indicators are inherently hard to obtain.

Some of the report's indicators are therefore least satisfactory in this area, and more work will be needed. For example, the indicator on long-term care and protection orders for children, is not an adequate reflection of actual levels of abuse or neglect. The indicator, 'repeat offending', was chosen because cycles of Indigenous imprisonment can have severe impacts on family life and communities. The data show that Indigenous people are not only massively overrepresented in prisons — four in five Indigenous inmates were found to have had previous stints in prison.

A strong theme running through our consultations with Indigenous people was that while spiritual and most cultural matters were not amenable to, or appropriate for, statistical reporting, access to traditional lands played such a fundamental role in their culture and community wellbeing that it needed to be reflected in the reporting framework.

Substance use and misuse

The interconnections between substance abuse, social problems and poor health are well established, and are manifest within the wider community. Among legal and commercially available drugs, the rate of (regular) smoking was more than twice as high for Indigenous people. In contrast, and notwithstanding perceptions to the contrary, survey-based data indicates that the incidence of excessive consumption of alcohol was not much higher overall, though more concentrated in remote communities. Nevertheless, nearly three-quarters of Indigenous homicides involved both the victim and the offender having consumed alcohol at the time —four times the rate for the rest of the population.

Marijuana is the most common illicit drug in Indigenous as well as non-Indigenous populations. Anecdotal evidence suggests that its use has spread quickly. The use of inhalants (glue, petrol) by children also appears much more prevalent in some Indigenous communities, but there is little or no data to verify this.

Environmental health systems

The conditions in which people live and work have a major influence on their wellbeing and social behaviour. Sanitation, drinking water quality, disease control and housing conditions are some of the factors that contribute to environmental health.

An indication of the relative living conditions of Indigenous people is that the incidence of diseases associated with poor environmental health is up to four times higher than for other Australians.

Overcrowding in housing is a particular problem, even allowing for cultural differences, and has been shown to have particularly adverse impacts on health, family violence and educational performance. Indigenous people were nearly six times more likely to live in overcrowded households than other Australians.

Economic participation and development

The strategic areas discussed above have a bearing on material as well as other aspects of disadvantage in the longer term. However, a separate set of indicators relating to the current economic participation and development of Indigenous people was seen as critical to focusing attention on what could be done in the shorter term. The extent to which people participate in economic life is closely related to their living standards and broader wellbeing. It also influences how they interact at the family and community levels.

Published employment data show much lower rates of full-time employment, and higher rates of unemployment, for Indigenous people. This is also the case to a lesser extent for long-term unemployment. However, the unemployment data for Indigenous people are not really comparing like with like, as they do not distinguish CDEP jobs from other jobs.

Under CDEP, Indigenous people undertake to have their Centrelink entitlements pooled to pay for their employment in projects managed by Indigenous community organisations. It is thus akin to a work-for-the-dole program. While data on CDEP are poor, the scheme clearly accounts for a substantial proportion of Indigenous employment. In remote regions (including the Torres Strait Islands), it accounts for the overwhelming majority of jobs. This is not surprising, of course, as in such areas there may be little market-based employment available to Indigenous people, at least at the wages prevailing in the pastoral and mining industries.

This strategic area also contains an indicator relating to Indigenous owned or controlled land, in recognition of its economic as well as cultural value. Most such land is in very remote parts of Australia and its potential productive value will clearly vary a lot from place to place. The scope to realise the economic potential of Indigenous land is inhibited in many cases by common property ownership and inalienable title — the effects of which have been well documented in the development economics literature. This need not be an insuperable barrier, as developments in other countries have shown, but it will generally need the creation of institutions that give stronger *defacto* property rights.

Finally, the report reflects the growing recognition of the importance of good governance to economic performance. However, capturing this in any meaningful quantitative sense is a major challenge. Initially, the report has focused only on training in the skills relevant to capacity building in administration. The incidence of such training among Indigenous people was found to be only one-fifth of that for other Australians. In addition, future reports will seek to provide case studies that can illuminate aspects of good governance within Indigenous communities and organisations that may have wider application.

Doing better

This excursion through the indicator results confirms the pervasiveness of Indigenous disadvantage. It is distressingly apparent that many years of policy effort have not delivered desired outcomes; indeed in some important respects the circumstances of Indigenous people appear to have deteriorated or regressed. Worse that that, outcomes in the strategic areas identified as critical to overcoming disadvantage in the long term remain well short of what is needed.

The report challenges us to do better. It also vindicates COAG's decision to give new impetus to the development and coordination of Indigenous policies and programs.

Harnessing the report's potential

The report's contribution to this important national endeavour is essentially *informational*. It does not (and cannot) provide policy answers. But it can (and hopefully will) help governments and Indigenous people to identify where programs need to deliver results, and to assess whether they are succeeding.

For it to be effective in this, it will be important that governments integrate elements of the reporting framework into their policy development and evaluation processes. One important national vehicle for this is the Action Plans that are being developed by Ministerial Councils in such areas as health, education, employment, justice and small business. The whole-of-government, outcomes orientation of the framework also complements the coordinated service delivery trials in eight different regions across Australia that were initiated by COAG.

Information of this kind can thus help governments to devise coordinated strategies and to monitor their impacts. But it can also help to clarify the problems or targets for policy action. It can provide an agreed basis for community awareness and debate. And it may help to engender broader support for new policy actions.

This report is merely a first step in that direction — a work in progress. Its immediate contribution is constrained by serious gaps and deficiencies in data. For example, we know that hearing impediments in young children can seriously undermine their ability to succeed at school, yet we have little basis for knowing whether this problem is getting better or worse. We know that attendance at school is critical to lifelong achievement, but we have inadequate data to monitor it. Substance abuse is blighting young lives, but we have little systematic information on it. Data on the extent of disabilities among Indigenous people is almost non-existent. The Review documents these and a range of other data priorities that will need to be addressed if the report is to realise its potential and meet COAG's needs.

Policy implications: some personal observations

As noted, the report seeks to inform us about emerging outcomes in the areas that count most for improving disadvantage over time. It is up to governments to devise and maintain the policies and programs that can improve matters. That said, the process of testing the indicator framework with relevant government agencies and (especially) Indigenous representatives, brought out a number of insights and lessons for policy makers that seem too important to ignore.

(In order to make clear that they do not form part of the official report, I label them 'personal observations'.)

The first thing I learnt from those consultations in which I was personally involved, was how little I knew. It was cold comfort to be assured that government officials designing programs were sometimes not adequately informed either. We heard several stories of solutions devised at the 'top' that didn't work at the 'bottom', or where it counted. For example, we heard of Indigenous housing that failed to recognise basic needs and preferences of Indigenous people (too many doors, not enough communal space). We heard about related programs that were delivered in parallel without any apparent coordination between those involved.

Sometimes programs designed with the best intentions have actually had perverse results. For example, when in central Australia, we were told about a program to help young petrol sniffers that provided them with certain beneficial inducements to join the program. Sounded logical enough in conventional terms: but because the benefits were not provided to those who were not users, some young people allegedly became users to get on the 'bandwagon'.

The implication is pretty simple. Good policy in this area, as in others, depends on acquiring a good understanding of its likely effects. That generally requires consultation with those affected. In my experience, the culture of most bureaucracies is not conducive to really effective consultation, the kind that involves some serious listening. Indigenous people are often best placed to know what is likely to work and can help governments think 'outside the square'.

Where consultation has been well done, the measures have sometimes been highly innovative and effective. A small example that we first heard of when in Western Australia, is the 'no school, no pool' initiatives that have been implemented in a number of country towns with the involvement of community leaders. This uses the carrot of access to the town's swimming pool to get children to attend school and keep themselves clean — apparently improving both their health and their educational performance (not to mention their swimming skills!). Another locally devised scheme is the Heavy Equipment Management and Training Project (HEMTP) in the Torres Strait Islands. This scheme, operating in partnership with the Queensland Government, provides cost-effective road building and maintenance to Torres Strait communities. The scheme combines formal training and on-the-job experience, creating opportunities for local employment and boosting the communities' self-sufficiency in managing their own assets.

While some programs or services have not been adequately attuned to cultural differences, it has been argued that in some areas culture is being used as a cloak for double standards in service delivery. Education is again one cited example. In all jurisdictions of Australia, attendance at school is compulsory. But there is much anecdotal evidence that truancy is seen as okay for Indigenous kids, perhaps drawing on the reality that cultural or family obligations may require periods away from school. If Indigenous children do not attend school regularly, their ability to rise above disadvantage is fundamentally compromised. This is a serious issue for policy. It is therefore alarming that, as noted, we do not have consistent statistics on school attendance, despite the relative simplicity of collecting them. (The national data we do have — on participation — can actually hide the problem.)

I am not suggesting that the reasons for absenteeism by Indigenous children, or their poor educational performance, are simple or easily remedied by standard procedures. Indeed, I believe that the problems observed in this area are instructive of the need for differentiated approaches and have some wider implications. They are not new insights, but they bear repeating.

One is that equality of opportunity for Indigenous people is unlikely to be achieved merely through equality of treatment. A child with a dysfunctional home life, or who is suffering persistent mental or physical abuse, or who has little familiarity of the English language, cannot be expected to prosper at school (among other things) without extra help. Service delivery cannot be infinitely tailored to individual needs. But it can and should respond to more systemic problems through systemic solutions. Thus in the education field we are beginning to see more schools with Indigenous educators, cultural components in curriculum and even breakfast programs, among other initiatives. But are we doing enough? Casual observation suggests that we are not.

A second implication with wider relevance is that the solutions to poor educational performance do not depend on the actions of education portfolios or institutions alone. Community services, justice administration, health policy, and other government services can all have a bearing on outcomes. Governments are generally not well structured to deal with issues that transcend individual portfolio responsibilities. However, with prompting from some Indigenous leaders, there is now recognition that fragmented 'silo' approaches have not worked and that more coordination is needed. The COAG trials are an important attempt to achieve more coordinated action. It is essential that we learn from and build on this national initiative.

A third general message has perhaps been expressed most forcefully by Noel Pearson, when he observed in a recent speech that, 'man cannot live by service delivery alone'. The ultimate responsibility for ensuring that children are well looked after and attend school lies with their parents. The State cannot do it all, and it may be counterproductive to try.

The broader implication is that the quality of leadership and governance within Indigenous families and communities is likely to be central to overcoming economic and social disadvantage. A new emphasis on these matters in policy discourse is evident, and we are seeing some important initiatives within Indigenous communities. These include, in Cape York and other places, the forging of productive relationships with private industries, to develop opportunities for sustainable wealth creation and reduce reliance on public welfare.

The potentially corrosive effects of public welfare have long been recognised. How to design safety nets that do not undermine incentive and ultimately compound disadvantage represents a challenge that is wider than Indigenous policy. However, as Pearson has observed, in combination with the introduction of award wages in the pastoral industry that perversely cost many thousands of Indigenous people the opportunity to work for a living, 'passive welfare' has played a destructive role within Indigenous communities.

The CDEP program has attempted to address these problems by channelling welfare payments into the provision of work. Marcia Langton has noted that it had its origins in the Northern Territory in the early 1970s, at the suggestion of Indigenous people worried about the emerging social problems associated with their newly won entitlement to 'sit-down money'. As the scheme has evolved, it aims to provide meaningful employment and training for Indigenous people, that would not only have beneficial motivational and social spinoffs, but also increase the prospects of a progression to 'real' jobs.

I do not pretend to be in a position to make informed comment on how well CDEP has met these goals. What I can report is that there is considerable ambivalence and some criticisms within Indigenous communities (as well as by analysts such as Langton) about how the scheme is working in practice. In particular, there is little evidence of it serving as a conduit to mainstream paid employment for Indigenous people. The extent and scale of the scheme, and the significance of the welfare-related problems that it seeks to address, are such as to invite closer scrutiny through an independent public review. It would need to consult widely and go beyond the relatively narrow remit of the Australian National Audit Office's reports, to assess CDEP's rationale and options for improving the scheme or replacing it.

More generally, governments can never be sure exactly how policies or programs will play out or what side-effects they may have. But they can reduce the potential for unexpected outcomes by a careful policy-formulation process that is clear about objectives and that tests thoroughly the pros and cons of different measures, especially with those affected. And they can follow up once policies are in place to ensure that they are having the intended effects. Mechanisms then need to be in place to propagate successes and, equally importantly, terminate failures.

On the evidence of this report, governments have yet to meet these demanding standards in policies towards Indigenous people. However, to end where I began, there are important signs of a new commitment by all governments, based on a new appreciation of how important it is to do better in the interests of both Indigenous people and the wider community. I hope that this report will become a useful resource in this endeavour.

Strong Indigenous organisations show the way*

There is a good news story about Aboriginal and Torres Strait Islander Australians. But if the past is any guide, you may not get to read much about it or see it on television. That is partly because it deals with a pretty dry topic, 'governance'. But also because it does not fit with the image of dysfunctional Indigenous communities and organisations that most Australians have been led to believe is the norm.

It has been my privilege to be on the judging panel for the 'Indigenous Governance Awards' sponsored by BHP-Billiton and Reconciliation Australia. The Productivity Commission's research for COAG on Indigenous disadvantage has convinced me of the crucial importance of good governance, and the value of supporting a venture that seeks to promote it.

This is the third set of Awards and the second with which I have been associated. My experience has been the same on each occasion: I have been bowled over twice! Each time, around 50 Indigenous organisations across diverse areas and functions stepped forward to be assessed. The majority were worthy contenders with important stories to tell. The eight finalists, with which I became more familiar, distinguished themselves as exemplary organisations.

The best among these Indigenous bodies actually outclass most mainstream organisations or enterprises in Australia. They do everything that mainstream organisations should do to reflect good governance principles and practice. They have strong leaders, clear goals, accountable boards and effective administrations. And they have sound policies for making decisions, strategic planning and dealing with disputes. But they have something more: a profound connection with community and a cultural fit that makes the best of them truly remarkable organisations.

During the 2006 Awards, Mick Dodson and I visited WuChopperen Health Service in Cairns, an essential healthcare facility established in 1979 to serve Indigenous people in the region. Since that time it has greatly surpassed its humble beginnings,

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* First published in the *Australian* on 28 August 2008. Gary Banks is on the judging panel for the BHP-Billiton/Reconciliation Australia Indigenous Governance Awards.

providing first-rate services in a first-rate clinical setting. It is an Indigenous-run organisation, with a strong Indigenous presence among its medical and other staff. From our initial meetings with the CEO and Board, to those at the end of the day with an assembled throng of stakeholders and clients, it was clear to us that this innovative, caring organisation was achieving excellence at many levels. What stood out was the passion and commitment to serve the community, allied to the highest professional standards and impressive attention to detail in service delivery. People said they felt ‘at home’, and it was obvious that they did. As one patient put it: ‘They take the time to listen. We have a beautiful gem.’ The judges agreed, awarding WuChopperen first prize.

Another organisation, Murriajabree, at Deception Bay just north of Brisbane, could not be more different. It has only existed for a few years and still occupies a modest house owned by its Chairman, Uncle Allan. It has only a few staff and most are volunteers. In a recent visit with Professor Mick Dodson, and fellow judge Heather Ridout (from AIG), it became clear that this little organisation, whose name means ‘gathering together’, was achieving something very special. Its mission, to meet the social and other needs of a diverse and hitherto fractured community, was pursued not only with (unassuming) professionalism and dedication, but also with a degree of inclusiveness and community involvement well beyond what could be imagined in any organisation as successful in getting things done. This was all encapsulated for me by one person’s heartfelt comment that ‘Murriajabree’s boomerang is bringing us all in’.

I don’t pretend that such organisations have done it easily — on the contrary — or that they will not face challenges in the future. After all, they are seeking to meet a range of objectives in situations far more complex than those faced by most mainstream organisations. Yet, like other organisations, they need adequate resources and the continuing commitment of talented individuals.

What these organisations and others like them have clearly demonstrated, though, is that Indigenous organisations are achieving excellence in governance, providing examples that others can learn from. But for that to happen, the experience of those organisations needs to be accessible and shared. Despite decades of Indigenous policy development, involving a myriad of programs, governments have not done enough to encourage good Indigenous governance. Yet it is the bedrock on which the success of many other actions and policies directed at overcoming disadvantage depend.

Recognition of the importance of good governance is at last gaining momentum, drawing inspiration from the Harvard Project on American Indian Economic Development. Its work is reinforced by the Australian experience that successful institutions generally have much in common, but are also closely attuned to local circumstances and contexts.

It would be gratifying to see this and other Indigenous good news stories actually making the news. I'm not saying that the media should dwell only on the positives and ignore the negatives. But the public needs a realistic picture of both. If we choose to recognise Indigenous success more, we may just see more of it.

Human capital, the universities and microeconomic reform*

Human capital: it is the sort of expression that can glaze the eyes of most people. But for economists, it is a useful way of characterising the productive capacity of an economy's most important resource, its people. We can think in terms of 'stocks' of human capital and about flows, or investment, in human capital — and how these are influenced by institutions and incentives.

Like physical capital, there are many types of human capital. But two broad ones deserve particular attention. These are, firstly, the ability to do things — 'specific' skills — and, secondly, the ability to think about what to do and how — analytical, discovery and communication skills — which we can call 'generic' skills. They're both important, but the second category is becoming increasingly so.

The link to innovation

Human capital is fundamental to the progress of societies and economies over the long term. As the new growth theory has demonstrated formally, knowledge generation and dissemination are inherent (endogenous) to the growth process itself. And human capital drives both the creation and the application of knowledge. In turn, technological change and the rapid obsolescence of specific skills that comes with it, puts a premium on people's receptivity and adaptability to change.

One thing that emerged from the R&D inquiry which the Commission conducted a few years ago, was an increasing recognition of the importance of *tacit* knowledge — knowing how things are done. Codified knowledge, in patents and literature and so on, is of little value without the human spark in applying it.

At the Commission, we also get a close look at the role of human capital in many of the individual firms with which we deal in our various inquiries. It comes through as a key source of competitive advantage in all sorts of ways. To give one example,

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* Edited transcript of a presentation to the Victorian Economic Society Forum on Human Capital, Melbourne, 16 September 1998. Gary Banks was a member of the Higher Education Financing and Policy Review Committee (West Review), which reported in April 1998.

the Industry Commission's TCF report showed that while only one firm in three was involved in technological innovation, those firms accounted for over 80 per cent of that sector's exports. Typically they were also the most conscious of the need for complementary training — human capital investment — within the firm (IC 1997d).

Moreover, firms that do their own R&D generally have a much greater capacity to learn or benefit from the technological advances of others. In other words, to again use economists' jargon, they're better at 'absorbing spillovers' than other firms.

But innovation is not just about R&D. As the Business Council of Australia's (BCA) path-breaking Innovation Study Commission found, the key attribute of successful enterprises is an ability to innovate in *all* its dimensions — management and production systems, marketing and other things — not just through improvements in technology. Moreover, the BCA found that the most innovative enterprises have responded to, or been prompted by, a more open Australian economy with 'a great deal of learning and relearning' and were seized by the need to 'unlock the potential of their workforces'. Few enterprises succeeded without first tapping the goodwill and creativity of their employees (Carnegie et al. 1993).

This, of course, is primarily a management responsibility. Our inward-looking economy, our protected economy, was not conducive to human capital development in that area. We have the legacy of that still — although, in more recent years, we have seen a lot more training, retraining and replacement of managers. (If we wanted an illustration of how important that particular category of human capital is for any company, we can find it in the sharp rise in the share price of BHP when its CEO departed last year.)

Investment in human capital does not just yield benefits to firms and their shareholders; it is obviously also of considerable benefit to the individuals concerned. To the extent that it implies higher productivity, it means higher incomes, more interesting jobs, jobs of choice, and less vulnerability to unemployment. The statistics indicate that university graduates have an unemployment rate that is one-third of that for people who have not been to university, despite a burgeoning in the number of university graduates in recent years. The same applies for higher-skilled over lower-skilled workers.

To cite the TCF sector again, aggregate employment fell by 12 per cent overall during the past decade. But jobs involving formal training declined by only 1 per cent, whereas other jobs declined by 26 per cent.

How are we doing?

So, the right investment in human capital is an investment in higher incomes for Australians generally. How are we doing in this respect? The short answer is that we do not really know. This is not surprising. It is hard enough to measure the physical capital stock, let alone human capital.

There are hopeful proxy indicators such as the rapid rise in post-secondary education and training. The West Report noted that about 90 per cent of today's teenagers will find themselves in some form of post-secondary education, with about half of them in universities and half in vocational education and training (Higher Education Financing and Policy Review Committee 1998). University participation has increased by over 60 per cent in the past decade, and Australia now ranks seventh in the OECD in terms of participation of 17–34 year olds.

At the same time, we still have a situation in which only a little over half of 25–34 year olds have completed secondary school in Australia. That puts us down at about 19th in the OECD pecking order. This is an important issue not only economically, but also politically and socially. Apart from the other benefits, the ability of an electorate to resist simplistic political nostrums and to be a bit more discerning, is directly related to its level of education. In rural and remote areas, where One Nation has received most support, less than 40 per cent of the community has finished secondary school.

So participation in education is important, but so too is the *quality* of education and training actually received. Data on educational outcomes, or performance, are very poor in Australia. This remains a major gap in what otherwise has been a very successful COAG process of cooperation between the Commonwealth and the states in generating information by which to compare government service provision across different jurisdictions.

We do have data on government expenditure per student, however. Some of this raises questions about the cost effectiveness of public spending on education. For example, the Northern Territory and the ACT both spend substantially more per student than the states. But the Northern Territory has the smallest class sizes in Australia (and a large Indigenous study body) whereas the ACT has the largest.

Simply investing more public money in the education sector will not optimise the benefits from human capital development. We need the right *kinds* of investment and the right *utilisation* of human capital in the workplace. The framework that determines incentives to learn, to teach well, and to employ and use people in productive ways, is the critical thing.

Reforming higher education

This naturally brings me to the role of microeconomic reform. As the Commission noted in its *Stocktake of Microeconomic Reform* report, making the best use of Australia's human potential is fundamental to ensuring progress in a rapidly changing world (IC 1996e). It is a huge agenda, but there are two aspects in particular that are important. One relates to our education and training institutions; the second to our workplaces, and the regulatory and institutional environment in which they operate.

I think it should be obvious from my earlier remarks, that I see universities playing an increasingly important role in Australia's human capital development because of their role in building generic skills and attitudes. Critical thought and openness to new ideas are important ingredients in achieving a flexible and innovative economy in a changing world. They also provide the base for building more specific (but ever-changing) skills. This suggests an important complementary role for VET in relation to higher education. Many more people who complete a degree are availing themselves of the VET system, as well as the other way around. Clearly what we need is a responsive and diverse educational system in which that kind of movement is logical and productive.

What strikes an economist is the lack of use, or even misuse, of the market in our higher education system. There have been some changes — indeed for some, too many changes — but we still have the legacy of a centrally controlled system designed for a small elite in a relatively stable world. A system which is ill-suited to mass participation in an economy and society with diverse and rapidly changing needs.

This new world that we live in is very hard to optimise from the centre. Information requirements are extreme, involving allocation decisions among different universities, among different courses, and among large numbers of students with different capacities and needs. In the rest of the economy, it is the role of the market to sort all that out. Why not in higher education? The West Review concluded that higher education was too important *not* to make better use of market mechanisms. This was based on a pragmatic judgment about the pressures and challenges of the next 10 to 20 years, rather than any ideological position.

However, we certainly did not recommend an 'open slather' approach. As in other areas of policy with important social dimensions, the challenge is to make the most effective use of market forces in order to meet all of our objectives as a society, including both efficiency and equity.

For a start, we supported substantial public funding. That is despite the fact there remain major questions about the nature and extent of the societal 'spillovers', taking a purely economic perspective, and of the inducement effects of public funding. The pragmatic judgment of the West Review was that it was better to err on the upside, rather than risk *under*funding in this important area.

The second thing we strongly advocated was a direct financial relationship between universities and students, which we called 'student-centred funding' — and the newspapers simply called vouchers! Primarily the intention was to get the universities more focused on satisfying those who in any case are already paying significantly for their education through HECS fees, and who constitute the main source of external benefits that justify public funding in the first place.

We did not share the views of those who are concerned about the ability of students to be sufficiently discriminating or that they will be out-gunned informationally by the education establishment. Students showed themselves, in our discussions with them, to be discerning about what was in their interests and that of their prospective employers. We did recommend, however, regulated provision of information, as well as the establishment of complaints mechanisms to provide formal protection to students.

Thirdly, we argued for universities to be able to set prices that can reflect choices about the type and cost of courses that they offer. And that allow greater latitude in the remuneration of teaching staff. This provides the only viable mechanism in a future of continuing budgetary parsimony — to use Bruce Chapman's words — if we are to stem the otherwise inevitable brain drain. There aren't all that many choices: if we need to pay people more money to ensure quality, the money has to come from somewhere.

However, we also argued for transitional limits to such price freedoms and strongly endorsed the maintenance of a HECS-type approach, with no requirement for upfront payment of any fees.

We argued that this kind of approach — more market-based, but complemented by good regulation — would achieve a more diverse, innovative and accessible system.

Accessibility became an article of faith within the West Review very early on — almost to the point where I had to ask whether we were going to *force* everybody to go to university. I still harbour some uncertainties as to whether a university education is for everyone. I think the VET system has a valuable, separate contribution to make, which is more suited to many people. But that's against my general point that increasingly over time what universities have to offer is going to be needed by many more people.

Accessibility is not an issue confined to the design and funding of the higher education system alone. The under-representation of students from lower socioeconomic, Indigenous or remote region groups, is reflected very much in the point I made earlier about the low completion levels for secondary school in those areas.

There's a big issue here of the respective roles of universities and the TAFE colleges. The long term vision reflected in the West Report was of a seamless funding system in which students could move between the two areas, bringing the same source of public funding with them. VET obviously has to be directly responsive to the needs of firms, but it is questionable how directly responsive the universities should be.

A learning workplace?

This brings me to the second aspect bearing on the payoff from human capital: namely, skill development and utilisation within the workplace.

A learning organisation requires a culture of involvement and common cause from management down. Organisational culture and attitudes are greatly influenced by the market environment and by industrial relations regulation. The Commission has gained useful insights from studies that we have conducted recently at the request of the Government, looking at work arrangements in coal, stevedoring and, meat processing. We found in those areas that both the market environment and workplace regulation had constrained and distorted the development and use of human capital, and in turn had detracted from productivity at the enterprise and industry levels.

For example, we heard in the coal industry inquiry that there was a lack of effective management training and people skills, and it was easy to see why. State regulation had long prescribed the qualification and training required at all levels in a highly detailed way (PC 1998a). In stevedoring, we had a set of work arrangements with curious titles, such as 'the order of pick' and 'equalisation' of earnings, which essentially removed managerial discretion in allocating workers to particular tasks. It was hard to believe that these sort of work practices, which people in the industry spoke of as the norm, actually existed. It was not surprising, therefore, that there was little emphasis on training or, as in the case of coal, that industry had a very poor OH&S record (PC 1998c).

In the meat processing industry, the 'tally system', as prescribed in awards, was also very heavily pre-emptive of the management function (PC 1998d). Of course some managers said that they liked that kind of system. The sort of managers who grew up under a system that did not require much management expertise, would obviously have an inclination to stay with such a system.

In each of those three areas, we observed very poor workplace cultures: the antithesis of what the BCA, in that report I spoke of earlier, saw as the essential precondition for innovative and successful firms. In each case, we found strong unions — with almost comprehensive coverage of the workforce — weak management, and muted product competition. In fact, in all three, there was an emphasis on volume over production cost.

Summing up

In sum, human capital is clearly fundamental to economic progress. Its connection with innovation at all levels within firms, and more broadly, is especially important, and even more so in the rapidly changing world in which we live today. Generic skills and the role of universities are looming larger in this situation, with a VET system responsive to the changing specific skill needs of industry playing a complementary role.

In a complex, diverse and rapidly changing world, we need to enable more decisions about human capital investment and its use to be made by those directly involved. Flexibility and responsiveness are required both in our education institutions and in our workplaces. Policy has been heading in that direction — but not always as effectively as it might. In a highly competitive economy, which is increasingly global in its reach, we need to do better; and I think that challenge has never been greater than it is right now.

The Productivity Commission's gambling inquiry: three years on *

It is almost three years to the day since the Productivity Commission delivered to Government its final report on Australia's gambling industries (PC 1999a). In releasing the report, and issuing his Government's initial response, the Prime Minister observed:

> The Productivity Commission report is the first comprehensive investigation of gambling in Australia and it is the first time we have had a complete picture not only of the economics and regulatory structure of the gambling industries, but also of the social consequences of the recent rapid expansion of gambling in this country. (Howard 1999)

The 1000 page report was the culmination of an independent public inquiry that lasted some 16 months and attracted 320 submissions. It involved a draft report, two rounds of public hearings across all states and territories, six roundtables with interest groups and experts, and 60 meetings 'on location' with governments, the industry, community groups and individuals. The analysis in the report also drew on an extensive literature, both in Australia and overseas, supplemented by three national surveys and other original research by the Commission itself.

The report's essential message was that liberalisation of the gambling industries had generated major social costs as well as benefits. It also found that the social impacts, related to 'problem gambling', had not been adequately addressed, either in policy formulation or industry regulation.

The report evoked a variety of reactions, ranging from laudatory to hostile. There was support for, or at least acceptance of, the report by governments at all levels. And non-government organisations praised it. But the industry's reaction was mixed. Some, although critical of aspects of the report, responded constructively. Others were vehemently opposed to the report and its findings.

Since then, there has been a flurry of activity directed at ameliorating problem gambling. The Australian Government initiated a Ministerial Council on Gambling

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* Keynote address to the National Association for Gambling Studies 12th Annual Conference, Melbourne, 21 November 2002. This speech benefitted from research inputs by Monika Binder and Ross Wilson.

and introduced legislation banning interactive gambling. Most state and territory governments introduced or proposed new ‘responsible gambling’ policies. And those in the industry who were initially hostile to the Commission’s report, began introducing their own responsible gambling measures. Indeed, the Commission’s report is increasingly being invoked as an authoritative source to support the industry’s position on gambling issues, including problem gambling.

How many ‘problem gamblers’?

Perhaps the most startling finding, for many people, was the Commission’s estimate that nearly 300,000 Australian adults had significant problems with their gambling, with 130,000 experiencing severe problems.

These findings should not have come as a surprise, as they were consistent with a number of other studies. However, the extent of problem gambling had tended to be downplayed, by referring merely to their 1 to 2 per cent share of the total population. This is sometimes also misconstrued as 1 to 2 per cent of gamblers. However, as the Commission found from its survey, the proportion of *regular* gamblers experiencing significant problems Australia-wide was more like 15 per cent. And, because problem gamblers spend a lot more time and money at it than other (‘recreational’) gamblers, their prevalence in a gambling venue at any time would normally be higher again. Indeed, the Commission estimated (again consistently with some earlier studies) that problem gamblers accounted for around one-third of the industry’s total revenue.

While there have been no other national surveys conducted since then, there have been a few done at the state or regional level. However, most have made significant modifications to the screening instrument, rendering comparison difficult.

The Queensland Government conducted a large sample survey in that state this year, using a recently developed screen from Canada: the Canadian Problem Gambling Index (CPGI). Like the Commission’s own approach, the CPGI is based on the notion of a problem gambling ‘continuum’, rather than a simple yes or no categorisation. While the Queensland research found that only 0.83 per cent of adults scored above a defined problem gambling threshold, it estimated that another 2.7 per cent were in a ‘moderate risk’ group.

The search for an ‘ideal’ screening instrument is worthwhile, but we should not allow it to become a distraction. What does seem important is to apply a given test, around which there is reasonable professional agreement, consistently across jurisdictions and over time. Otherwise there is a danger of creating more confusion than clarity about the extent of problem gambling and, importantly, whether it is actually responding to remedial measures.

Whether the actual *number* of problem gamblers, equates to 1, 2 or 3 per cent of the population, we are still talking about hundreds of thousands of Australians, and several hundred thousand more who are directly affected by their affliction. The precise number is a nicety, with little bearing on the need for effective policy action.

Anyone obsessed with decimal points should also bear in mind that *all* survey screens are likely to understate the extent of problem gambling — however they may choose to define it — simply because people have a natural reluctance to reveal the facts about such matters. That is why the estimate of gambling expenditure from the Household Expenditure Survey is one-quarter of the actual amount based on industry statistics — rendering that instrument of little use for analysis of gambling patterns or problems. The Commission asked 400 self-confessed problem gamblers in counselling how they would have responded to a survey prior to them actually seeking help. Only 29 per cent said they would have answered honestly; one-third said that they would have concealed their problems, and some 24 per cent said they would have refused even to answer the survey!

With this in mind, arguably the biggest practical challenge confronting prevalence studies is not the precise screening instrument, but rather the extent to which the design and presentation of the questionnaire can counter this inherent downward bias. The extent to which that happens in practice will hinge partly on the motives and interest of the survey sponsor, and on the skill and persistence of the interviewer.

Cost and benefits of liberalising gambling

A novel feature of the Commission's study was its attempt to quantify the (social) costs of gambling as well as the benefits. This was seen as necessary to counter the natural tendency to ignore what cannot be valued.

The real benefits are to consumers

A second source of novelty was the Commission's approach to measuring the benefits of the gambling industries. Typically, these had been seen as deriving primarily from the jobs and income associated with the industry. The Commission showed that this was a 'furphy'. Unleashing a previously constrained activity like gambling does not in practice create many new jobs. What it does do is enable people to spend more on gambling and less on other things. (The vocal complaints of retailers whenever new gambling operations set up in their vicinity bear testimony to this at work.) But that also means that the jobs and income created in the gambling industry have a counterpart in jobs and income destroyed in other parts of the economy. Except in depressed areas where unemployment is very high, the gambling industry's new jobs will be some other industry's existing jobs.

The real benefits from the deregulation of gambling come from people having increased access to something they like doing (better than some other things) and at a price lower than they would ultimately be prepared to pay. This 'consumer surplus' — while not without conceptual limitations — can be estimated, and it turned out to be sizeable, amounting to billions of dollars.

The industry, while puzzled and upset at the Commission's dismissal of the production-side gains from its expansion, was gratified at the discovery that there were quantifiable benefits on the *consumption* side, which had not previously been estimated. (Some members of community groups and the press, however, were not so sure.)

But where the Commission again parted company with the industry — or at least some of its consultants — was in not treating the consumption gains equally for recreational and problem gamblers, discounting them for the latter group to a level that corresponds to more normal expenditure. The fact that many problem gamblers report an inability to control their gambling, despite a desire to do so, and resort to self-exclusion and other devices to constrain themselves, provides strong support for this approach.

Social costs need to be accounted for

When it came to the *costs* of gambling, the Commission recognised that the psychic or emotional impacts on problem gamblers and their families — such as through family break-up and depression — are valid societal costs for which a value should also be assigned. That is not straightforward, of course, and it was necessary to use proxy measures and provide low and high estimates. Even then we erred on the conservative side (not attempting, for example, to place a value on the social cost of the 35 to 60 suicides attributed annually to problem gambling). As with the benefits, the costs turned out to be substantial.

The upshot was our estimate that the net impact on society of the liberalisation of gambling could be anywhere from a net loss of $1.2 billion to a net benefit of up to $4.3 billion. There were found to be significant differences by gambling mode, however, with lotteries showing a clear net benefit, whereas gaming machines and wagering included the prospect of a net loss. The reason for this is the much higher incidence of problem gambling for these modes.

The Commission's methodology has been broadly endorsed by most (though not all) of those professional economists who have acquainted themselves with it. And, since the inquiry, there have been a number of studies on the regional impact of poker machines that have drawn on the Commission's approach.

However, some industry-sponsored studies have changed key aspects of the model to derive a lower social cost estimate. This illustrates a theme to which I will return: namely the importance of securing arrangements for independent research in this complex and highly contentious area of public policy. Otherwise we will end up with a lot of research that is mainly directed at satisfying the needs of its sponsor. (This has already become a major problem in the United States, where the 'pedigree' of a piece of gambling research has become the surest guide to its findings, and the public debate is the poorer for it.)

Gambling regulations were inadequate

The Commission recognised that its quantification exercise could only produce 'ballpark' estimates that would be of limited usefulness for policy. What the exercise did make clear, however, was that the social costs as well as the benefits of gambling were likely to be substantial. This affirmed the need for considerable care in regulating the conditions of access to gambling. It also supported the Commission's general principle that regulation should be directed at effectively limiting the costs of problem gambling, without unduly impacting on the benefits of recreational gamblers.

In practice, regulatory processes and measures in all jurisdictions were found to fall well short of that ideal. The Commission observed an 'incoherent' regulatory environment, one characterised by complexity, fragmentation and inconsistency. Regulation was found to be driven mainly by revenue-raising and probity considerations, rather than the more fundamental objectives of consumer protection and amelioration of social costs.

Deregulation had greatly expanded the availability of legal gambling — particularly gaming machines — to an extent unprecedented in the western world. But there had been little attempt to ensure that people could be adequately informed about the price and nature of the product, its risks to their wellbeing, or sources of assistance. On the contrary, advertising and promotion typically spread the message that '*everyone* can be a winner!' There was also little attention to issues such as the access of problem gamblers to cash and credit on gambling premises, or to containing potentially hazardous features of machine design (such as spending rates or bill acceptors). Moreover, mechanisms to enable problem gamblers to exclude themselves from venues were limited (or poorly implemented) and the scope to provide gamblers with pre-commitment options to limit their losses had hardly been considered (other than for the emerging Internet gambling industry).

This was a pretty tough report card; however, most governments took it on the chin. From the outset of the inquiry they began to modify aspects of their regulatory frameworks to address a number of its deficiencies. (In some cases, they conducted their own supplementary reviews to facilitate this, and to provide for some differentiation in response.)

The gambling industry itself began to appreciate that its initial state of denial was not sustainable and, through the newly formed Australian Gaming Council (AGC), developed more pro-active strategies to address the social costs associated with its activities.

A recent tapering in 'expenditure' growth

In the decade before the Commission's inquiry, expenditure on gambling ('losses' in common parlance) more than doubled in real terms, rising from 2 to 3 per cent of household disposable income, or an average of around $800 for each adult in this country.

Most of this came from liberalisation of gaming machines, the number of which more than trebled, reaching some 185 000. (As the industry itself first noted, and detailed Commission research confirmed, this was about one-fifth of the number of *comparable* machines in the world at that time — and five times as many per person as in the United States). The *accessibility* of gaming machines also increased greatly, as they spread from their original stronghold in New South Wales clubs, to include pubs and clubs across all states and territories except Western Australia.

Since 1997-98, gambling expenditure has continued to rise, but its growth has slowed discernibly, largely reflecting a slowdown in gaming machine expenditure.

At face value, this might suggest that initiatives to moderate problem gambling have had some success. However, the fact that the slowdown or decline has not been consistent across jurisdictions complicates matters and — assuming that the differences cannot be attributed simply to differences in the measures taken — raises the possibility of other explanations.

A plausible explanation of the different expenditure trends across jurisdictions is that they simply reflect the maturation (or emerging saturation) of the gaming machine market. The typical market growth pattern for any new good or service is one of relatively rapidly rising expenditure initially, while consumers 'come on board', followed in time by a slowing and then levelling out of expenditure (or proportionate expenditure) as demand becomes satisfied. The fact that the gambling market contains a special group of compulsive consumers, whose wants do not conform to the normal pattern, needs of course to be taken into account. However, there is a limit to the spending of even problem gamblers (as their frequent resort to theft and larceny illustrates) and over time many will become ‘cured’ and leave the pool.

Thus, we observe that the tapering of expenditure is most pronounced in New South Wales and the Australian Capital Territory, which have had access to gaming machines for longer, and it is generally also more pronounced in those jurisdictions where household spending on gambling is highest.

That the tapering of total gambling (and gaming machine) expenditure — or industry income — reflects maturing markets, particularly in the larger states, may find some additional support in stock market trends. Gambling stocks have outperformed other stocks on average for much of the past three years, suggesting that the industry’s prospects have continued to look relatively good to investors. However, if we look more closely at individual gaming stocks, it is clear that the gambling enterprises in New South Wales and Victoria have recently done less well than in Queensland.

The gaming machine share of total expenditure on gambling has risen further to 57 per cent in 2000-01 from 52 per cent in 1997-98 (and only 34 per cent in 1991-92). This is relevant to the broader question of what expenditure trends may mean about the costs of problem gambling, as the social costs loom larger for this mode than for, say, lotteries, which has experienced a reduction in its share of gamblers’ spending.

Developments in regulation

In its report, the Commission identified a variety of harm-minimisation or consumer-protection measures which could be taken, rating them against the principle that they needed to target sources of social cost without detracting unduly from the undoubted consumer benefits to be derived from gambling. In that way, the benefits of action were likely to exceed the costs, although there are also compliance costs to consider (which can be significant in some cases).

Apart from the important area of counselling for those problem gamblers who seek it, there are three broad categories of measures that we identified (table 1). Two of these — relating to what might be called ‘informed choice’ and ‘consumer control’ — are essentially about empowering *all* consumers, including problem gamblers, to make informed and deliberate choices. They are therefore likely to satisfy our guiding regulatory principle, providing win-win outcomes for all gamblers.

The third category involves constraints that would potentially benefit problem gamblers, but could also detract from the enjoyment of recreational gamblers. Such measures were therefore seen as requiring more careful assessment of their costs and benefits. Nevertheless, we considered that, at face value, restricting venue-based access to additional money, and limitations on spending rates, looked promising.

Since then, actions have been taken by both industry and government in many of these areas.

Table 1 **Potential harm-minimisation and prevention measures**

Informed choice	*Consumer control*	*Venue/games restrictions*
• Meaningful 'price' and odds information • Expenditure statements • Warnings • Help service information • Ethical promotion • How games work	• Self exclusion • Pre-commitment – spending – duration	• ATMS – location – withdrawal limits • Credit restrictions • Bill acceptor limits • Cheque payouts • Spending rates • Enforced breaks • Machine caps • Opening hours • Advertising restrictions • Lighting, sounds and clocks

Industry 'self-regulation' initiatives

According to a recent report prepared for the AGC, some 30 voluntary codes of practice have been developed relating to gaming alone. Among the more significant of these are the AGC's own Responsible Gambling Code, the New South Wales Clubs' Clubsafe 2000, the Victorian Gaming Machine Industry Code of Practice and, most recently, Queensland's Responsible Gambling Code of Practice.

However, it is apparent that the most commonly applicable measures tend to be the 'softer' or more discretionary variety, like provision of information or warnings. Moreover, none of the codes contain processes for independent monitoring of their implementation or the collection of independent evidence of compliance rates, and few contained processes for periodic independent review and evaluation.

This is a significant deficiency, because as the Commission emphasised in its report, the danger of relying on such voluntary codes of behaviour is that venue operators face an inherent conflict of interest in dealing with problem gambling, given the extent to which their earnings depend on the disproportionate spending of problem gamblers. Indeed, they have a strong financial incentive to do as little as they can get away with. This is not to denigrate them. It is entirely understandable and logical.

Self-regulation works best when there are either inherent incentives to comply or external disciplines that create such incentives. The first condition clearly does not hold and, as recent test cases relating to a common law duty of care illustrate, there are currently weak external disciplines that could be brought to bear without explicit regulation.

Developments in government regulation

Informed choice

In the area of providing for more informed choice, most jurisdictions have introduced some key measures.

- Several governments now require venues to provide information to enable a reasonable understanding of the odds and to address false perceptions of how games work. Redressing such misconceptions, which experts see as contributing to problem gambling, is not straightforward and should desirably involve trials.
- Most governments have now introduced requirements for warnings about the dangers of excessive gambling, and information about the signs of an emerging problem, as well as of sources of advice and assistance.
- There are now also regulatory requirements in most jurisdictions relating to advertising and promotions.
- A requirement to provide gamblers participating in loyalty schemes with statements of their expenditure (losses) has been introduced in Victoria and New South Wales.

Consumer control

In the second category — giving problem gamblers options for self-imposed constraints on their spending — there has been a considerable extension and improvement of self-exclusion provisions. So far there is little provision for self-exclusion to be readily extended *across* venues: an important requirement for full effectiveness.

Self-exclusion is an important option for problem gamblers, but going ‘cold turkey’ is an extreme measure, and possibly unsustainable for many. The Commission saw a need to explore options to enable a gambler to continue gambling, but to set self-imposed limits on his or her losses prior to commencing gambling, when good intentions are more likely to prevail. At the time, such pre-commitment mechanisms were only being developed for Internet gambling

Venue and games restrictions

With respect to the third category of measures — imposed ‘constraints’ — there has been considerable regulatory activity, although the cost-effectiveness of measures has not always been tested prior to their implementation.

A number of the measures which seemed less promising to the Commission — such as light and clock requirements, and (minor) modifications to venue operating hours — were generally among the first to be introduced. They have populist appeal, but their potential effectiveness has not been demonstrated

Most governments have introduced, or will soon introduce, constraints on access to cash in venues (such as ATM withdrawal limits) and prohibitions on credit or cheque cashing, as well as requirements for ATMs to be located away from gaming areas. The Commission’s survey provided some compelling support for action on ATMs. Only 5 per cent of recreational gamblers reported using ATMs ‘often’, whereas this was the reported experience for 60 per cent of (severe) problem gamblers.

Gaming machine ‘caps’ are widespread

The most common imposed constraint on the gambling industry, pre-dating the Commission’s inquiry, are caps on the number of machines permitted in different jurisdictions. Since the inquiry, most states and territories have introduced various changes to caps on gaming machine numbers or ‘frozen’ existing caps pending review.

The Commission was at best ambivalent about caps as a harm-minimisation mechanism for two reasons. One is that, if binding, they impact on the accessibility of services to recreational gamblers. The second is that their effectiveness in limiting the extent of problem gambling is unclear, depending on the size and reach of the cap. (What is effectively a zero cap in Western Australia, for example, will produce quite different results to Victoria's cap of 27 500 machines.)

One obvious problem in constraining supply is that it can place upward pressure on the 'price' of gambling (compounding problem gamblers' spending difficulties). Another is that it provides strong incentives on both the demand and supply sides for the more intensive use of available machines. Thus Victoria, with one-third the machines in New South Wales, has spending rates per machine that are twice as high — and expenditure per head is three-quarters that of New South Wales.

With geographic caps, there will be a tendency for machines to migrate to those locations and venues where they can be used most profitably. A common complaint by hotel owners in Victoria during our inquiry was that the duopolists who 'own' the machines would generally remove them from any venue that was not getting enough out of them. This can obviously exacerbate incentives for venue owners to ignore the welfare of problem gamblers.

Regulatory and policy-making processes

The Commission's review of the processes by which gambling regulation had come about (or not come about), and the regulatory structures for overseeing the industry, demonstrated why the regulatory frameworks were so deficient. Decision making was generally poorly informed about the social impacts, ad hoc and piecemeal, with poorly specified or conflicting objectives and no systematic monitoring and evaluation of outcomes. Regulatory oversight was compromised by potentially incompatible objectives, lack of clarity in reporting responsibilities, conflicts of interest and lack of transparency.

Drawing on basic principles of good government, as well as international precedent, the Commission laid out the sort of institutional framework that it believed was necessary to remedy these shortcomings — clearly separating policy making from regulatory functions, as well as providing independent mechanisms for the research needed to inform government policy.

Since then, most jurisdictions have introduced worthwhile improvements — such as the introduction of consumer-protection objectives, requirements to consider the economic and social impacts of licensing applications and greater transparency and public consultation.

But the core requirement of a truly independent regulator is still proving elusive. Moreover, in all jurisdictions, policy and regulatory responsibility currently lie either with a separate industry portfolio or with Treasury and Finance. Neither arrangement is ideal, as the first is vulnerable to industry capture and the second is vulnerable to what might be called *budgetary* capture. The mooted re-location of portfolio responsibilities in Victoria from the Department of Treasury and Finance to the Department of Justice is a significant initiative, warranting serious consideration by other jurisdictions.

One possible spinoff from introducing a more 'neutral' policy and regulatory setting in each jurisdiction — apart from getting better decisions and regulatory outcomes — might be more effective coordination or cooperation among jurisdictions. While different policy approaches and regulatory 'experiments' provide desirable learning opportunities in a federal system, divergent approaches to research and information gathering do not, and this has been compounded by lack of transparency. The current balkanized approach to research is wasteful of scarce resources and missing important opportunities to apply common methodologies to explore common issues of concern (such as the effectiveness of harm-minimisation measures and treatment techniques).

In its report, the Commission favoured the establishment of a national research institute to be block funded by all governments. Apart from the useful national perspective that it could bring, it could be a key source of advice untainted by the real or perceived tensions that arise with research sponsored by special interests (whether industry, community or political).

Some priorities

Three years on from the Commission's inquiry it is apparent that significant progress has been made. Recognition that there *is* a problem is perhaps the most important change, together with acceptance by governments and industry that existing policies and practices were inadequate to deal with it. The many regulatory and self-regulatory initiatives since the inquiry began are impressive in their breadth and coverage of the industry, with some useful innovations occurring in harm-minimisation measures.

However, measured against the ultimate policy objective of maximising the net contribution of this industry, by reducing its social impacts without detracting unduly from its benefits, a number of gaps and deficiencies still stand out.

First, there is a burning need for more research on what actually works among the many possible harm-minimisation measures. (This is particularly important for those measures that can involve significant compliance and other costs.) If we are serious about doing things that are effective, rather than just being seen to be doing things, trialing and testing of different approaches is critical.

A *second* and related issue is the need for more follow-up analysis on what forms of remedial treatment (counselling) work best. Significant resources are being directed at help services, but there has been little 'performance auditing' of programs or detailed analysis of outcomes over time that I am aware of.

This leads me to my *third* priority: the need for much greater transparency about what research is being done and, more importantly, what results are emerging. Lack of transparency can encourage suspicions that only 'convenient' research sees the light of day.

My *fourth* priority, therefore, is the need for governments to establish arrangements designed to promote independent research and *fifth*, much greater coordination in data collection and research methodologies across jurisdictions. A jointly-funded national research centre could be an important focus for this. Current arrangements under the Ministerial Council are in the right direction, but in my view do not go far enough.

Sixth, there is a need to have effective arrangements in place to monitor and enforce industry compliance, whether with government regulations or self-regulation. Penalties on venues that do not meet required standards of harm minimisation need to be enforced as readily as those that neglect matters of probity.

This brings me to the *last* and, in my view, *highest* priority: the need to reform policy making and regulatory governance arrangements. Ensuring the substantive independence of the core regulator in each jurisdiction is central to this. It has demanding requirements, which the Commission spelt out in its report. In most jurisdictions those requirements have not yet been met.

PART 4

THE ROLE OF INSTITUTIONS AND PROCESSES

Policy-making and, especially, structural reform confront many technical complexities and political obstacles. Successful outcomes depend on a government's capacity to marshal good information and advice, and on the public's understanding of what is at stake in different policy choices. These speeches focus on the issues surrounding 'evidence-based policy making' and the role played by the Productivity Commission.

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

Evidence-based policy making: What is it? How do we get it?*

The American humorist, P.J. O'Rourke once said, 'the mystery of Government is not how it works, but how to make it stop'. In an earlier century, Otto von Bismarck is famously reported to have said 'Laws are like sausages: it's better not to see them being made'.

Those witty observations have become enduring aphorisms for a reason. They reflect a rather cynical and widespread view of long-standing about the operations of government. Also, let's face it, within government itself, many of us today find ourselves laughing knowingly at the antics of *The Hollow Men*, just as we did with *Yes Minister*; and perhaps also cringing in recognition at how a carefully crafted policy proposal can be so easily subverted, or a dubious policy can triumph with little real evidence or analysis to command it.

The idea for *The Hollow Men* was apparently conceived, and the first few episodes developed, under the previous Government. That said, a change of government did not seem to reduce the program's appeal, nor its ratings. No doubt that is because it contains some universal realities of political life — notwithstanding which party happens to be in power. And, indeed, notwithstanding the greater emphasis placed by the current Government on evidence-based policy making, as reflected in a variety of reviews and in new processes and structures within the Commonwealth and COAG.

Thus we have seen considerable public debate about the basis for a range of recent policy initiatives. These include: the 'alcopops' tax; the change in threshold for the private insurance surcharge; the linkage of indigenous welfare payments to school attendance; fuel watch; grocery watch; and the Green Car Innovation Fund. There was similar public debate under the previous Government about the basis for such initiatives as the Alice-to-Darwin rail link; the Australia-US Free Trade Agreement;

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the Baby Bonus; the banning of filament light bulbs; Work Choices and the National Water Initiative, among others.

Moreover, where public reviews informed such initiatives, they have themselves been subjected to considerable criticism — in relation to their makeup, their processes and the quality of their analysis.

This too is obviously not a new phenomenon, but it illustrates the challenges of properly implementing an evidence-based approach to public policy — and of being *seen* to have done so, which can be crucial to community acceptance of consequent policy decisions.

Advancing further reforms will be challenging

It is as important that we have a rigorous, evidence-based approach to public policy in Australia today as at any time in our history.

Australia faces major long-term challenges; challenges that have only been exacerbated by the economic turbulence that we are struggling to deal with right now. When the present crisis is over, we will still have the ongoing challenges of greenhouse, the ageing of our population and continuing international competitive pressures. We should not underestimate the significance of those challenges, which place a premium on enhancing the efficiency and productivity of our economy.

The good news, as you would also be aware, is that there is plenty of scope for improvement. The bad news is that there are few ‘easy’ reforms left. A lot of low-hanging fruit has now been largely harvested. Even in the competition area, rather than further deregulation, we are confronting the need for regulatory refinements that are quite subtle and complex to assess. In the new agenda to do with enhancing human capital, complexities abound. We do not know all the answers to the policy drivers of better health and educational outcomes, for example, let alone to the pressing goal of reducing indigenous disadvantage.

These are all long-term issues. They also have an interjurisdictional dimension, bringing with it the challenge of finding national solutions to problems that have been dealt with by individual states and territories in the past. This has ‘upped the ante’ on having good analysis and good processes to help avoid making mistakes on a national scale that previously would have been confined to particular jurisdictions.

In an address to senior public servants in April 2008, the Prime Minister observed that, ‘evidence-based policy making is at the heart of being a reformist government’ (Rudd 2008). I want to explore why that is profoundly true; what it means in practice; and some implications for those of us in public administration. In doing so, I will draw on the experience of the Productivity Commission — which with its predecessors has been at the heart of evidence-based policy making in Australia for over three decades (Banks and Carmichael 2007; PC 2003c) — to distil some insights into what is needed across government generally if we are to be successful.

Why we need an evidence-based approach

I don't think I should have to convince anyone of the value of an evidence-based approach to public policy. After all, it is not a novel concept. Its absence in practice, however, has been long lamented. Over a century ago, for example, Florence Nightingale admonished the English Parliament in the following terms (Pearson 1924):

> You change your laws and your administering of them so fast, and without inquiry after results past or present, that it is all experiment, seesaw, doctrinaire; a shuttlecock between battledores.

The term 'evidence-based policy making' has been most recently popularised by the Blair Government, which was elected on a platform of 'what matters is what works'. Blair spoke of ending ideologically-based decision making and 'questioning inherited ways of doing things' (Modernising Government 1999). The advent of a new government is clearly a good time to initiate an evidence-based approach to public policy, especially after a decade or more of previous one's rule. I think that resonates too with the take-up in Australia of these 'New Labour' ideas from the United Kingdom, commencing with the Bracks Government in Victoria.

But evidence-based policy making is by no means new to this country. Probably the oldest example, or longest-standing one, is tariff-making, which for many years was required under legislation to be informed by a public report produced by the Tariff Board and subsequently the Industries Assistance Commission. The nature of those evidence-based reports changed dramatically over time, however, from merely reporting the impacts on industries under review to also reporting the effects on other industries and the wider economy.

Other key economic policy reforms that have drawn heavily on evidence-based reviews or evaluations include the exchange rate and financial market liberalisation of the 1980s, the National Competition Policy reforms of the 1990s and the shift to inflation targeting in monetary policy in 1993. Examples from the social policy arena include the Higher Education Contribution Scheme in its initial configuration, and the introduction of lifetime community rating provisions in private health insurance regulation.

The tariff story illustrates the crucial point that the contribution of an evidence-based approach depends on its context, and the objectives to which it is directed. Evidence that is directed at supporting narrow objectives — a particular group or sector, or fostering use of a particular product or technology — will generally look quite different to that which has as its objective the interests of the wider community. Of course, this depends on having the analytical tools to enable such a broad assessment to be undertaken.

Policy decisions will nearly always be influenced by much more than objective evidence, or rational analysis. Values, interests, personalities, timing, circumstance and happenstance — in short, democracy — determine what actually happens. But evidence and analysis can nevertheless play a useful, even decisive, role in informing policy makers' judgements. Importantly, they can also condition the political environment in which those judgements need to be made.

Most policies are experiments

Without evidence, policy makers must fall back on intuition, prejudice, or conventional wisdom — or, at best, theory alone. And many policy decisions have indeed been made in those ways. But the resulting policies can go seriously astray, given the complexities and interdependencies in our society and economy, and the unpredictability of people's reactions to change.

From the many examples that I could give, a few from recent Productivity Commission reviews come readily to mind:

- Our report into road and rail infrastructure pricing showed that the presumption that road use was systematically subsidised relative to rail was not borne out by the facts (facts that were quite difficult to discern) (PC 2006e).
- Our inquiry into state assistance to industry showed that the bidding wars for investment and major events the state governments engaged in generally constituted not only a negative sum game nationally, but in many cases a zero sum game for the winning state (Banks 2002).
- Our recent report on parental leave indicated that binary views in relation to whether childcare was a good or a bad thing were both wrong, depending on which age group you were looking at, and that there were many subtle influences involved (PC 2009c).

To take a separate example from the education field — which is rightly at the centre stage in COAG's National Reform Agenda — the long-term policy goal of reducing class sizes has received very little empirical support. In contrast, the importance of individual teacher performance, and the link to differentiated pecuniary incentives, are backed by strong evidence, but have been much neglected. (That illustrates not only a lack of evidence-based policy in education, where social scientists appear to have had little involvement, but also the influence over the years of the teachers' unions.)

Policies that have not been informed by good evidence and analysis fall more easily prey to the 'Law of Unintended Consequences' — in popular parlance, Murphy's Law — which can lead to costly mistakes. For example, the Commission found, in a series of reviews, that the well-intentioned regulatory frameworks devised to protect native flora and fauna, and to conserve historic buildings, were actually undermining conservation goals by creating perverse incentives for those responsible (PC 2004b, 2006a).

Our report for COAG, *Overcoming Indigenous Disadvantage*, is littered with examples (SCRGSP 2007). But, as Noel Pearson and other Indigenous leaders have affirmed, perhaps the most calamitous and tragic example of all was the extension of full 'award wages' to Aboriginal stockmen in the late-1960s. Despite warnings by some at the time, this apparently well-motivated action led to the majority losing their jobs, driving them and their extended families into the townships — ultimately subjecting them to the ravages of passive welfare; with liberalised access to alcohol as the final blow. Good intentions, bad consequences; very, very difficult to remedy.

I am not saying that policy should never proceed without rigorous evidence. Often you can not get sufficiently good evidence, particularly when decisions must be made quickly. And you can never have certainty in public policy. All policy effectively is experimentation. But that does not mean flying blind — we still need a good rationale or a good theory. Rationales and theories themselves can be subjected to scrutiny and debate, and in a sense that constitutes a form of evidence that can give some assurance about the likely outcomes. Importantly though, all policy experiments need to be monitored and evaluated and, over time, corrected or terminated if they turn out to be failures. These are things that governments typically find hard to do — particularly the termination part.

Conditioning the political environment

Complexity and uncertainty would make policy choices hard enough even if they could be made purely on technical grounds. But policies are not made in a vacuum. Rather, they typically emerge from a maelstrom of political energy, vested interests and lobbying. Commonly, those with special interests will try to align their demands with the public interest. The average person rationally does not do the hard work necessary to find out whether that is correct or not, but often feels intuitively supportive.

In that *realpolitik*, evidence and analysis that is robust and publicly available can serve as an important counterweight to the influence of sectional interests, enabling the wider community to be better informed about what is at stake in interest groups' proposals, and enfranchising those who would bear the costs of implementing them.

Tariff reform again provides a classic instance of evidence being used to galvanise potential beneficiaries from reform in the policy debate. In Australia, the losers under the tariff regime were the primary exporting industries — the farmers and the miners — who started to appreciate, with help from the Industries Assistance Commission, the extent of the implicit taxes and costs they were bearing; and they soon became a potent force for tariff reform. National Competition Policy has seen a similar political role being discharged through evidentiary processes.

To take a quite different example, the gambling industry got a lot of political support for liberalised regulation that was essentially based on a myth: namely that it would generate many jobs but have only minor adverse social impacts. The Commission's report showed the reverse to be true. Gambling did not (and cannot) generate significant additional jobs in the long term, and has very substantial social impacts (PC 1999a). Establishing that gave community groups a stronger platform to push for reforms to gambling regulation and the development and funding of harm minimisation measures.

The essential ingredients

For evidence to support good public policy, however, it needs to be the right evidence; it needs to occur at the right time and be seen by the right people. That may sound obvious, but it is actually very demanding. I want to talk briefly now about some essential ingredients in achieving it.

Methodology matters

First, methodology. It is important that, whatever analytical approach is chosen, it allows for a proper consideration of the nature of the issue or problem, and of different options for policy action.

Half the battle is understanding the problem. Failure to do this properly is one of the most common causes of policy failure and poor regulation. Sometimes this is an understandable consequence of complex forces, but sometimes it seems to have more to do with a wish for government to take action regardless.

A contemporary example that has received a bit of airplay as a consequence of the Commission's report on waste management (PC 2006f), is the move to ban the ubiquitous plastic shopping bags from our supermarkets. This initiative drew much support from the alleged problems that these bags pose for the litter stream and for marine health. But closer investigation by the Commission soon exposed gross inaccuracies and overstatements in those claims. Indeed some of what passed for 'evidence' was contrary to common sense, and some outright hilarious. (A Regulation Impact Statement soberly cited media reports from India that a dead cow on the streets of New Delhi had 35 000 plastic bags in its digestive system!)

In situations where government action seems warranted, a single option, no matter how carefully analysed, rarely provides sufficient evidence for a well-informed policy decision. The reality, however, is that much public policy and regulation are made in just that way, with evidence confined to supporting one, already preferred way forward. Hence the subversive expression, 'policy-based evidence'!

Even when the broad policy approach is clear, the particular instruments adopted can make a significant difference. Thus, for example, economists overwhelmingly accept the superiority of a market-based approach to reducing carbon emissions, but they differ as to whether a cap-and-trade mechanism or an explicit tax (or some combination of the two) would yield the best outcomes. Australia's apparent haste to embrace the trading option remains contentious among some prominent economists.

How one measures the impacts of different policies depends on the topic and the task — and whether it is an *ex ante* or *ex post* assessment. There is a range of methodologies available. There is also active debate about their relative merits. Nevertheless, all good methodologies have a number of features in common:

- They test a theory or proposition as to why policy action will be effective — ultimately promoting community wellbeing — with the theory also revealing what impacts should be observed if the policy is succeeding.
- They have a serious treatment of the counterfactual — what would happen in the absence of any action?
- They involve, wherever possible, quantification of impacts — including estimates of how effects vary for different policy 'doses' and for different groups.
- They look at both direct and indirect effects (often it is the *indirect* effects that can be most important).
- They set out the uncertainties and control for other influences that might impact on observed outcomes.

- They are designed to avoid errors that could occur through self selection or other sources of bias.
- They provide for sensitivity tests.
- Importantly, they have the ability to be tested and, ideally, replicated by third parties.

Australia has been at the forefront internationally in the development and use of some methodologies. For example, we have led the world in general equilibrium modelling of the direct and indirect effects of policy changes throughout the economy. But Australia has done relatively little in some other important areas, such as 'randomised trials', which can be particularly instructive in developing good social policy.

Most evidence-based methodologies fit broadly within a cost-benefit (or at least cost-effectiveness) framework, designed to determine an estimated (net) payoff to society. It is a robust framework that provides for explicit recognition of all costs and benefits, and requires the policy maker to consider the full range of potential impacts. But it hasn't been all that commonly or well used, even in relatively straightforward tasks such as infrastructure project evaluation.

The head of Infrastructure Australia's secretariat recently commented in the following terms about many of the infrastructure proposals submitted to that body: 'the linkage to goals and problems is weak, the evidence is weak, the quantification of costs and benefits is generally weak' (Deegan 2008).

It is very welcome, therefore, that Infrastructure Australia has stressed that any project that it recommends for public funding must satisfy rigorous cost-benefit tests. It is particularly important that this includes quantification of the more 'subjective' social or environmental impacts; or, where this proves impossible, that there is an explicit treatment of the nature of those impacts and the values imputed to them. In the past, this has proven the 'Achilles heel' of cost-benefit assessments for major public investments: financial costs are typically underestimated, non-financial benefits overstated. (Rubbery computations of this kind seem to be endemic to railway investment proposals, particularly 'greenfield' ones, which rarely pass muster on the economics alone.)

It is undoubtedly challenging to monetise some of the likely costs and benefits associated with certain areas of public policy. But often we do not try hard enough. There are nevertheless some examples of creative attempts. These include work by the Productivity Commission in areas such as gambling, consumer protection policy and even animal welfare (PC 1998b 1999a, 2008d,).

Good data are a pre-requisite

A second essential ingredient, of course, is data. Australia has been very well served by the Australian Bureau of Statistics and the integrity of the national databases that it has generated. But in some areas we are struggling. Apart from the challenges of valuing impacts, and disentangling the effects of simultaneous influences, we often face more basic data deficiencies. These are typically in social and environmental rather than economic domains, where we must rely on administrative collections — or indeed there may be no collections at all.

Data problems bedevil the human capital area of CAOG's National Reform Agenda. Preventative health strategies and pathways of causal factors are one example. Indigenous policy provides another striking one, involving a myriad of problems to do with identification, the incidence of different health or other conditions, and their distribution across different parts of the country. In the education area, obtaining performance data has been an epic struggle. In the COAG priority area of early childhood development, a recent survey article from the Australian Institute of Family Studies concludes:

> The dearth of evaluation data on interventions generally … makes it impossible to comment on the usefulness of early childhood interventions as a general strategy to sustain improvements for children in the long-term. (Wise et al. 2005)

Data deficiencies inhibit evidence-based analysis for obvious reasons. They can also lead to reliance on 'quick and dirty' surveys, or the use of focus groups, as lampooned in *The Hollow Men*. The other risk is that overseas studies will be resorted to inappropriately as a substitute for domestic studies. One topical example is the celebrated work by James Heckman in the United States demonstrating the benefits of preschool education based on the Perry Program. That work has become a policy touchstone for advocates of universal intensive preschool education in Australia. While that policy may well prove to be sound, Heckman's work does not provide the necessary evidence. As he himself has clearly acknowledged, the Perry Project was confined to disadvantaged children. And the main gain from the intensive preschool treatment that those kids got came from reduced crime.

A major failing of governments in Australia, and probably world-wide, has been in not generating the data needed to evaluate their own programs. In particular, there has been a lack of effort to develop the baseline data essential for before-and-after comparisons.

Australia could and should have done a lot more to take advantage of its federal system as a natural proving ground for policy learning across jurisdictions. Indeed, in some cases, rather than encouraging data provision to enable comparisons across jurisdictions, the basis for such comparisons has actually been suppressed.

So I think there is an opportunity, under the New Federalism banner, to fund the evidence base that we need to compare policy performances across our Federation, and thereby to devise better national policies where national approaches are called for.

Real evidence is open to scrutiny

Much policy analysis actually occurs behind closed doors. A political need for speed is often behind that. But no evidence is immutable. If it hasn't been tested, or contested, we can not really call it 'evidence'. And it misses the opportunity to educate the community about what is at stake in a policy issue, and thereby for it to become more accepting of the policy initiative itself.

Transparency ideally means 'opening the books' in terms of data, assumptions and methodologies, such that the analysis could be replicated. The wider the impacts of a policy proposal, the wider the consultation should be. Not just with experts, but also with the people who are likely to be *affected* by the policy, whose reactions and feedback provide insights into the likely impacts and help avoid unintended consequences. Such feedback in itself constitutes a useful form of evidence.

The Commission's processes are essentially based on maximising feedback. In a range of areas, we have learned a great deal through our extensive public consultation processes, particularly in response to draft reports. If you compare the drafts with our final reports you will often see changes for the better: sometimes in our recommendations; sometimes in the arguments and evidence that we finally employ.

Evidence building takes time

Transparency can have its downsides. In particular, it 'complicates' and slows down the decision-making process — transparency involves time and effort. On a number of occasions in the past decade I have been approached about the possibility of the Commission undertaking an attractive policy task, but in an amount of time that I felt was unreasonable for it to be done well, particularly in view of the time people need to make submissions and give us feedback. When the Commission does something, people rightly expect to be able to have a say. As a consequence, those tasks have more often than not ended up going to consultants. (And in most cases the results have vindicated my position.)

Good evidence requires good people

The fifth area of importance is capability and expertise. You can not have good evidence, you can not have good research, without good *people*. People skilled in quantitative methods and other analysis are especially valuable. It is therefore ironic that we appear to have experienced a decline in the numbers with such skills within the Public Service at the very time when it has been called upon to provide an evidence-based approach that relies on them. Again, that's been largely a consequence of budgetary measures over a long period of time. Research tends to be seen as a more dispensable function when governments and bureaucracies are cut back.

Several manifestations of the consequential reduction in capability have struck me. One is the lower calibre of some of the departmental project teams that I have observed trying to do review and evaluation work. Secondly, there appears to be increased poaching of research staff within the public sector, or at least pleas for secondments.

We are also seeing major new initiatives to train staff. One significant example is the Treasury's sponsorship of a new program, to be run by Monash University, to teach economics to non-economists.

We have also seen a major increase in the contracting of policy-related research outside the Public Service. A lot of those jobs have gone to business consultants rather than to academics. This contrasts with the experience in the United States, where the academic community seems to be utilised much more by government.

Contracting out is by no means a bad thing. It has been happening progressively for decades. But it does seem to be changing in character more recently. The focus seems to be broadening from provision of *inputs* to policy making, to preparation of *outputs* — the whole package.

There are clear benefits to government from using professional consultants: new ideas, talented people, on-time delivery, attractive presentation and, possibly, cost — although some of the payments have been surprisingly large. But there are also some significant risks. Consultants often cut corners. Their reports can be superficial. And, more fundamentally, they are typically less accountable than Public Service advisers for the policy outcomes.

Whether academics could be drawn on more is a key issue. In an earlier era, the involvement of numerous academics was instrumental in developing the evidentiary and analytical momentum for the first waves of microeconomic reform. Where are the new academic generation's equivalents in support of the 'Third Wave'? Only a few names come to mind, for example, of academics making a notable public contribution to policies bearing on human capital development.

Such involvement is of course a two-way street — with both demand and supply sides. The supply side seems to have been diminished over time, partly as promising academic researchers have sought more attractive remuneration elsewhere and partly as their time has been increasingly consumed by their 'day jobs'. On the demand side, one sometimes hears senior public servants complain that academics can be very hard 'to do business with' or that they are too slow, or lack an appreciation of the 'real world'.

There may be some validity in these perceptions, though I suspect that they may also reflect an unrealistic view of how much time is needed to do good research; and perhaps a lack of planning. Perhaps also a desire for greater predictability in the results than many academics would be willing to countenance.

Independence can be crucial

Evidence is never absolute; never 'revealed truth'. The choice of methodologies, data, assumptions and so forth, can all influence the outcome, and they do. Given unavoidable need for judgement in evaluation, evidence is more likely to be robust and seen to be so if it is not subjected to influence or barrow-pushing by those involved. What this means is that good research is not just about skilled people, it is also about whether they face incentives to deliver a robust product in the public interest.

Some years ago, following a talk that I gave at a gambling policy conference in Melbourne, an American academic came up to me and said that the Commission's report was being used extensively in public debate in the United States. I expressed surprise, given the extent of home-grown research there. She said 'Yes, but we do not know what to *believe'*. That appears to be because research is polarised in that country between that sponsored by community and church groups and that sponsored by the industry. And there is suspicion that 'he who pays the piper, calls the tune'.

Independence is even more important when dealing with technical research than with *opinions*. People are better able to judge opinions for themselves, but the average person is naturally mystified by technical research. They look for proxies to help them know whether the results of such research are believable. The status of the researcher (or who is paying for the research) is one such proxy.

Economic modelling is replete with these sorts of issues. Any model comprises many assumptions and judgements that can significantly influence the results. For example, the Productivity Commission and industry consultants used similar models recently to estimate the economic impacts of reducing tariffs on cars. The Commission found that there would be significant economy-wide gains from maintaining scheduled tariff reductions (PC 2008b). The other modellers, using different (and some less conventional) assumptions, projected net losses — with the current tariff rate coincidentally turning out to be 'optimal'.

A 'receptive' policy making environment is fundamental

We come to the final and most important ingredient on my list. Even the best evidence is of little value if it is ignored or not available when it is needed. An evidence-based approach requires a policy making process that is receptive to evidence; a process that begins with a question rather than an answer, and that has institutions to support such inquiry.

We often see the reverse, especially for more significant proposals. The joke about 'policy-based evidence' has not been made in abstract — we have long observed such an approach in operation through the lens of regulation making in Australia.

Ideally we need systems that are open to evidence at each stage of the policy-development cycle: from the outset when an issue or problem is identified for policy attention; to the development of the most appropriate response, and subsequent evaluation of its effectiveness. The ongoing struggle to achieve effective use of regulation-assessment processes within governments tells us how challenging that can be to implement.

I admit that an evidence-based approach undoubtedly makes life harder for policy makers and for politicians. Lord Keynes, who seems to be well and truly back in vogue, said in the 1930s:

> There is nothing a government hates more than to be well-informed; for it makes the process of arriving at decisions much more complicated and difficult. (Moggridge 1982)

I think we can see what he meant. But, against this, are the undoubted political *benefits* that come from avoiding policy failures or unintended 'collateral damage' that can rebound on a government, and from enhancing the credibility of reformist initiatives.

Some implications for the Public Service

How can those of us in the Public Service help advance the cause of evidence-based policy making? We begin with the considerable advantage of explicit endorsement by the Prime Minister and senior ministers for an evidence-based approach to public policy. In his speech to the Senior Executive Service in 2008, Kevin Rudd declared, 'we cannot afford a Public Service culture where all you do is tell the Government what it wants to hear' (Rudd 2008). We have also heard from the head of the Public Service, Terry Moran, that 'for civil servants, a capacity to analyse problems rationally and empirically and to advance options for action by governments is a basic ethical duty'.

What both are talking about, in old parlance, is 'frank and fearless' advice: robust advice that does not second guess the politics or the politicians. So the first suggestion I have for advancing evidence-based policy making is for us to be frank and fearless. That does not mean being a loose cannon, or acting contrary to a government's broad objectives, but using the opportunity of such political support to strengthen the bureaucracy's capacity to provide evidence-based advice — and *delivering* that advice, even if it is against the current, or not confined to a minister's or government's favoured position (which often are not set in concrete anyway).

Making better use of existing processes

There exist currently vehicles and frameworks within government that can be used more effectively to this end. Indeed, the recently upgraded regulation-assessment requirements are ready made for that purpose. As noted, these are based on a best-practice 'policy cycle', with explicit provision for evidence to be utilised at each step.

In relation to spending programs, there is also likely to be scope to enhance some of the requirements, particularly to strengthen *ex ante* evaluation, and to make explicit provision for *ex post* review.

Effective COAG arrangements

At the COAG level, we have a new working group structure, which is well placed to advance an evidence-based approach to public policy, given sufficient space and lead time. That said, these arrangements in themselves represent an experiment. Their novel design, in which state department CEOs essentially report to Commonwealth Ministers, faces obvious challenges.

More problematic are the time constraints imposed on COAG processes under the punishing dictates of the quarterly cycle of meetings. The seeming imperative for bureaucrats around the country to be constantly preparing for these meetings appears to be displacing some of the work that should be done to inform decisions.

It is to be hoped, therefore, that over time we might see a return to a more measured approach, which retains, or even strengthens, the new framework of working groups behind the scenes, but involves more time between meetings of COAG itself.

Building greater institutional capacity

Building capacity — or *re*building it — is also very important. But it can not happen overnight. For one thing, we need to be recruiting into the Public Service more graduates in the social and economic sciences. The United Kingdom saw a doubling in the number of researchers in the Civil Service in one decade under the Blair Government.

Any agency that is serious about encouraging an evidence-based approach needs to develop a 'research culture'. Establishing dedicated evaluation units, achieving a critical mass of researchers, strengthening links with academic and other research bodies, are all integral to this.

There is also the broader question of institution building to underpin better evaluation generally across government. Some initiatives have developed out of the foreign aid programs and literature that may be instructive. These include 'evaluation clubs' or forums that promote cross-fertilisation, peer support and learning about what works — both in relation to methodologies and policy approaches themselves. We could think of developing comparable institutions as centres of excellence to foster greater interjurisdictional learning in Australia — a kind of Cochrane Collaboration in the policy arena. Government/COAG sponsorship for such institution building is worth considering. Indeed, it could be contemplated as a useful extension to the role of ANZSOG, given its 'ownership' by all governments in Australia and New Zealand.

Better use of external contracting

When it comes to the (inevitable) use of external contractors, I think we need to give far more attention to defining the task, and to identifying how contractors can best help us to make good public policy. Choosing the contractor — getting the right consultant for the task — is obviously fundamental. I would suggest that in many cases, it is better to go directly to the experts rather than to the big jack-of-all-trades management consulting firms that may be willing to tackle anything, but have an indifferent performance record in policy-related work (to say the least).

Part of the challenge, if consultants are to become contributors to a truly evidence-based approach, is to limit their tendency to second guessing, which can compound bureaucrats' own tendencies in this direction. As noted previously, this may be less of an issue for academics, who typically do not rely on such sources of income, than for business consultants, who do. An evidence-based approach ideally requires contractual arrangements that create neutral incentives for the researcher to make robust findings — for example, by making it clear that his or her work will be peer reviewed.

More generally, monitoring and reviewing the quality of such external work is crucial and, again, academic specialists would seem particularly well placed to help with that, as well as helping agencies choose which consultant to use in the first place.

Peer review can also be very worthwhile for the research that is done within government, but this is not common practice. It is especially valuable where political sensitivities require secrecy during the policy-development phase, but where there may be significant downside risks for the community from getting it wrong.

Resourcing evaluations properly

We need to ensure that all government programs are designed and funded with future evaluation and review in mind. That includes data needs, especially *baseline* data. We should be pushing harder for more and better data generally, particularly in the social and environmental areas. Instead of being seen as an extra or a luxury, data for policy evaluation needs to be recognised as a necessity — and a funding priority right now if we are serious about developing an evidence-based approach.

As already emphasised, we also need to be building in more time, where it is needed to come up with robust evidence that is adequately tested. In a crisis situation such as the present, time is of the essence of course, and some decisions need to be made quickly. That is inevitable. But it is important that we lay the groundwork now to evaluate the consequences of those measures later, so the inevitable problems can be detected and timely adjustments made.

In the current context, this is particularly important for spending initiatives motivated by short-term demand management objectives, which could have an ongoing impact, or create a sense of entitlement and political pressure for their retention. For example, increased assistance to an industry — by strengthening its ability to withstand foreign competitors in a recessionary market — may initially help to shore up that industry's workforce. But this selective support will tend to weaken job retention in other local industries and, if sustained, inhibit overall job creation and productivity growth in the longer term.

Bottom line

The goal of evidence-based policy making is unquestionably important, and it is encouraging that it has received vocal support at the highest political levels. However, measured against the various ingredients for an effective approach, it seems clear that current practice continues to fall short. Addressing this is now largely up to the Public Service. Not only is there a need to improve the capacity of the Public Service to deliver evidence-based policy advice, there is a need for it to improve political understanding of what that entails. If we fail, it will compromise government's capacity to implement the beneficial national reforms that this country needs for the long term.

Markets: how free?*

The invitation to speak at this symposium was an offer I could not refuse. First, the topic, 'markets: free but not beyond government intervention', was appealing. It involves recognition that markets have a very important role to play, but also that governments too have a key role — and it is important to get the mix right for the community's sake in the long term. I've spent much of my career puzzling over the tradeoffs in that territory and indeed that is the principle focus of the Productivity Commission itself.

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

Whitlam saw clearly that the pursuit of economic efficiency and social progress were complementary. And he acted on this insight. It was he who dealt the first blow against Fortress Australia, with the 25 per cent tariff cut in 1973. While there were multiple rationales, and the reduction was partially reversed in following years, it was a politically brave, indeed unprecedented, gesture that demonstrated what was possible. It contributed greatly to developments in policy thinking that saw the next Labor government, a decade later, pick up where Whitlam had left off and succeed in opening up the Australian economy on a more sustainable basis.

Those further reforms, and the reforms that have occurred since then, were Whitlam's legacy in another way. Whitlam also understood that policy reforms to promote efficiency and community wellbeing are often stymied by vocal minorities who stand to lose, while not being adequately appreciated by the much larger section of the community who are the ultimate beneficiaries. He created the

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* Extract from an address to the 'Governing the Economy Symposium' convened by the Whitlam Institute, Sydney, 30 November 2009.

Industries Assistance Commission, out of the old Tariff Board, to expose such claims to careful analysis and public scrutiny, and thereby promote more informed policy decision making in a more neutralised political environment, where the tradeoffs in reform could be better appreciated by the community.

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

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

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

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

What do markets offer?

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

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

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

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

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

As noted, not all societies have been persuaded by the logic of markets. However experiments around the world with alternative systems have only served to demonstrate their value. And indeed we have seen a progressive shift towards, or back to, markets across the globe in recent decades; a move which has generally paid off for the countries concerned. Since 1980, world GDP has risen by two and a half times, or an unprecedented 40 per cent per capita, with millions of people rising out of extreme poverty.

For example, China's performance since the end of the Cultural Revolution, when it tentatively began to open the door to markets, speaks for itself. Since the beginning of the reforms in China in 1978, we have seen real GDP in that country grow by more than 10 per cent a year. That in turn has seen dramatic reductions in poverty, rises in life expectancy, and gains in other indicators of wellbeing and capability, like literacy and health. The OECD has described China's advance to a market economy as among the greatest economic success stories of modern times.

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

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

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

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

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

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

What markets *can't* do

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

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

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

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

But that also means that at any time some firms will contract or even close down; some people will become unemployed, at least for a while; and some towns and regions will stagnate or decline, while others prosper. That seems harsh to most people, especially to those most directly impacted. So we see considerable resistance to the logic of markets, and indeed lobbying by industries for taxpayer support. This can be successful if the industry is influential enough, or regional politics favour it — though governments generally know that it is better to provide people with transitional income support in a dynamic economy, than to try to help them by making the economy itself less dynamic. Australian governments have been liberal in providing such income support to households and this has underpinned a relatively stable distribution of income in Australia during what has been an extended period of wide-ranging structural reform.

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

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

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

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

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

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

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

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

Achieving regulatory 'balance'

Some lessons can be briefly drawn from two inquiries on which I am presiding — executive remuneration and gambling — in terms of the bigger picture in balancing freedom and intervention in markets.

The first lesson is that it is 'horses for courses'. Unless you are operating in a perfect market with social and private valuations and effects coinciding, and complete information for all, there may be a case for intervention to influence behaviour. But how much and what kind will depend crucially on the particular market.

Secondly, interventions that can target the source of a problem without unwanted side effects or other collateral damage will generally be superior, and give greater confidence of achieving a net benefit to the community over the longer term.

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

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

Moreover, the risks of unintended consequences are generally highest when making *ad hoc* or piecemeal changes to an *interactive* system — which is the essence of a market.

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

Domestic transparency and trade liberalisation*

A successful conclusion to the Doha Round remains elusive despite six years of intensive negotiations. The sense of déjà vu is palpable. As in previous rounds, the key sticking point — divisions between the European Union, United States and developing countries on the adequacy of current 'concessions' — reflects perceptions within those countries that their liberalisation only benefits them if it is reciprocated by their trading partners. That in turn is a reflection of a poorly informed policy discussion within WTO member countries, and the lack of domestic processes to promote it.

This, of course, is not a new diagnosis. Two decades ago, two international study groups reporting on ways to overcome the then impasse in progressing multilateral trade negotiations advocated establishing 'domestic transparency' mechanisms within member countries to generate better information about the costs and benefits of domestic liberalisation, and thus a more 'positive' approach to international trade negotiations (Leutwiler et al. 1985, Long et al. 1989). The proposal was also revived in the early stages of the Uruguay Round in the negotiating group on the functioning of the GATT System (Rattigan, Carmichael and Banks 1989) but consideration was deferred pending establishment of an *external* monitoring process within the WTO, the Trade Policy Review Mechanism (TPRM). That deferral became permanent.

The consequences of this deficiency in national preparations for trade negotiations have become more profound given the expansion of 'trade' negotiations beyond tariffs and quotas on manufactures to more difficult areas of domestic policy, and by the expansion in membership of the WTO. These days, negotiations encompass agriculture, services and 'behind-the-border' issues such as foreign investment, competition law, product standards, intellectual property, governance and other matters which are widely seen as belonging to domestic policy. The complexities of

* Edited extracts from Banks, G. and Carmichael W. B., 'Domestic transparency in Australia's economic and trade reforms: The role of "the Commission"', presented to the Lowy Institute and Tasman Transparency Group conference, 'Enhancing Transparency in the Multilateral Trading System', Sydney, 4 July 2007. (Bill Carmichael is a former Chairman of the Industries Assistance Commission.)

this broadened trade agenda, the fact that it has more to do with domestic than international policy matters, and the lack of mechanisms to examine the consequences of policy change, have compounded the difficulties of achieving liberalisation in international settings.

The broadened international agenda has heightened the need for more transparent domestic policy-making processes. Australia's experience in this area, reflecting in part our traditional lack of negotiating scope in the GATT as an agricultural exporter, has attracted renewed international attention. The latest WTO Trade Policy Review of Australia makes the following observation:

> The high degree of transparency in the formulation and evaluation of Australia's economic policies in relation to their rationale, nature, and economic effects, enhances government accountability and public debate over the merits of these policies. Hence, transparency has contributed greatly to the continued process of reform, which began in the 1980s, and in which trade liberalization, much of it unilateral, has played an integral part. (WTO 2007, p. vii)

The TPRM report emphasised that the transparency function had become institutionalised in Australia, notably through the role of the Productivity Commission (and its predecessor organisations) as an independent review and advisory body on microeconomic policy and regulation.[1]

While other countries have organisations within the public or private sectors that do research or provide advice on trade and related policies, Australia appears to be unique in having fashioned an independent institution within government to pursue this on an ongoing basis, using public processes and an explicit national interest perspective. Even within the Australian tradition of extensive use by governments of public inquiries to investigate all manner of public policy issues (Prasser 2006), the Commission's standing transparency function is distinctive.

Although formed in 1998, the Productivity Commission's institutional roots go much deeper. It is the direct descendent of the Industry Commission (1990–1998) and, before that, the Industries Assistance Commission (1974–1990). In turn, that body was created from the Tariff Board, which was founded in 1921.

The Tariff Board was established to advise the Commonwealth Government on questions of assistance for import-competing industries. It served an essentially protectionist role until the mid-1960s, when, under the combined influence of a new Chairman (Alf Rattigan), a separate high profile public inquiry into Australia's

[1] Growing interest in the Commission is also evident as part of a wider push within a number of countries to enhance their own capacity for policy formulation and economic decision making. A recent focus for this has been 'institution building' within Asian members of APEC and New Zealand, but interest extends as far afield as Chile, Botswana, Kazakhstan and even France.

economic policies (the Vernon Committee) and developments in protection analysis fostered by Australian academics (notably Professor Max Corden), the Board began to question the effects on the wider economy of its longstanding, needs-based approach to tariff advice.

In the face of considerable resistance from the then Government, the Board increased its analytical capacity, began estimating and making transparent its measures of the relative protection levels accorded different industries (using the relatively new concept of the ‘effective rate’ of assistance) and published a tariff review program focusing on broad groups of manufacturing industries — rather than narrow product lines — commencing with those most highly assisted.

As a result of the Board’s use of transparent criteria against which to assess claims for assistance, and concern for the wider economic impacts of its recommendations, its advice gained greater respect and authority.

The election of the Whitlam government in December 1972 brought decisive changes to Australian tariff policy. The Industries Assistance Commission (IAC) replaced the Tariff Board in January 1974, with a wider remit, and a clearer focus on national economic performance. The new Commission was seen as providing a counterweight to the sectional and other political pressures resisting trade and industry liberalisation.

The legislation creating the IAC provided it with a charter and independence required to ensure that its advice to governments would be disinterested, open to public scrutiny and formulated with regard for the best interests of the community as a whole, not just those of particular groups.

Three features of the IAC’s structure and operations underpinned the effectiveness of its contribution to public debate and policy formulation: independence, transparency, and an economy-wide mandate. These features have remained fundamental to the role and operations of the two organisations that succeeded the IAC, namely the Industry Commission and today’s Productivity Commission. In combination, these institutional arrangements preserve the autonomy of governments over policy, while ensuring transparency and an economy-wide perspective in the advice provided to them on key issues.

The main differences between the three organisations have been in their coverage, which has been progressively extended beyond industry assistance matters to include structural reform issues across all sectors of the economy, and in social and environmental as well as economic spheres. Around 80 per cent of the IAC’s inquiry reports concerned assistance for manufacturing industries. These days, around 80 per cent of Productivity Commission inquiries relate to cross-sectoral, infrastructure, social and environmental policy issues. The breadth of matters addressed by the Commission in recent years is illustrated by its major reports on public support for science and innovation, infrastructure regulation and pricing, waste management, energy efficiency, water markets, paid maternity leave, implications of the ageing of the population, and Australia's gambling industries.

The public inquiry process

The Commission's public inquiries tend to be resource intensive and have a high public profile compared to other research studies and are therefore not designed for trivial or straightforward matters. Rather, they typically concern policy issues that have a significant impact on different groups within society, or are otherwise contentious or complex to assess, but where the potential of a long-term payoff for the nation from better informed policy making is high. These features put a premium on good process and effective engagement with potentially affected sections of the community.

Once the Australian Government agrees on the focus and scope of an inquiry (often in consultation with other governments and community groups), the Treasurer sends a 'reference' to the Commission. The terms of reference outline in writing what the inquiry covers and how long the Commission has to report. Most inquiries specify a duration of 9 to 12 months, sometimes less for urgent matters. Such timeframes need to ensure adequate opportunity for public participation and for feedback on the Commission's preliminary findings before its report is finalised and sent to the Government.

Public inquiries are widely advertised and provide an opportunity for different points of view to be heard and considered. The Commission is active in identifying those potentially interested in the inquiry and all individuals and organisations with an interest can participate. They may do so through the Commission's visit program, through written submissions and attendance at hearings, or at workshops and other forums. Submissions and transcripts of public hearings are posted on the Commission's website and are also available in hard copy.

These transparent processes ensure that the arguments of interest groups are subject to close scrutiny, as is the Commission's own analysis.

Final inquiry reports must be tabled in Parliament within 25 sitting days of the Treasurer receiving the report. But it is up to governments to make the final decisions in response to the Commission's findings and recommendations.

The value of a supporting research function

Crucial to the Commission's contribution has been its capacity to undertake research on its own initiative. According to Rattigan (1986, p. 21) many of the early difficulties of the Tariff Board could be traced to its incapacity to stand back from day-to-day inquiry work, assess the shortcomings in its overall approach and to develop ways to overcome them.

In its earlier forms, the Annual Report was the main vehicle through which the Commission could publish research findings on the structure of protection, sources of structural change in the economy and related matters, and to explain the rationale for the Commission's general approach to its inquiry work. In comparison, the Productivity Commission has an explicit statutory duty to initiate research that complements its other functions and to promote public understanding of the tradeoffs involved in different policy approaches. In addition, it must report annually on the impact of assistance and regulation on the productivity and performance of the Australian economy as a whole. The Productivity Commission's supporting research program is integral to its work and comprises a significant proportion of its output.

Impact on trade policy debates and decisions

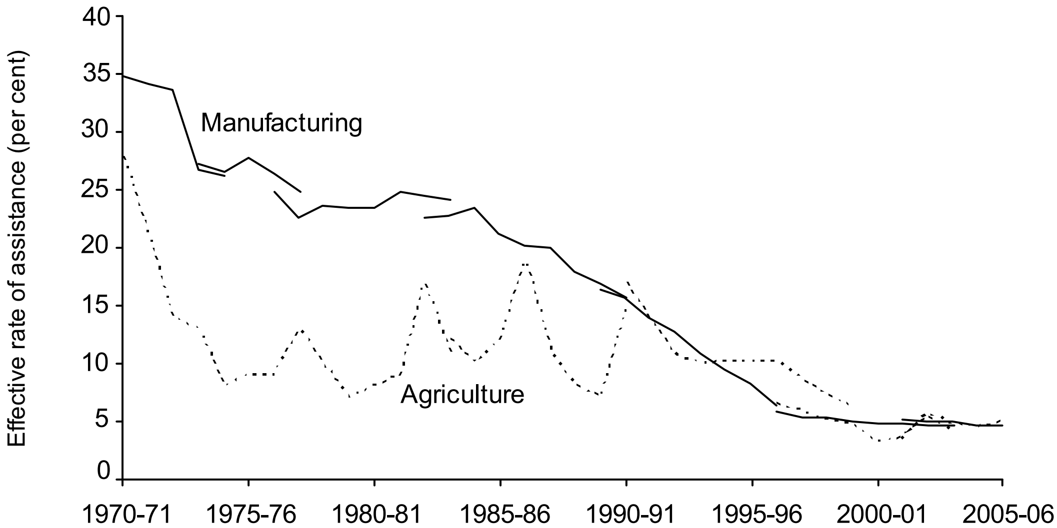
In seeking to gain an understanding of the Commission's role, international visitors often ask for evidence that it has made 'a difference' to policy making in Australia. It is hard to be conclusive. After all, the Commission is only an advisor, not a decision maker; there are many other sources of advice to government, and there can be lags between when the Commission reports and the ultimate policy decision, such that attribution is difficult. And of course, views by different parties on the performance of the Commission can be conditioned by how those interests have been affected by its advice and analysis.

One simple indicator of the Commission's influence is government acceptance of its findings and recommendations. In the case of its inquiries into industry protection or assistance, notwithstanding some high profile rejections (generally in politically charged circumstances), the great bulk of the Commission's recommendations have been implemented either fully or in part.

It has taken more than four decades of policy effort and debate to lower Australia's trade barriers and industry assistance levels, but the protectionist regime has been almost dismantled (figure 1). Nevertheless, tariff reform remains incomplete. In 2000 the Australian Government deferred implementing the Commission's recommendation to reduce the remaining general tariffs of 5 per cent to zero, preferring to delay removal until a time 'consistent with trade and fiscal objectives'. Moreover, the legislated reduction in automotive tariffs has the caveat of a further review to be conducted by the Commission in 2008 'to determine whether changes are warranted to the legislated tariff reductions in view of conditions in the international trade environment'.

With Australia's tariff walls falling and competitive pressures on the traded goods sector rising, policy impediments 'behind the border' began to attract attention.[2] Initially, the Commission's reporting helped to widen the microeconomic reform program in the 1990s to improving the performance of economic infrastructure services dominated by government-owned monopoly suppliers in energy generation and distribution, water, rail, ports and postal services.

Figure 1 **Declining industry assistance in Australia**



Data source: Productivity Commission estimates.

Some implications

Australia's experience demonstrates that institutionalised transparency can help governments undertake beneficial reform and make better policies, but is also suggestive of some general cautions. Expectations need to be tempered:

2 The Tasman Transparency Group (2007) has pointed out that domestic transparency procedures are needed to bring opaque 'behind-the-border' barriers into account in trade negotiations. These barriers are pervasive in the markets for services.

transparency is unlikely to transform to policy environment overnight. Building a pro-reform constituency in government and the wider community is a gradual process. It took Australia four decades to get tariffs down and more than a decade tackling sources of underperformance in economic infrastructure services. And neither reform program is yet complete.

That said, reforms once made in Australia have tended to stick, having stronger foundations of support or acceptance within the community precisely because the basis for reform *was* transparent. The programs of tariff liberalisation and regulatory reform initiated under one government have generally been maintained by new governments of different political complexions.

The Australian experience with early tariff reform is also instructive of the adverse consequences of avoiding transparency. The 25 per cent tariff cut of 1973 followed a report prepared secretly within government and was implemented without warning. In hindsight, there can be little doubt that it set back public acceptance of protection reform and created uncertainty about how reform would be conducted in future. Reflecting that uncertainty, and in response to pressure from those who stood to loose most from the tariff cuts, the Government subsequently acted to effectively quarantine Australia's most highly protected industries from the general reduction. While the 25 per cent cut lowered the average level of protection, the Government's subsequent selective imposition of quantitative restrictions increased the disparities in protection across industries. This greatly reduced the potential benefits. It is significant that, more than three decades later, the two manufacturing groups quarantined from the across-the-board reduction in tariffs are still the exceptions in Australia's otherwise low protection regime.

A second implication is that reform is a *process*, not an event. One set of reforms exposes the need for others. As Australia opened its borders to foreign goods, services and capital, 'upstream' inefficiencies in government utilities and inflexibilities in labour market regulation became more apparent and unacceptable to those facing new competitive pressures. This effectively enlarged the 'constituency for reform' within Australia. As noted, the Commission's work program went increasingly 'behind the border', to cover an array of industry assistance issues and anti-competitive regulation across the economy and, nowadays, the human capital related drivers of productivity growth and living standards.

A point to emphasise, given the context for this international conference, is that the Commission's contribution to Australia's trade policy has generally not been made as part of the trade negotiation process itself. Rather, the Commission's reports have focused on the case for domestic liberalisation. However, this unilateralist focus progressively affected Australia's approach to multilateral trade negotiations. In effect, the negotiations largely served to 'lock in' our protection reductions, through binding international agreements, rather than driving the reforms themselves (Banks 2003b).

The nature of the Commission's contribution, which relies not only on solid research but also on providing adequate scope for public input and scrutiny, is not a good fit with the secrecy and rapidity that characterises decision-making in trade negotiations. However there is scope for the Commission to play a more direct role, by providing an assessment of the potential for gains and losses for Australia when prospective trade agreements are contemplated and, subsequently, before agreements are signed, assessing whether the final outcome from negotiations is likely to deliver net benefits for Australia. It could also provide guidance on more general or systemic issues, such as the product coverage of negotiations, the design of rules of origin or identifying the greatest distortions from a domestic welfare perspective.

A caveat is that there needs to be sufficient lead-time for the Commission to consult and test its analysis with other experts and those potentially affected. This applies equally to modelling work, which has previously been performed by consultants under tight timeframes. While the Commission no longer has a monopoly on modelling technology or expertise (to the contrary) it does provide a 'neutral' incentives environment for modelling directed at the national interest. In hindsight, the 'battle of the models' that occurred during the Australia United States Free Trade Agreement negotiations, arguably did more to confuse than enlighten the community about the likely outcomes for Australia from that agreement.

Finally, the longevity of 'the Commission' should not obscure the difficult times it weathered along the way. The institution found itself under threat of closure or emasculation on several occasions. It is the insights gained from the Commission's survival that are most likely to be of interest to those contemplating how transparency might best be introduced into the policy apparatus in their own countries.

The Commission's independence has been invaluable in ensuring that its advice is not compromised or swayed by particular sectional or bureaucratic interests. Independence, together with quality analysis directed at community-wide ends, underpin the credibility of the Commission's advice in contentious areas of public policy.

For a transparency body to be effective, responsibility for it should rest with a minister having economy-wide responsibilities. The Australian experience is that the Commission prospered least when it reported to a minister with responsibility for a particular sector of the economy. A properly functioning domestic transparency agency acts as a counterweight to sectional interest groups, whereas industry ministers have industry constituencies to which they naturally feel the need to be responsive.

In practical terms, adequate funding and control over its use determine how well the domestic transparency function can be performed. These were early ‘battle grounds’ as the Tariff Board began to reinterpret its role and saw a need for greater research, and bureaucratic opponents sought to hinder this. Subject to general governmental controls affecting public sector agencies, the Commission has discretion in allocating its budget to meet the needs of its inquiry, supporting research and other functions.

Effective policy formulation in contentious areas of public policy requires effective consultation as well as good analysis. The hallmarks of the Commission’s inquiry procedures are: public notification of new inquiries and their terms of reference; face-to-face visits or roundtable discussions with major interest groups; insistence that all key aspects of submissions and the information and views provided at hearings be made publicly accessible; and exposure of the Commission’s preliminary analysis and conclusions to public scrutiny before its advice to government is finalised.

As a result of the system of open inquiries and public reports that form the basis for Australia’s transparency arrangements, decision making has been better informed about the future consequences of policy initiatives under consideration. This system has helped make it possible for Australian governments to move forward on economic and trade reform, a journey that is not yet over.

Why have a Productivity Commission?*

The Productivity Commission has been given an important job. Its role, expressed most simply, is to help governments make better policies, for the benefit of the Australian community. As its name implies, the Commission's focus is on ways of achieving a more efficient and productive economy — the key to higher living standards.

The Productivity Commission is an independent Commonwealth body, created by Act of Parliament in April 1998, to replace the Industry Commission, the Bureau of Industry Economics (BIE) and the Economic Planning and Advisory Commission (EPAC). It has been launched at a time of almost unprecedented debate about key policy directions for Australia. There has been a backlash against many of the policy reforms of the past decade, particularly those which have exposed Australian workplaces and regions to increased competition. And this reaction has spilled over to the institutions of government associated with that transformation.

As a catalyst for change in policy areas where there are often vested interests in maintaining the status quo, the Commission will often find itself in the firing line. Those who disagree with the Commission's findings will naturally be tempted to shoot the messenger. Recently, there have been three broad areas of criticism. One accusation, carried over from the Industry Commission, is that the new body is ideologically driven. A related criticism is that the Productivity Commission, in combining three separate agencies, now monopolises policy advice. A third approach has been to dismiss the Commission as irrelevant because its predecessor's advice was not followed on some key issues.

Which ideology?

The first and most ingrained of these, that the Commission has an ideological antipathy to all forms of government intervention, probably has its origins in the protection debate under the former Industries Assistance Commission. While it is true that the Commission and its predecessors, including the BIE and EPAC, have

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* Address to the Committee for Economic Development of Australia, Public Education Forum, Brisbane, 26 August 1998.

been consistent in advocating reduced industry protection, this has had more to do with removing the costs on the Australian economy and community than with any ideological predisposition against government intervention.

Indeed, in its recent submission to the Mortimer review of business programs, the Commission outlined various circumstances in which governments needed to assist industry (IC 1997c).

The Commission and its predecessors have also emphasised the value of competitive market disciplines to promote greater efficiency and productivity — and thus higher living standards. But this has not involved doctrinaire adherence to unbridled market forces. Each case has been assessed on its merits. For example, in areas such as health and education, the Commission has emphasised the importance of mechanisms to ensure access for those on lower incomes. In a number of reports dealing with environmental issues, the Commission has supported government regulation to achieve better outcomes.

A careful, case-by-case assessment has also informed the Commission's approach to privatisation, which has generally been seen as of secondary importance to removing constraints on competition and advocated only where it would clearly bring additional benefits.

When one goes beyond industry assistance and public utility regulation to consider the other diverse policy areas in which the Productivity Commission now has a role, it becomes even more difficult to button-hole us. Yet the pattern, or lack of it, was already apparent under the Industry Commission. For example, what is the common ideological basis for:

- the Commission's support for public provision of housing?
- its recommendations to maintain the 150 per cent tax concession for business R&D, or its strong support for basic research in universities?
- its advocacy of stronger duty of care enforcement for OH&S?
  - or the extension of the duty of care concept to land management regulation?
- its recommendation that the tax deductibility of donations to community social welfare organisations not only be retained, but extended?
- its rejection of unilateral open skies deregulation of international air services?
- its identification of the role of poor management practices as well as that of unproductive work arrangements in stevedoring?

There is little evidence of an open slather free market ideology in these recommendations. Not only that, I suspect that most of them would not have been predicted by the participants in those inquiries — or even by the Commission itself at the outset. The fact is that most of our inquiries are a voyage of discovery. Where we end up depends on what we learn along the way.

Similarly, accusations that the Commission pursues a narrow concept of economics with little regard for adjustment or social issues have missed some important strands of its work. Some of our critics clearly have not read our reports.

There is a long tradition through the Commission's predecessors, of recommending phased or graduated change to allow time for orderly adjustment or to meet equity objectives.

A key instance is the consistent advocacy of gradual, predictable reductions in tariff levels, including in the most recent passenger motor vehicle (PMV) and textiles, clothing and footwear (TCF) reports (IC 1997a, 1997d). But there are many others. For example, while the Industry Commission's report on urban transport found that restrictions on taxi numbers were costing the public on average an extra $2 a trip, it recommended that the restrictions be eased over a number of years by auctioning additional plates, with the possibility of compensating existing licence holders with the sales proceeds (IC 1994b). In its report on private health insurance, the Commission recommended modifications to community rating based on the age of entry, to help stabilise the system and make it fairer to long-standing members. It also proposed, however, that this change apply only to future entrants and that there be an initial grace period during which anyone could enter under the old rules (IC 1997b).

In these and other inquiries, the Commission has generally given careful consideration to both the adjustment and distributional implications in making its policy recommendations.

For example, although not widely reported at the time, the TCF report identified a need to provide targeted support to improve the employability of workers needing language training and to ensure assistance to depressed regions where there is significant TCF activity (IC 1997d). Emphasising the important role of generally available training and welfare programs in the adjustment process, the Commission recommended that the eligibility of any redundant workers for employment services should not depend on them receiving social security benefits.

Where the Commission has not recommended tailored support to facilitate adjustment by particular groups, this is not through any ideological objection, but because it has seen no additional pay-off from such schemes, which can be difficult to design and generally have a poor track record.

A concern for the effects of policies and policy changes on different groups of people and regions is embedded in the Productivity Commission's current research and inquiry program. But it was also evident in the work of the Productivity Commission's predecessors. For example, the Industry Commission documented the regressive incidence of import taxes (tariffs and quotas) and how some states benefited at the expense of others (IC 1996c). More recent Commission research has explored the effects of a range of microeconomic reforms on employment in different industries and regions, and on the income levels of different socioeconomic groups (De Laine et al. 1997; Murtough et al. 1998). Such work has demonstrated that policy reforms have been only one among many pressures for change, often being outweighed by developments in technology and on international markets.

The Commission has also attempted to advance understanding of the social dimensions of microeconomic reform through published research, in its annual reports and community workshops — one example being its conference on 'equity, efficiency and welfare' (IC 1996b). We can of course do more in this complex area and that is why it has a central place in our work program and our consultative processes.

I think all of this reveals the hollowness of accusations that the Commission's output is narrow in focus or predictably ideological. If we have one guiding principle, it is the community-wide perspective that we bring to our work. That is the real key to the diversity of the Commission's recommendations.

As already indicated, our findings and recommendations emerge from consultations with a wide variety of industry and community groups. To give a few examples, the Industry Commission inquiry into charitable organisations involved 220 visits to interested parties, 800 written submissions and 284 participants in public hearings; the OH&S inquiry involved 250 visits and over 400 submissions; and the land management inquiry undertook 20 roundtable meetings, involving about 200 people across most regions of Australia. I expect the inquiries into the gambling industry and the effects of competition policy to involve more of the same.

The Commission can draw on a range of skills within the institution itself. Commissioners and staff have diverse backgrounds, qualifications and life experiences. The amalgamation of staff from the BIE, EPAC and Industry Commission enhanced this diversity, as did the appointment of new Commissioners. The *Productivity Commission Act 1998* requires that there be Commissioners with extensive skills and experience in matters to do with the environment, social welfare delivery and the operations of industry.

This is supplemented by the appointment of Associate Commissioners with skills relevant to particular inquiries. Thus, the Industry Commission was fortunate to have had Sister Margaret McGovern from the Mercy Family Centre as an Associate Commissioner in the charitable organisations inquiry; Michael Easson, with his union background, on the inquiry into OH&S; Professor Mick Common from the Australian National University's Centre for Resource and Environmental Studies on the greenhouse inquiry, and so on.

Such part-time appointees enrich the Commission's understanding of the issues and enhance the credibility of its judgments. They obviously also need to share the requirement on permanent Commissioners that there be no conflicts of interest that could be seen as affecting their judgment. This has been highlighted by the recent designation of the Productivity Commission as Australia's authority for hearing claims for temporary import protection under the safeguards provisions of the WTO. Any doubts about the impartiality of those processes in the current pigmeat case, for example, would put Australia at risk of subsequent challenge in Geneva.

The Commission also has the flexibility to draw on the expertise of others in a variety of ways, including through external consultancies and staff secondments. These mechanisms are widely used.

But we can always do better. In the gambling inquiry, for example, we intend to form a consultative panel of eminent people with a range of social and industry perspectives, to generate and test ideas and provide constructive feedback.

Monopolisation of advice?

There has been some criticism that creating the Productivity Commission through the amalgamation of three separate agencies has diminished the competition for ideas and the breadth of views available to government.

It is undeniable that there are now fewer such government organisations than there were before, and this will inevitably have some effect. But this needs to be put in perspective.

For one thing, the key functions of each agency have been preserved in the Productivity Commission. For example, in addition to the public inquiry activity of the Industry Commission, the BIE's international benchmarking of economic infrastructure is continuing — as evidenced by our recent waterfront report (PC 1998c) — and EPAC's concern with social issues is a core feature of the new Commission's program. Moreover, there is now a more widely ranging research program than existed under the separate agencies. Much of this work is published as staff papers.

It is also possible to exaggerate the separate contribution of the three agencies. In recent years, there was considerable commonality in their findings and conclusions in those areas where their work overlapped, which it increasingly did.

Governments have available to them many other sources of advice.

The Productivity Commission could scarcely be regarded as having a monopoly within the public sector. The policy departments (including Prime Minister and Cabinet) are all very forthcoming in presenting their views to Ministers, as of course are Ministers' own offices. And most Commonwealth departments have a substantial research capability as well, or could build it (or contract it) if they chose.

It is also misleading to lump the Productivity Commission in with the Treasury as is sometimes done. Although the Commission reports to the Treasurer, it is quite separate from the Treasury Department and has its own independent voice.

The Commission must also compete with the wide-ranging sources of advice from private sector consultancies and think tanks, such as the Centre for Independent Studies, Evatt Foundation, Institute for Public Affairs, Access Economics, Centre for International Economics, ACIL and the many other 'centres' now proliferating at our universities. Then there are the myriad lobbyists and organisations representing particular industries and community interests, as well as individual companies.

If anything, the Productivity Commission's public inquiry processes *facilitate* the competition for ideas among these many parties, whose influence may otherwise be exercised behind closed doors and never be adequately tested.

This also suggests why the Productivity Commission's role could not simply be privatised or contracted out. Its critical distinguishing characteristics of independence, transparency and a community-wide perspective constitute what is fundamentally a public good, which government itself needs to establish.

Governments can and do set up *ad hoc* committees of inquiry or review on key issues. And there has been a variety of them in recent times. Their contribution depends very much on how they are constituted and resourced and whether they can exercise an effective independent role. Some recent ones in the industry policy domain have performed poorly against such criteria; others, like the recent review of the financial system, have performed very well.

How influential?

One potential liability for government in sending references to the Commission, especially on issues where the political stakes are high, is that it will not always like the answer. To be true to its charter, the Commission needs to look at issues on their merits, against economy-wide tests, without second-guessing the politics. It can of course provide options for governments to consider, but needs to be clear about the basis for its preferences. This inevitably means that the Commission's advice will not always be accepted.

It would be misreading the Commission's role, however, to interpret any rejection of its advice as indicating that the institution is of no value to the policy-making process.

A government must make policy decisions based on a range of considerations, including its judgment about what will be acceptable to the public and about the appropriateness of the timing. The Commission's advice is but one input among many to the eventual outcome. Because it is independent and directed at the long-term public interest, it nevertheless plays a significant role in helping governments understand the tradeoffs in different policy choices.

The fact that a government may not initially accept key recommendations in a particular report does not mean that that report has no influence. If we take the PMV and TCF reports (IC 1997a, 1997d) as the most relevant recent examples, a number of the findings and recommendations in both reports were in fact accepted by the Government. And, although the Commission's majority positions on the rates of tariff phase-down were rejected, both the Government and industry agreed to further reductions after the current programs are completed in the year 2000. It is reasonable to ask whether this could have been achieved in the absence of those inquiries. I think not. Indeed, the political pressures building at that time were such that we could well have gone in the opposite direction.

It is also not uncommon for recommendations to be acted on some years later. This may be triggered by a change in government or in the economic climate, or just greater public acceptance of new ideas with the passage of time. The general program of phased tariff reductions that commenced in 1988 under the Hawke government, owed much to a 1982 report on approaches to general reductions in protection on which the Fraser government took no action (IAC 1982). A more recent example is the Government's deregulation of the petroleum industry, which was broadly in line with the recommendations of the Industry Commission's 1994 report (IC 1994a).

A final perspective on the Commission's influence, which has its own irony, is the steady demand for its reports from international agencies and foreign governments. To provide a first-hand illustration, I was recently invited to address a conference on private health insurance in Ireland, where I was astonished to find our report (IC 1997b) being described as a key input to the current review of that country's own health insurance system. Among other examples, the Industry Commission's pioneering work in measuring industry assistance has been picked up by the WTO and APEC and is now adopted in many countries. Our approach to regulation review has been embedded in OECD codes for member governments. And the Commission itself has been advocated as an institutional model for other countries by international agencies concerned with policy reform.

In conclusion

The Productivity Commission is getting on with an extensive program of work, ranging across policy areas of long-term importance to the community. While it has the advantage of well-established processes of transparency and independence, the Commission's output will also be shaped by its new legislation and appointments. These have served to broaden its perspective further and have brought greater emphasis to the adjustment and social dimensions of structural reforms.

Recent political developments demonstrate the importance of dealing effectively with these issues, if generally beneficial policy changes are to proceed. When people are doing it tough and there is mounting pressure for piecemeal policy responses and quick fixes, it is particularly important that we as a society can maintain the basis for a properly informed debate.

I believe that the Productivity Commission's role is integral to this process. While its findings will rarely please everybody, they have the benefit of a robust consultative process in which the interests of the wider community are recognised to be the dominant consideration.

Great expectations: management (and other) lessons from the Regulation Taskforce*

Many of those addressing this conference are leaders of major Public Service departments, with responsibility for large budgets and major policy programs. In contrast, my own organisation, the Productivity Commission, is relatively small and has no executive responsibilities. It also has a special role among public sector entities, with statutory powers to undertake public reviews of government policies and programs and to inform the community about what is at stake in pursuing reforms.

The leadership and management requirements of such a body are therefore likely to differ in a number of respects from those elsewhere in the Public Service. At the same time, the core business of the Productivity Commission — conducting (public) inquiries and reviews — is becoming an increasingly prevalent feature of contemporary policy development, involving the appointment by governments of an array of taskforces and eminent individuals or specialists from the public and private sectors.

Some examples from the last couple of years of such *ad hoc* reviews include Professor Hogan's Aged Care Review, Andrew Podger's Health System Review, the Fisher/Moore-Wilton/Ergas Taskforce on Export Infrastructure, the Biofuels Taskforce, Venture Capital Review Committee, Warburton/Hendy study of Australia's comparative tax burden, Tourism Strategy Consultative Group, Nuclear Energy Review (Switkowski), Agricultural and Food Policy Reference Group, Wheat Export Marketing Committee (Ralph) and, among those in train, the Prime Minister's Task Group on Emissions Trading and the Opposition's Garnaut Review of Climate Change and its Economic Impact.

* Address to the L21 Public Sector Leadership Conference, Sydney, 15–16 May 2007. Gary Banks chaired the Regulation Taskforce. (Co-authored with Ian Monday, who had been seconded from the Productivity Commission to the Taskforce secretariat.)

Some of these dealt with issues for which my own organisation could be said to have had legitimate claims, and some not. The reasons for taking the special-purpose or *ad hoc* review approach, notwithstanding generally higher set-up costs, possibly include a need to achieve an early breakthrough (the Productivity Commission's public processes need time), a wish to specify who is involved, particularly in achieving a blend of private as well as public sector experience (although this can also be achieved through the appointment of Associate Commissioners on particular reviews) and, following the old maxim about Royal Commissions, a desire to avoid 'surprises'.

Regardless of the particular motivating forces, once set in train, *ad hoc* reviews face many of the challenges with which the Productivity Commission has had to grapple over the years, and its experience could provide some useful guidance. However, as I discovered when heading such a review myself, they also present distinct challenges of their own. With this in mind, I have sought in this paper to outline some of the particular lessons that emerged from the Regulation Taskforce, which may be of benefit to other such reviews in the future.

The context

Australia has undergone a major program of microeconomic reform over the past two decades, which has contributed significantly to this country's unprecedented run of economic growth. Much reform has been regulatory in character. It has in many cases been concerned with removing or reforming anticompetitive regulation of various kinds across the economy. The irony is that this era of 'deregulation' has also seen the fastest growth in *new* regulation in the nation's history. For example, at the Commonwealth level, there has been more primary legislation (measured in pages) passed since 1990 than in the nine preceding decades since Federation.

Much of this regulatory inflation has been in response to the heightened social and environmental demands of an increasingly affluent and risk-averse society. For the most part, these demands are legitimate and probably hard for governments to resist. But in many cases they have been addressed through regulatory interventions that have shown more concern for the potential benefits than appreciation of the inevitable costs, and the need to balance the two.

Small business, having least capacity to absorb or pass on regulatory costs, was the first to complain. A Taskforce headed by the late Charlie Bell (CEO of McDonalds) was established in 1997 to address their concerns and, notwithstanding some suggestions to the contrary, many of its recommendations were implemented (Bell 1996). However, the target of cutting red tape by 50 per cent proved elusive and small business remained a vocal critic of regulation in subsequent years, particularly after the introduction of the GST.

Big business also became increasingly vocal, with a particular focus on competition regulation and, most recently, the onerous obligations of the Financial Services Reform Act.

On 12 October 2005, the Prime Minister and Treasurer jointly announced the appointment of a 'Taskforce on Reducing Regulatory Burdens on Business'. Appointees to the Taskforce comprised Richard Humphrey (former CEO of the Stock Exchange), Rod Halstead (corporate lawyer), and Angela MacRae (tax and small business specialist), with me as its Chairman. Our remit was wide-ranging, enabling us to identify reforms to reduce regulatory burdens across all areas of Commonwealth regulation and their intersection with state and territory regulation.

The most obvious challenge faced by the Taskforce was the reporting deadline — with Christmas in the middle it left 3 months for the task. This was compounded by the potentially open-ended scope of the exercise, and the fact that neither the Taskforce nor most of its secretariat had worked together before, and most secondees had had no previous experience working on a project of this nature.

The challenges were made more acute by the high profile nature of the exercise — presented by Government as the means by which it would be able to address business's concerns (Howard and Costello 2005).

The reception by business itself to the Taskforce announcement was ambivalent. Behind the necessary public support for an initiative that was directed at meeting its needs, was a degree of scepticism about what any such review could achieve in the allotted time. At the same time, business leaders seemed encouraged by the composition of the Taskforce, and the way it proposed to go about its task.

In the event, the outcome of the review has generally been regarded as successful, with Government 'accepting' — if not implementing — most of the Taskforce's recommendations. Actions taken comprise many reforms to the stock of regulations, but also to the processes and institutions responsible for new regulation, which had been a particular concern of business and other groups (Banks 2006a, 2006b).

Making the task manageable

The scope of the Taskforce's brief was potentially very wide. It was asked to identify problem areas and solutions from across the entire spectrum of Commonwealth regulation in Australia, including areas of overlap with state and territory regulation.

At first blush this seemed to many an impossible task, especially in a few months. After all, taking into account primary and subordinate legislation and quasi-regulation, there are over a thousand new instruments made each year. And, while the sobering reality is that no-one really knows precisely the extent of the stock of regulation, it is undoubtedly many multiples of the annual inflow.

Clearly, it was not going to be possible for the Taskforce to comb through the entire regulatory morass in any comprehensive way. A more selective or targeted approach was called for. Achieving this, while meeting the expectations of government and business, was going to be crucial to the success of the exercise.

That the Taskforce was asked to identify areas where regulatory reform could provide 'significant immediate gains to business' proved an important escape clause. Rather than scan the body of regulation itself, the Taskforce initially called on business groups to identify priorities from their perspective. The focus in the terms of reference on addressing regulations that were 'unnecessarily' burdensome, provided a second important avenue for narrowing the scope of the task. The Taskforce took from this that its job was not to examine or analyse policies as such, but rather to focus on undue (avoidable) costs associated with their implementation through regulation. It was a critical distinction.

Nevertheless, it was anticipated that, in some cases, the compliance costs would be intimately connected with the nature of the policy approach itself. The Taskforce took the view that, where justified, such areas should not be ignored, but recommended for more detailed follow-up reviews. Similarly, it was clear that in the time available the Taskforce would not be able to confidently make recommendations in all the areas that it considered significant. So an approach that involved early actions where the appropriate course was clear, together with an agenda of follow-up reviews, was an important way of credibly managing the potentially wide range of regulatory problems that business was likely to put forward. The Taskforce further limited the dimensions of its work by excluding from consideration regulations that were still 'in play' or those already subject to effective review processes.

Forging a cohesive project team

Having a team of good people who work well together and are committed to a common objective is crucially important to the success of any such enterprise, particularly one facing severe time constraints.

The mixed record of achievement of *ad hoc* reviews can on occasion be explained by the origins and make-up of their secretariats. The biggest problems typically arise where an appointed review is fitted up with a secretariat drawn from the department responsible for the policy area under review. The dominance of the department's own interests and views can be hard to shake.

Our review started with the considerable advantage of an appointed taskforce comprising four people of an independent cast of mind, whose experiences, skills and inclinations proved highly complementary. We also got on well together, which was a further advantage.

The secretariat was drawn from across government. It included officials nominated by the three 'stakeholder' departments (Prime Minister and Cabinet, Treasury and Industry, Tourism and Resources) as well as one each from the Departments of Health and Ageing and Employment and Workplace Relations. The person appointed to head the secretariat was head of the Office of Small Business within the Department of Industry, Tourism and Resources. In addition, I was permitted to appoint several researchers from the Productivity Commission, including an SES Band I officer to act as the deputy project manager.

The advantage of such a 'whole-of-government' secretariat is that it was able to bring relevant skills and experience, as well as providing conduits for communication with relevant areas of government, without the problems that can arise with a concentration of people from an interested portfolio.

Nevertheless, most members of the secretariat had never worked together, and most had had no experience working in such a setting. It was important to establish quickly a sense of belonging and of commitment to the exercise, over and above the particular interests of home departments. In this I believe we were successful.

A number of deliberate initiatives contributed to the team's effectiveness. A key early decision was to bring the team together in one location, at the Productivity Commission's Canberra office. The Commission's Function Room was commandeered for the departmental appointees and also served as a meeting place for the whole secretariat. This soon created a hothouse atmosphere for discussion and team bonding. In my view, the proximity of team members is absolutely essential for a 'short, sharp review'.

A guiding principle behind a number of operational practices within the Productivity Commission is that ideas must be able to withstand robust internal scrutiny and debate if they are to have any prospect of prevailing externally. Through the course of a project there are regular team meetings at which all members are encouraged to have a say, as well as various other mechanisms to test ideas with the rest of the organisation. This culture of scrutiny was fostered within the Taskforce as well. Debate and discussion within the project team was promoted through daily planning meetings, as well as *ad hoc* meetings on key issues as they emerged. These were in addition to several meetings involving all members of the Taskforce, which served to make higher level judgements and establish directions for the secretariat's efforts.

'Optimising' community participation and consultation

Lack of consultation with those affected by a proposed regulation is often the main cause of poor regulatory design and excessive burdens on business. Government agencies have generally been poor at consultation and this was one of the main complaints of business.

As noted previously, we deliberately chose to rely heavily on the views and information from business in order to do our job. It was essential, therefore, that we got extensive business participation in the review and that we extracted quality information from business. How to achieve this in a tight timeframe was perhaps the biggest challenge of the whole review.

The main elements of the strategy, more or less in sequence, were as follows:

- immediate contact with heads of the largest business associations, to encourage their support and active participation
- immediate advertising of the review and call for submissions in the national press, plus some media interviews to raise the review's profile
- release of an Issues Paper (Regulation Taskforce 2005) and meetings with key individual stakeholders, to obtain views and solicit (substantive) submissions
- a series of roundtables and forums to enable better interaction with some stakeholder groups (for example, small business and the aged-care industry) and more focussed discussion in key areas (for example, social/environmental regulation and economic/financial regulation)
- follow-up interaction on an *ad hoc* basis in response to particular submissions.

The Issues Paper and early meetings helped encourage participation by demonstrating the potential payoff, as well as by providing guidance on the sort of input that was needed. The Taskforce received 150 submissions, most of which were of high quality.

In the Commission's experience, visits to stakeholders during a review and the relatively informal discussions that they entail, can be just as valuable as formal submissions and public hearings (more so, in some cases). The Taskforce visited some 60 organisations within a six week period. As a practical matter, this required some specialisation among Taskforce members, based on pragmatic considerations of geography, area of expertise or interest, and availability. This is not ideal, as much learning occurs through such visits. And some stakeholders will expect to see the whole Taskforce, particularly its Chair. We handled this by reserving certain meetings for all or most members to attend. In all cases, meeting notes were made and disseminated to all members of the Taskforce and its secretariat.

The roundtables and other forums proved to be a valuable part of the consultation process. The Productivity Commission's experience was useful — particularly in reinforcing the need to be strategic and selective. The lesson from some Commission projects is that there needs to be a well-defined target group and set of issues. It is also important to have a clear agenda, which participants see in advance and can prepare for. That way, there is more prospect of an informed discussion that focuses on issues important to the review, and from which useful information and insights can be gained.

Consulting with government

In addition to consultations with business and community organisations, there was also extensive interaction with the Public Service itself. Much of this was through correspondence related to preliminary proposals for reform, but there were also opportunities to speak to senior officials from various departments. The terms of reference specifically asked the Taskforce to consult closely with the Secretaries of Prime Minister and Cabinet, Treasury and Industry, Tourism and Resources. This was discharged through meetings with individual Secretaries in the early stages of the review, and a subsequent meeting with all three Secretaries at the 'early bottom lines' stage, where attention was also given to the proposals bearing on systemic reform.

Producing an accessible document

Contrary to the Government's expectations when commissioning the review, it became increasingly apparent that, to do justice to the response from business, the report would need to include a large number of recommendations. That posed obvious presentational challenges for the report itself. The Government's desire for a 'short sharp report' was shared by the Taskforce, but how short and sharp can a report be when it contains 178 recommendations?

The different character of most of the Taskforce's recommendations meant that it could credibly opt for breadth without depth. Moreover, as noted, in most cases the recommendations had the advantage of business support and departmental acceptance. Where both agreed (and third parties were not affected) the burden of proof was considerably lightened. So we adopted the 80:20 rule, providing the minimum explanation necessary to indicate why a particular reform was advocated. The result was a report of eight chapters and 184 pages.

Given the large number of recommendations, rather than listing them word for word at the front of the report (which would have amounted to some 30 pages), we captured each as a one-line summary, together with its identification number and the page of the report where it could be located. This proved very effective as a quick entry-point to the report, as well as conveying the entirety of the report's bottom lines in a dozen pages. Its utility was affirmed by the Government's adoption of the same format in summarising its response to the report.

Attention to implementation priorities

While these presentational devices helped make an extensive report more accessible and reader-friendly, the more important or substantive means by which the Taskforce accommodated the Government's wish for a manageable agenda, notwithstanding the breadth and scope of our report, was through the clear identification of priorities.

In identifying the priorities, the Taskforce considered the prospective gains, the likely ease of implementation and logistical issues, such as the need to avoid overloading COAG or particular portfolio areas. Its priorities encompassed both specific reforms and proposed reviews, and were listed under thematic headings in the report's final chapter. Ten of each of the most important stock reforms and proposed reviews were then highlighted in the Overview.

'Selling' the report

The attention given to the report's structure and readability no doubt contributed to its success. Effectively engaging readers can usefully begin with the choice of a report's title. Determined that this Taskforce would not squander the opportunity to have a meaningful and useable title for its report, a competition was set in train to see which team member could come up with the best one. In the end, 'Rethinking Regulation' got my vote (and the assent of the Taskforce) for being not only catchy, but also for capturing the central message in the report about the need to address the underlying causes of bad regulation. The attention given to the title has been partly vindicated by its frequent use in official references to the report, and as the title for a number of subsequent conferences and seminars on regulatory reform.

A second presentational feature relevant to our selling of the report was the inclusion of a foreword, signed by the Taskforce members. This again enabled the key messages of the report to be relayed at the outset in simple and direct language. Perhaps more importantly, it also signalled that all four members of the Taskforce had ownership of the report's recommendations.

Briefings and other direct interaction

Beyond the appeal of the report's contents, the scope to influence the take-up of its recommendations within government was limited in some respects, but enhanced in others.

On the debit side, the lack of a public draft meant that there was no opportunity to enlist support for specific recommendations. However, given that many recommendations were based on business submissions anyhow, this was not much of a liability. Moreover, the staged nature of the Government's response meant that, with the release of the report at stage one, there remained scope for business to provide support for the balance of the recommendations ahead of the final response (Costello 2006, Howard and Costello 2006). The release of the report in advance of the Government's final response also enabled members of the Taskforce to talk freely about its contents at various business forums and conferences (Banks 2006a, 2006b).

Perhaps the most effective avenues for selling the report have been directly with government itself. I have already noted the ongoing testing of proposals with departments as the review proceeded, which laid the groundwork for a number of the final recommendations to be supported. This was reinforced and extended through briefings to heads of the three sponsoring agencies (Prime Minister and Cabinet, Treasury and Department of Industry, Tourism and Resources) and other briefings to officials across affected portfolios. In addition, the Taskforce had the opportunity, shortly after submitting its report, to present and discuss its findings with the Prime Minister and Treasurer.

The return of officials seconded to the secretariat back to their home departments provided a direct opportunity to influence the responses of those agencies to the report's recommendations. Indeed, a senior member of the secretariat was able to assist the work of the Interdepartmental Committee responsible for preparing a whole-of-government response for Cabinet consideration.

These experiences have served to impress on me the vulnerability of such reports to the processes and individuals charged with their implementation. It is all too easy for carefully considered proposals to be subverted at the implementation stage by misinterpretation, even if not intentional. This argues for ongoing communication between review and advisory bodies and those responsible for developing government responses or for detailed implementation. I do not underestimate the contribution of those ongoing communication channels in this case to the generally positive outcomes. That said, it is also crucial to the integrity of an independent process, where independence is called for, that the reviewing body not cross the line into policy implementation. The right balance is needed.

Summing up

We are seeing a rising trend in the use by governments of special-purpose 'taskforces' and 'review groups' to assess and make recommendations about contentious or complex policy issues. This is a positive development, in terms of its potential to facilitate greater public involvement and the generation of objective, expert advice — and thus better informed policy decisions.

Whether that potential is realised in practice, however, is not a foregone conclusion. It depends on the ability of the reviewer to get on top of the issues and effectively engage stakeholders in the time allotted to the review. Moreover, to pave the way politically for policy actions flowing from the review, it needs to be seen to be relatively independent, especially where exercising judgement is crucial to its findings and recommendations.

Experience thus far is mixed. Some reviews have been influential in the short term as well as having an enduring impact; others have achieved or resolved little and have been soon forgotten. In some of the latter cases, members of the review groups may of course not be to blame. Sometimes even the best report can get overtaken by events. Sometimes the reviewers' remit is too constraining, or loaded. Sometimes (often?) the amount of time that is allowed for the task is too little, especially to permit adequate consultation when major policy issues are being assessed. Nevertheless, the Taskforce's experience demonstrates that a review group can use the discretion and choices available to it to make the best of the hand it is dealt.

The more important factors, in my view, relate to: team composition and development; strategies for consultation and the testing of ideas; developing implementation priorities, and providing ongoing advisory support in the implementation phase itself.

In conclusion, reaffirming my initial proposition, to the extent that the Regulation Taskforce has been successful in discharging its remit, this can be attributed not only to how the review was constituted by Government, but also to how it was 'managed' by the Taskforce itself. Hopefully, some of what we learned will prove helpful to those contemplating how to handle policy reviews in the future.

PART 5

TRIBUTES

The contribution to public policy of Professor Richard Hal Snape, 1936–2002*

Professor Richard Snape was just 65 years old when he was taken from us. That is not a long life by conventional standards. But measured in terms of his accomplishments, Richard led both a long and exemplary life. And his contribution will endure, not only on the strength of his considerable intellectual output, but also through the influence he has had on policy makers, and on younger generations of economists.

Richard Snape's professional contribution began earlier than most. In 1960, with a first class honours degree in commerce from Melbourne University behind him, he entered the London School of Economics on a scholarship. Under the supervision of Basil Yamey he completed his doctorate in just two years, producing an innovative and incisive analysis of the welfare costs of barriers to international trade in sugar.

It soon became clear that the young Richard Snape was destined for great things when the doyen of the economics profession, the redoubtable Harry Johnson, was stimulated by Richard's thesis to publish an article sub-titled 'Variations on a theme by R.H. Snape'. As Jonathan Pincus has remarked, in one of many letters of support for Richard's recent successful nomination as Distinguished Fellow of the Economic Society of Australia: 'What a splendid launch: Richard's name in the title of a publication almost before he had a publication to his name!'

* Eulogy delivered at the Armadale Uniting Church, Melbourne, 8 October 2002.

The only misgiving that Richard may have had about this brilliant debut, which included highly rated journal articles of his own, was that he thereby acquired the nickname 'Sugar Snape', which stuck with him for some considerable time!

Richard's research and publications record soon transcended even these auspicious beginnings. Returning to Australia in 1962, he took up a position as lecturer at the fledgling Monash University, where he and other young lions of the profession — most with freshly minted doctorates from prestigious overseas universities — soon made the Faculty of Economics and Politics the pre-eminent centre for the 'new economics' in Australia.

Another of those youthful academics was Alan A. Powell, now also an Emeritus Professor. Alan will speak about Richard's considerable achievements at Monash University in an academic career spanning some 35 years.

In the time available, my own remarks will focus on Richard Snape's influence on public policy, and the contribution that he has thereby made to enhancing the welfare of the community — the end purpose of an economist's training.

As a specialist in international trade and the economics of protection, it was natural that Richard Snape would choose to make his first real foray into the policy arena at the Tariff Board. Richard was among a group of young academics — including Max Corden, Fred Gruen, Alan Powell and Garry Pursell — who in the mid-1960s helped the Tariff Board under its new Chairman G.A. (Alf) Rattigan develop a proper economic framework for tariff-making. Bill Carmichael, who played a key role at the Tariff Board in bringing this external expertise to bear, recalls Richard Snape taking the lead in organising a joint letter from academics to the newspapers, supporting the Tariff Board in its attempts to broaden its reporting in the face of staunch opposition from the Government.

This is an early example of what a number of Richard's colleagues have identified as his concern not just for academic rigour, but to use his analytical skills to help produce practical results; and to stand up publicly and be counted.

Richard's next foray into public policy required him to take leave from his academic duties in 1973-74 to be on the Priorities Review Staff (PRS) under the Whitlam Government. The PRS was an institutional innovation designed to bring fresh analytical insights to policy development for the benefit of the Prime Minister and his Cabinet. In his letter supporting Richard for Distinguished Fellow, Michael Porter recalls that Richard took responsibility within the PRS for trade and assistance policy, anticompetitive regulation and energy policy (an area which, under Rex Connor, had particular need of Richard's careful analysis).

The reports of the PRS were highly influential on public debate and policy outcomes during its short life. Its reports on industry regulation and adjustment policy are still influential today.

In the late-1970s, under a different government, Richard Snape was appointed to the Treasurer's Panel of Economists and then to his Economic Advisory Group. Ian Macfarlane, Governor of the Reserve Bank — and, like many of us, a former student of Richard's — has recounted the opinion of a previous Treasury Secretary that Richard's contribution at that time to the debate on the relationship between real wages and unemployment, while not widely recognised, was in fact 'more valuable than anyone else's', and that he had been so impressed that he had attempted to hire him.

This illustrates another facet of Richard's contribution. While rightly confident about his analytical ability and forthright in expressing and defending his views, Richard Snape's main concern was to advance the arguments, not himself.

In subsequent years, Richard returned to the Tariff Board's successor, the Industries Assistance Commission (IAC), as a consultant, often on complex conceptual issues. Perhaps the standout contribution in this respect was a 1985 consultancy for the IAC that he undertook with Gary Sampson, developing a framework for analysing barriers to international trade in services. This work soon reached an international audience and eventually became the foundation on which the General Agreement on Trade in Services was built during the Uruguay Round.

As a consultant, Richard upheld the finest traditions of academic independence. Unlike many so-called independent consultants today, Richard always delivered what he believed to be sound advice, not merely what his sponsor may have wanted to hear. Thus in the mid-1980s when the Trade Minister of the day was seeking to justify a Free Trade Agreement with the United States, Richard produced a robust but inconvenient report, making it plain that such a course would not necessarily be economically beneficial. (Since then, other consultancies have been enlisted on this matter, but Richard Snape's original work is still commonly referred to.)

In this period, Richard also made his mark at a number of international institutions, including stints at the UNCTAD and the World Bank. More recently he also made an important direct contribution to the work of the WTO, as a member of an eminent international panel reviewing aspects of India's import protection regime. Garry Pursell notes:

> Richard was the only economist on the panel and he contributed in key ways to the carefully reasoned findings against the Indian Government's position … which were welcomed by domestic supporters of trade liberalisation in India … and established a very important precedent on this issue at the WTO.

Richard's skills as an editor and editorial adviser for an array of professional journals and publications — including Australia's own *Economic Record* — were also sought by the World Bank. A number of those acquainted with Richard's work as editor of the World Bank's *Economic Review* and *Research Observer* have remarked on the way in which he quickly established the reputation and reach of these new journals. Nicholas Hope has recalled his regrets at the time that Richard could not be persuaded to stay on at the Bank in a more direct policy role, choosing instead to return to Australia.

Nick Hope records his subsequent delight, however, in learning that this had enabled Richard eventually to assume such a role in Australia at the Productivity Commission.

Richard Snape was appointed to the then Industry Commission in 1995 as an Associate Commissioner. He was brought in primarily as a research leader and mentor, but he soon became active and expert in all aspects of the Commission's work. As a result, he was appointed Commissioner in the newly (re-)created Productivity Commission in 1998 and, following my own appointment as Chairman, he was made Deputy Chairman.

Richard initially worked on public inquiries and research with a trade policy or industry assistance orientation. His knowledge in that area, together with his capacity to grasp the essentials of an argument and to understand the circumstances and motivation of 'interested parties', are all reflected in the quality of those early reports, one of which has become a model internationally for how WTO 'safeguard' investigations should be conducted.

In the next few years, Richard headed key national inquiries into important areas of public policy outside the traditional industry assistance domain. These included reports to government on the regulation of international air services, broadcasting, telecommunications (as supporting Commissioner) and airports. Richard brought his customary analytical rigour to each of those reports, as well as a level-headed appreciation not only of the potential costs of market power, but also of the limits of regulation in achieving better outcomes.

Alan Mitchell, writing about Richard in last weekend's *Financial Review*, observed:

> His most recent major reports for the Productivity Commission included airports and broadcasting. The Government has accepted most of the wisdom of the airports report and is still trying to evade the wisdom of the broadcasting report.

As I read those words on Saturday, I could almost hear Richard chuckling in appreciation.

Richard took a keen interest in the Press as a vehicle for promoting policy ideas and influencing public opinion. He delighted in a good story about our reports. And he would get very annoyed if a reporter got it wrong. This, unfortunately, was not an infrequent occurrence. On a number of such occasions Richard gave the hapless reporter a stern talking to.

Richard could be tougher still if the offender happened to be an academic, and indeed if he perceived any lapse in academic standards or conduct. Ian Harper has recounted with feeling an earlier and quite innocent experience of his own, noting 'the rebuke of one's professional senior is carried throughout one's career and passed on to the next generation!'

This brings me back finally to the influence that Richard has had, and continues to have, through the work of those students and colleagues who have benefited from his guidance and collaboration. At the Productivity Commission, Richard's door was always open to junior and senior staff alike; he was always willing to help and his support was always timely. Richard's interest in staff went well beyond guiding their work. He also took a keen interest in their professional development and would encourage those with potential to exploit it to the full.

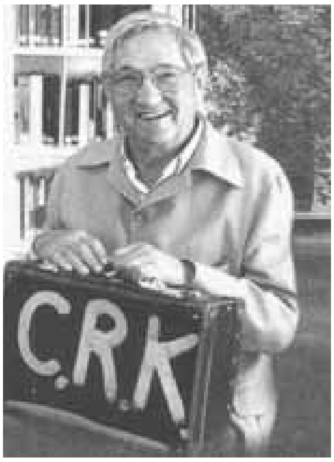
As Philip Williams has remarked from personal experience, Richard's guidance and support for his students was not a temporary thing, but involved a long-term commitment. He writes:

> One of the characteristics of good teachers is that they succeed in transferring their enthusiasm for their subject to their students. It is not so common for this to continue for decades after the student-teacher relationship has ended.

For my own part, it is hard to express how privileged I have felt to have been able to work alongside Richard in common cause over these past few years. And, during his last difficult year, it has been inspiring and humbling to observe Richard's continuing contribution to our work and to have had his unfailing support.

In a sense, those of us who worked with Richard are all his pupils. The standards he set for himself are standards to which we should all aspire. Through his own substantial intellectual achievements and the influence of his teaching, Australia is a better and more prosperous place.

Bert's legacy: a talk to the 'Society of Modest Members'*



Charles Robert 'Bert' Kelly CMG (1912–1997) was a prominent member of the Australian Parliament and a federal government minister. He was influential in urging Australian political parties to move away from protectionist policies. He was well known for his 'Modest Member' and 'Modest Farmer' articles in national newspapers and magazines. The 'Society of Modest Members' comprised parliamentarians with an attachment to Kelly's anti-protection ideals.

Bert Kelly's Modest Member newspaper columns in the late-1960s and early 1970s had a significant influence on my career choice. My first job as a graduate was with the Tariff Board and after a variety of other jobs, I ended up heading its 'descendent' the Productivity Commission.

The Commission was created by the Coalition Government in 1998 as a vehicle to assist it to advance the reform agenda. However, the Coalition has not always been a supporter of economic reform, nor of its advocates (including the Industries Assistance Commission and the Industry Commission — both established by Labor Governments).

When Bert Kelly began his tariff crusade in the early 1960s, his was a lone voice within his party and indeed the Parliament. In his book *One More Nail* (1978), he recounts:

* Parliament House, Canberra, 23 September 2002.

> To say that my message was received with indifference would be an understatement of immense proportions. I used to be able to empty the house quicker than any other Member, and believe me, the competition was not negligible. Lorna, bless her heart, used to be so sorry for me that she used to come over to Canberra if she knew that I had a series of tariff speeches looming. She would then sit doggedly in the Speaker's Gallery (there was never a great demand for seats when I was speaking) and it was some comfort to know that she was there. (p. 77)

However, it appears that Bert received some surreptitious encouragement for his mission. He records:

> Ministers would pass me in the corridors and after a quick look around to see that no one was watching, they would urge me to keep going even if it killed me because I was doing more good than I knew. (p. 84)

Part of Bert Kelly's difficulty in selling reform in those early years was that the Australian economy and community were doing pretty well. Growth was steady, unemployment and inflation low, and the incomes of Australians on average still higher than in most other OECD countries. Australia was at that stage still able to 'ride on the sheep's back'. The terms of trade favoured our primary commodities, and we benefited from a world-wide expansion in demand following the war.

Falling off the sheep's back

But we were riding for a fall. Even in the boom years, Australia's productivity performance was lagging other countries. Over the period 1950 to 1973, productivity growth in Australia averaged 2.3 per cent a year, compared to an OECD average of 3.6 per cent.

Productivity growth is the main determinant of income growth in the long term. Our relatively poor productivity performance was therefore translated into an inexorable slide in our comparative living standards, aggravated by declining terms of trade.

The reasons for our poor productivity performance were not hard to find:

- a fragmented, high-cost manufacturing sector, focussed on the domestic market
- indulgent, inflexible work practices, intransigent and powerful unions and lack lustre management
- outmoded technologies and low rates of innovation and skill development
- bloated public utility monopolies controlling key infrastructure services like power, transport and communications.

As a broadacre farmer selling on world markets, Bert Kelly was well placed to appreciate that these features were not inherent to Australia, but a consequence of an industry development strategy that had become increasingly focussed on impeding or suppressing the forces of competition.

For a small economy, the most important source of competition is international: it defines best practice in costs, quality and technology, and ensures that, at least in the traded sector, our resources are directed to those domestic activities that have the highest payoff. Barriers to international competition were therefore the logical starting point for what eventually became known as 'microeconomic reform'.

This brings me back to Bert Kelly's difficulty in pursuing tariff reform. Like all micro reform it involves unwinding policy measures that support inefficiency. Reform benefits the wider community. But in doing so it threatens the privileges or perceived entitlements of a (vocal) minority. The political calculus is made worse by the front-loaded timing of the losses relative to the benefits from reform, and by the lack of awareness by the potential beneficiaries of what is at stake. Indeed the general community will often find the arguments of vested interests more appealing than those of the reformers. These political difficulties are compounded by a government bureaucracy that often serves to sponsor the interests of particular sectors or groups, and makes it hard for governments to see the big picture.

Bert Kelly understood all this earlier than most. His energies were therefore directed at making the case for reform as simply and persuasively as he could. He staunchly defended the independent role of the Industries Assistance Commission and its successors, as objective sources of advice and information about the tradeoffs for the community in industry assistance.

Reform had a big payoff

I could at this point embark on a blow-by-blow description of tariff reform and the succession of wider microeconomic reforms, but I would not be telling you much you did not already know (or had not lived through). What is worth noting is that protection reform was a necessary precursor to other microeconomic reforms. By exposing firms to increased competitive pressure in the markets for their outputs it created pressure for reform in the markets for their inputs.

Firms and industry organisations that had long been complacent about unproductive work practices and the cost of public utility services, found that they could no longer contrive to pass those costs on. Thus the reforms to industrial relations and government business enterprises, culminating in the National Competition Policy, were a logical outcome of the opening of the Australian economy to international competition.

The reform process by any measure has been a sweeping one. It was successfully implemented only because key industry groups as well as governments became convinced that it would have a substantial payoff. However, that conviction has not always been adequately communicated to the wider community. Concerns and confusion about the reforms and their effects have provided fertile ground for misinformation and misrepresentation, especially in regional Australia. Some think we are worse off, or no better off; others admit to some benefits, but consider that we have had enough reform for the time being. So, *has* micro reform been worth it?

The headline answer can be found in the surge in Australia's productivity growth in the 1990s. Multifactor productivity growth averaged 1.8 per cent a year, one percentage point above the previous trend. This performance outstripped nearly all OECD countries, including the United States.

The sustained rise in Australia's productivity growth cannot be explained away — as some have tried to do — by business cycle effects or increased work intensity, or even by measurement errors. Better macroeconomic management has clearly helped — by bringing a more stable and predictable climate for investment and production decisions.

But *micro*economic reform has been the real driver of Australia's productivity boom. It did this in two ways:

- by heightening competitive pressures and sharpening incentives for firms to be more cost conscious, innovative and productive
- by allowing businesses greater flexibility to make the necessary changes and innovations (particularly through industrial relations reforms).

This clearly contributed to the unprecedented resilience and adaptability of the Australian economy in the face of the financial crisis in key export markets in Asia. The improved productivity performance brought about an acceleration in the average income of Australians from the customary growth rate of 1.4 per cent in the 1970s and 1980s, to 2.5 per cent in the 1990s. One percentage point of extra income growth annually soon adds up. If Australia's productivity had grown in the 1990s at its previous trend rate, households would have been $7 000 poorer on average by the end of the decade.

The benefits were widely spread

Commission research shows that the income gains have been shared fairly evenly between capital and labour at the aggregate level. In other words, business has not pocketed all the gains from the productivity improvements. (The main decline in labour's income share occurred in the 1980s — during the Accord years.)

Indeed, the competitive pressures engendered by microeconomic reform meant that productivity gains have been largely passed on in the form of lower prices. The Commission's review of infrastructure trends over the last decade shows that there have been lower prices to households for services such as electricity and telecommunications, notwithstanding some recent increases (PC 2002f). Less obvious but real benefits to the community have also come from lower prices to businesses (for example in electricity, rail freight, post). At the same time there has been greater cost recovery and less budget damage, which have fed through to lower final prices and taxes faced by consumers.

Of course, not all prices have fallen. Australia's scarce water resources have long been underpriced. This required urgent attention to promote sustainability. Following the move to consumption-based charges, per capita consumption has decreased by some 17 per cent in major urban and regional areas. Our assessment of service trends shows that price reductions have not come at the expense of service quality. For example, case studies indicate that the frequency and duration of electricity supply interruptions declined by up to half.

Moreover, our preliminary assessment of the distributional consequences of price trends post reform indicates that the direct impact on household expenditure has been more favourable for people on lower incomes (PC 2002f). There is also evidence that price trends have generally been comparable across regional and metropolitan areas.

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 National Competition Policy. 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 technology 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.

The Commission's detailed assessment was that country Australia as a whole would benefit from National Competition Policy, although there was likely to be more variation in the incidence of benefits and costs among regions than among more diversified urban centres (PC 1999b).

The saga of auto industry assistance

One of the industries of particular interest to Bert Kelly was the auto industry, which was conceived out of high protection and has fought vigorously, both as infant and adult, to extend and maintain that protection. The Commission has completed its inquiry into post-2005 automotive assistance (PC 2002e) and I can assure you that the industry's advocacy skills are undiminished. (Some of you may be experiencing them at first hand!)

While the automotive industry has always resisted cuts in protection and consistently predicted its demise if tariffs were reduced — whether from 57.5 per cent or 40 per cent or 25 per cent or indeed the present 10 per cent — the reality is that this industry has, almost despite itself, become an advertisement for the gains from protection reform.

Under the pressure of increased import competition there has not only been significant rationalisation of production (allowing greater scale economies), the industry's innovativeness and productivity have increased, and product quality has improved dramatically. This has meant that, while tariffs have fallen and imports have risen substantially, the industry has fully offset this through export sales, so that production has stabilised and is now projected to expand.

The industry has admitted that tariff reform spurred its performance in ways that it had not envisaged in more cosseted times. But it does not see scope for further gains from reducing tariffs and believes that any further liberalisation should be contingent, among other things, on other countries eliminating their protection.

The Commission has listened carefully to the industry's arguments. We accept that circumstances have changed and that with tariffs at 15 or 10 per cent, the (static) costs of resource misallocation are nowhere near what they were. But the burden on consumers of even a 10 per cent tariff remains significant. When the Automotive Competitive and Investment Scheme (ACIS) subsidies are accounted for, we are looking at over $1 billion of support annually. Moreover, the Commission has argued that further tariff reductions would yield worthwhile efficiency gains, including by keeping the pressure on firms and their workers to achieve best practice workplaces.

Looked at the other way, a decision by Government to maintain the assistance *status quo* would not be a helpful signal about the need for workplace change. It could also signal to other APEC countries that we are not serious about the Bogor commitment, and undermine the potential for gains to Australia from APEC liberalisation.

That said, the Commission has carefully considered the adjustment implications of different policy choices and come up with options that minimise the potential for disruptive change to the industry. To the extent that economic modelling can shine light on this aspect, it indicates that reducing tariffs further would make only a marginal additional contribution to ongoing employment reductions in the automotive industry and employment in all regions would continue to grow. Indeed the adjustment issues for this industry are less significant now than ever before, with rising skill levels improving the mobility of auto workers, and less regional dependence on the industry for jobs and income.

You should not be misled, therefore, by the orchestrated campaign in Victoria in which local governments and local newspapers are predicting big job losses from further assistance reform. These 'estimates' have been drawn from a so-called 'model' that has never been made available for external scrutiny — including by the Commission (despite our best efforts). A better litmus test of the regional implications of reform is the City of Geelong's support for the Commission's option of reducing tariffs to 5 per cent in 2010 (with some further ACIS support to facilitate it) — a marked contrast to its position during the last inquiry.

Further reform challenges

The auto industry's transformation can be seen as a reflection of the transformation of the Australian economy itself. In the past two decades our economy has become far more open and competitive, more specialised and productive, more adaptable and innovative; in short, a more dynamic economy, much better placed to meet the exigencies of globalisation.

Microeconomic reform — starting with the Modest Member's quest for some rationality in tariff policy — has had much to do with this transformation. But it would be idle to believe that the reform process had reached its conclusion, including on industry assistance. For example, I imagine that if Bert Kelly were writing today, he would express satisfaction with the substantial overall reduction in import protection, but he would be drawing attention to the remaining assistance peaks — and his mate Fred would be complaining not only about the level of support for autos, but the even higher rate of support for TCF. Our Modest Member might also be urging us to go further with general tariff rates, rather than holding them at 5 per cent on questionable budgetary grounds.

Being also a Modest *Farmer* he would no doubt be looking critically at the handouts to the dairy and sugar industries, and wondering out loud about their costs and their efficacy in securing competitive viability.

As a stickler for public transparency in industry assistance matters, he might raise concerns not only about those decisions, but also about the emerging trend to *ad hoc* assistance for particular firms, such as:

- the lack of clarity about the criteria for making a recent $35 million cash grant to Mitsubishi
- the support for domestic production of ethanol
- the inter-state bidding wars for investment projects, which are at best zero-sum games, but have so little transparency that it is impossible to assess their impacts.

The other key area of micro reform — National Competition Policy — is also still a work in progress. Recent reviews by the Productivity Commission of pro-competitive regulation of infrastructure services have found significant gains, but have also identified a looming danger of regulatory overreach, which could seriously weaken the incentives to invest in long-lived infrastructure projects (PC 2001b, PC 2002d). The Government's recognition of this in its recent response to the Commission's report on the National Access Regime is a very positive development.

When it comes to investigating reforms to improve the performance of Australia's social infrastructure — its schools, hospitals and community services — we have hardly begun to scratch the surface. Social infrastructure is a large and growing part of the economy — some 10 per cent of GDP — and the work the Commission is coordinating for the inter-governmental Review of Service Provision shows wide disparities in performance across and within jurisdictions.

In those areas, as well as in dealing with the important environmental challenges facing this country, the use of market incentives — property rights, prices and choice — can play a crucial role in getting better outcomes.

However the special interests and sense of entitlement that have made microeconomic reform difficult in the industry domain, are no less evident in the social and environmental domains. Moreover, in areas like education and health, access and equity issues loom larger and social sensitivities are greater.

So the need for ongoing reform, and the challenges of achieving it, remain substantial. The Productivity Commission, like its forebears, can help governments identify appropriate reforms, by laying out the costs and benefits of different policy choices. Through our public processes, we can also help promote community awareness about the need for change.

At the end of the day though, it is *your* ability and willingness to take the case for reform to the electorate that will determine its success. In this respect, Bert Kelly's example remains an inspiration for what Members of Parliament — whether modest or not — can achieve.

Building a career on solid foundations: advice to new graduates*

I am honoured to have this opportunity to speak to the many new graduates from the College of Business and Economics at my Alma Mater, the Australian National University (ANU). I had forgotten how exciting a day it is at a university campus when graduations are in progress. Indeed the excitement has communicated itself more widely throughout Canberra.

It is 34 years since I last wore academic robes at my own graduation ceremony at the ANU, but I have maintained connections with the university over the years for which I am very grateful, and indeed this is one of the benefits of studying at such a great institution.

When I graduated in 1974, my fellow graduates comprised mainly people with degrees in economics. Thirty four years later, the majority of you have qualifications in business, commerce or other commercial studies. I won't hide the fact that this is a source of concern to me, and indeed to the Productivity Commission, as an employer of economic graduates! Such graduates are the life blood of our organisation. They generate ideas and bring skills and enthusiasm to its work, which have made a significant difference over time. Indeed, my own first job as an economics graduate was at the Tariff Board, a distant ancestor of the Productivity Commission, for which I am currently the Chairman.

But I have to acknowledge that some shift in the pattern of study has been inevitable, and indeed desirable, given the significant changes in our economy and society over recent decades, and changes in other countries as well.

Australia in the 1970s and 80s was in great *need* of well trained economists! We had seen our economy deteriorate over preceding decades to the point where we had fallen from having the highest per capita income in the world, at the dawn of the century, to 18th position by the late-1980s. This was a consequence of poor policies and bad regulation. These had isolated us from world markets; they had sheltered inefficiency; they had weakened incentives for innovation and skill formation and,

* Conferring of Awards ceremony, College of Business and Economics, Llewellyn Hall, Australian National University, Canberra, 18 July 2008.

as consequence, had kept Australia's productivity growth significantly below the average for the OECD and reduced the relative living standards of Australians.

So for many young Australians in the 1960s and 70s, studying economics and contemplating a career in government was a natural choice, one that responded to the problems and opportunities of our economy and society in that era. Those graduates in turn contributed to the momentum for reforms in the 1980s, the opening up of our economy to foreign goods, services and capital, and the stimulation of competition and enterprise generally, such that Australia's economy and its performance have since been transformed. Today our per capita income has risen again to 6th place in the world.

That is not to say that Australia's, or especially the world's, economic policy problems have been solved! On the contrary, today we must confront such major long-term policy issues as greenhouse, population ageing and its impacts on workforce participation, not to mention the present fallout from the sub-prime crisis in financial markets. These and other challenges reveal an ongoing need for skilled policy makers, advisors and researchers.

But that said, we have today a more vibrant, evolved economy, offering opportunities for highly trained graduates not only in economics and in government, but also in the full range of disciplines relevant to our economy — in business, commerce, accounting and related fields — where positions in the private sector are abundantly available that did not exist three decades ago.

The corollary of this expanded opportunity and diversity — both in Australia and overseas — is that the career you can look forward to is no longer as static or 'path dependent' as it was when I completed my own degree all that time ago. Graduates of my generation, and those that came before me, would typically join a firm or organisation for life. In my own organisation we have recently seen a spate of retirements, with many of the individuals concerned having worked there for over thirty years. When I tell the new graduates this they look incredulous or horrified! Few among them would contemplate staying in an organisation, even one as satisfying to work at as the Productivity Commission, for longer than five years or so.

My own case is somewhat unusual. After a career spanning three decades I am back at the institution I first joined as a graduate. In between, I spent many years working overseas, as well as in a range of other organisations and positions in Australia. Today however, we are seeing considerable turnover and mobility generally, both between the public and private sectors and within each sector. There is also more scope to change course in one's specialisation, or even one's profession, these days.

And there is the opportunity to receive ‘top up’ skills or new skills, either at a TAFE college or at a university such as this.

This is all to the good of the individuals concerned and of our society. But it needs to be recognised that it is also a more demanding and competitive environment facing graduates today than ever in the past. There are no longer any ‘sheltered workshops’, either within the public or private sectors. Whatever profession or position you choose, how well you do will depend, more than ever in history, on your own performance; not whether you happen to be male or female, or who your parents are, or what school you went to.

Though I should say, especially today, that what *university* you went to can make a difference! And there is no better start, I am sure many here will agree, than having a degree from the Australian National University. But even then the important thing is not the name, but the substance of what you have managed to learn in your time here.

So with these opportunities and challenges awaiting you, the best that I can do for you today is to offer you the following seven tips, based on my own experience over the 34 years since I was last sitting where you are today.

First, do not be daunted by any early setbacks

When I joined the Tariff Board as a graduate, anxious to make use of my newly honed skills in economics and econometrics, I was initially assigned to provide research support for a visiting economic consultant from the United States, who I will refer to as Dr W. Now Dr W was a lovely man, but it turned out that he was a charlatan. He employed me in a variety of tasks, the relevance and utility of which, even as a young 21-year-old, I soon began to question. In the event, after a few months, following a minor skirmish with the law, Dr W was forced to return to the United States to avoid a messy legal process. On his departure, he assured the senior people in my organisation that he had completed the project for which he had been hired and that he had left all of his results with me.

Imagine my astonishment, therefore, having not seen any of this material — in fact I believe none existed — when the head of my division came to my room and asked me to hand it over! It was not easy to convince him that I had no knowledge of it, without also raising suspicions in his mind, probably justified, that I had been wasting my time for the previous three months. So when I sit down now for my first talk to the latest batch of young graduates, as head of my organisation, I cite this story against myself as living proof that it is possible to recover from a very bad start!

Second, seek out mentors

I hasten to add that I do not mean someone like Dr W! Indeed the best mentor for you may not be your immediate supervisor or boss. What you need is someone who is clearly successful, who you can observe and learn from in building a successful career yourself.

The best mentors are not only technically skilled people, but also those who are held in particularly high esteem within their organisation for their values, their ideas and their conduct in the workplace. A person with qualities such as hard work, commitment, open and friendly dealings with colleagues, and with courage and integrity on difficult issues, will be a role model which, if emulated, will stand you in good stead throughout your career.

Third, learn to be an effective communicator

Many extremely clever, well-trained people never make their mark in life because of a lack of ability to communicate well. Above all, it is important to work hard at your *writing*. Other communication skills will develop naturally in time as you gain experience and confidence. But writing well demands conscious effort and attention.

By writing well, I do not mean just writing grammatically, but also structuring an argument cogently, expressing your meaning clearly, focussing on the essentials of the case you are making and, ultimately, engaging the reader and making that person want to finish reading what you have to say.

Good writing is important not just when writing a paper or a major report; it is also important when you are seeking to communicate through a letter or, much more common these days, an email message.

It would be nice to believe that these skills will have been acquired at school or university. Unfortunately, from my experience that is rarely the case, even in an institution as good as this one. Therefore, a key post-graduate skill that you need to acquire is good writing, and ultimately effective communication. Acquiring those skills early will pay dividends throughout your entire working life.

Fourth, be open to criticism of your performance

Welcome it; embrace it! Of course this is easier if such criticism is offered constructively and, ideally, sensitively. But even when ineptly or badly delivered, it can be very valuable to you, if you approach it with a positive attitude. In fact the more you show you can accept critical feedback, the more it will be offered. And the more you respond to it by changing what you do, the less need there will be for it later in your career — and indeed the better your career will have been for it.

Compared to when I first embarked on a career in the early seventies, these days there are more structured opportunities for you to receive appraisal of your performance in the workplace. In the Productivity Commission, for example, such opportunities occur regularly every six months. My advice to you is to seize the opportunity presented by such regular appraisal sessions.

Fifth, take the bad with the good

Do not expect that every task you are given will be as fulfilling, stimulating and suited to your undoubted abilities as you may wish. The way you treat the more onerous or mundane tasks that will inevitably come your way as a newcomer to the workplace, provides an important signal to your managers and supervisors about what you are made of, and your ability to do more challenging things.

When I was a young research economist at the GATT in Geneva — the predecessor of the WTO — what turned out to be my biggest break was the opportunity to do my branch's most menial task; namely, transcribing editorial changes to the organisation's annual report that emerged from a painstakingly slow drafting discussion among my senior colleagues. However, I persisted in that task, those senior colleagues soon got to know me and eventually to trust me, and before long I found myself co-authoring reports with them. So the moral is, try to do your best even on the worst jobs, and eventually some of the best jobs will become yours.

Sixth, learn about the bigger picture for your organisation

As a young graduate commencing in your first job, you will inevitably be a small cog in a much larger machine. Understanding how that machine fits together — and your organisation's place in the wider world — will help with your own tasks and help you to put things in perspective. It will also give you a sense of where your best contribution may lie over time within the organisation. And it will signal to senior people that you have a more corporate or strategic view, which is one key quality for advancement.

Seventh, stay in touch with your university friends and colleagues

University life provides you with, to use economist's jargon, 'intellectual capital'. But it also provides you with, if I can use further jargon, *social* capital. Maintaining this network of friends and colleagues will enrich your own experiences of life and work, and may open up unanticipated opportunities. The reason, as should be obvious here today, is that your fellow students will end up doing many different things and will be located in many different parts of the world.

So remember: you are graduating from one of the world’s leading universities. If you now successfully build on this important foundation as you enter the next phase of your lives, the world itself will be your oyster.

Congratulations once again on your achievement. I wish you well in all that follows.

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