Microeconomic reform: beauty or the beast?

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The history of economic reform in Australia tells us that worthwhile policy changes have rarely been easy to achieve. Reforms which are in the enduring interests of the community as a whole, inevitably impose adjustment costs on some of its members. They also threaten established privileges and perceived entitlements, some of long standing. Vocal opposition from those who benefit from the status quo, together with a more general fear of change itself, have been powerful forces of resistance.

It is therefore not surprising that advocates of reform — and institutions such as the Productivity Commission (and its predecessors) charged with assessing existing arrangements and proposing better alternatives — have themselves come under challenge. When I addressed a CEDA forum in Brisbane last August on the topic *Why have a Productivity Commission?* I indicated that such criticism 'comes with the territory'. Nevertheless, it was particularly important at that time to respond to misrepresentations of the Commission's role and work, and to explain how the Commission's processes can help all governments find ways to improve Australia's productivity and living standards.

Today I want to move on and concentrate on some key issues in sustaining the reform process itself. I do so because concerns now evident in the community about the effects of change, and a desire for greater stability and security, could derail or block reforms which are to the overall benefit of the community.

We face a critical conjuncture. Ironically, at a time when evidence of the pay-offs from past reform efforts is mounting — and when, as we grapple with the aftershocks of the Asian 'meltdown', the importance of securing a stronger and more flexible economy has never been more obvious — there is a mood to stop or turn back the clock, rather than build on our achievements. This is as evident in the debates about tax reform and industrial relations, as it is in the areas of national competition policy and industry assistance.

While resistance to change is understandable, the consequence of stopping or reversing reforms necessary to enhance Australia's productivity, would be a progressive decline in the relative living standards of Australians. In a changing world, it is only by being adaptable and productive, that Australians can achieve real security in their workplaces and regions.

Challenges to reform

Much of the resistance to reform stems from disquiet about the effects of change and a heightened sense of uncertainty about the future. Many are worried about jobs and job security. Some in rural and regional areas see their services declining and the viability of their towns under threat.

I suspect that most people don't know what the underlying causes of these changes are. The tendency is just to blame it all on 'government' — and economic reform in particular. Thus there are demands for governments to slow down or halt microeconomic reform, or to take action to ameliorate or reverse what are perceived to be the adverse consequences of change.

Another challenge to the reform process is the perception that, after ten years or so, it's been 'all pain and no gain' for ordinary Australians. This has also been the subject of academic debate. Some analysts claim that the gains are inherently small. They say that they don't justify the adjustment costs involved and argue that compensation has been inadequate for those people adversely affected.

If nationally beneficial reforms are to proceed, we need to meet these concerns and criticisms head on.

An essential part of this is to continue explaining to the community why reform has been undertaken, what the benefits have been and why further reform is necessary. Political leadership is critical in this regard. And the Productivity Commission is specifically charged with helping governments explain the whys and wherefores of reform.

The second task is to recognise that the *way* reforms are evaluated and implemented is vital to achieving good outcomes. Policy choices need to be based on the best available information and analysis of the costs as well as the benefits of specific reform proposals — not just for particular groups, but across the wider community and economy. Understanding the adjustment dimension of reforms is part of this, and is again an area where the Commission is contributing.

Debunking some myths about reform

The hostility towards reform that has developed in some sections of the community has been compounded by misunderstandings and, at times, misrepresentation of the nature and role of microeconomic reform. There are a number of urban, and I might add, rural, myths that need to be confronted if there is to be a more informed and constructive community debate.

Myth 1: Stopping reform would ease pressures for change

Microeconomic reform has clearly become a lightning rod for discontent. But if one stands back a little, it's clear that reform is only one among many sources of economic and social change affecting the community.

The changes occurring in the Australian economy about which some people complain — as well as the favourable effects of change about which much less is heard — are driven by a range of forces, both domestic and international. Key drivers include the introduction of new technology, global shifts in the competitiveness of industries and fluctuations in the business cycle.

Many of the changes are 'people driven', as reflected in shifts in spending patterns due to demographic trends (including the ageing of the population), higher educational attainments and job aspirations, and changing community values and attitudes (such as towards working mothers and extended shopping hours).

To take one obvious example, the dramatic fall in the cost of computing power over the last 30 years has obviously been a boon to consumers and business and has enhanced our quality of life. But it has also seen the demise of typing pools and routine clerical functions — and forced people to upgrade their skills.

Although it is common to see reforms such as tariff reductions copping the blame for job losses across the economy, our research has shown that reduced trade barriers have not been a major contributor to increasing inequality of earnings or to unemployment over the last decade and a half. A major study for the USA, by William Cline at the Institute for International Economics in Washington, found the same thing. The wage and employment effects of changes in trade barriers in Australia have been overshadowed by technological changes requiring more high skilled labour, and by other developments such as adverse shifts in world trading conditions for primary commodities.

It would be foolish to believe that the diverse pressures on people's lives would evaporate if reform were stopped or reversed. Indeed, stopping reform could exacerbate those pressures. Without further improvements in the operation of the labour market and training systems, for example, it would surely be harder for enterprises and their employees to adjust when technological and other pressures require people to change jobs and acquire new skills.

This is a point not lost on even the most vocal opponents of reform. While decrying policy changes which adversely affect them, most look to government to accelerate reforms in areas which will benefit them. Few, for example, would oppose the introduction of greater competition in stevedoring, to help ensure that the benefits of waterfront reform are passed on to users.

When governments attempt to shield selected industries or groups from adjustment pressures, this shifts the burden of adjustment to other Australians. For example, acceptance of overmanning in public utilities may ease the adjustment burden on some workers, but it would entail a continuing burden on taxpayers, less competitive cost structures for business users and higher prices for consumers, including low income families.

Myth 2: Reformers have unlimited faith in 'the market'

Characterising microeconomic reform as the product of unthinking devotees of market forces is a caricature which confuses means with ends, fails to recognise how market incentives have been introduced and deliberately omits an important part of the reform agenda.

Microeconomic reform does not involve slavish adherence to market forces. Competition, deregulation and privatisation are legitimate and powerful tools in the reform armoury, but they are not objectives in themselves. Nor should they be used indiscriminately.

The ultimate objective of microeconomic reform — as it should be for economic policy generally — is to improve community living standards. It does so by enhancing choice and improving incentives for people in all walks of life to be more productive. Higher productivity and growth are essential to support higher wages and improve job prospects. They also underpin community expenditures on health and education and the maintenance of social support mechanisms, including for those most vulnerable to change.

The origins of microeconomic reform lay less in theoretical nostrums than in the gradual realisation that, over the years, key government policies and practices were preventing Australia from reaching its economic potential. Examples of policies designed to relate the incentives facing people to their productivity have included:

- the move to require public utilities and other government businesses to adopt a more commercial focus;
- winding back unnecessarily prescriptive regulation of business and labour markets;
- reducing import protection; and
- opening previously closed markets, such as airlines and telecommunications.

At the same time, there needs to be care in assessing how (or whether) market incentives are introduced into some activities. The search for more efficient and effective provision of health, education and housing, for example, has to recognise the value the community places on access for those on low incomes to services of acceptable standards. The Commission's inquiry into nursing homes is a case in point.

Similarly, the Commission has emphasised a case-by-case assessment of the merits of privatisation. It is necessary to weigh the potential benefits, such as the spur to better performance, against the potential costs that may be involved — for example, in constraining the exercise of market power where a natural monopoly is privatised.

The myth makers choose to ignore the fact that reform is as much about developing and implementing *appropriate* regulation as it is about deregulation. Take two examples.

- *Competition policy* is much maligned in some quarters for allowing the unconstrained play of market forces. Yet a major thrust of competition policy — as enshrined in the Trade Practices Act — has been to control the excesses and concentration of market power that endanger smaller yet efficient producers to the ultimate detriment of consumers, and to extend those powers to previously sheltered sectors of the economy.
- Although there has been substantial deregulation in Australia's financial sector, the need for *prudential supervision* remains unchallenged. Following the Wallis Review, the establishment of a single prudential supervisory authority for all deposit taking institutions, life and general insurance companies and superannuation funds, is hardly unfettered market rule.

Indeed, regulatory and institutional arrangements which establish a foundation of law and property rights are paramount in enabling markets to work effectively. Such rules underpin the division of labour, the exchange of goods and services and technological developments, that have been the keys to economic progress. As the World Bank put it in 1997, somewhat presciently as it turns out:

> Markets rest on a foundation of institutions. Like the air we breathe, some of the public goods these institutions provide are so basic to daily economic life as to go unnoticed. Only when these goods are absent, as in many developing countries today, do we see their importance for development. Without the rudiments of social order, underpinned by institutions, markets cannot function.

Myth 3: Reform as bean counting

One source of confusion in public perceptions about microeconomic reform is that not everything done in the name of microeconomic reform is genuine reform. Nowhere is this more evident than in the mis-identification of reform with cutbacks in public expenditure.

Microeconomic reform seeks to improve efficiency and this may lead to reduced expenditure. But the reverse need not hold. Budgetary considerations alone are unlikely to provide a basis for sound structural reforms. For example, the 3 per cent import duty imposed as a revenue measure on business inputs previously imported duty free under the tariff concession system, had little to do with improved incentives.

Similarly, the R&D tax concession has helped address what otherwise would be underinvestment in research, and thus its expenditures have a logic which does not extend to business tax relief on other investments. It is surprising that this was not made explicit in the Ralph Review. That said, the design of the tax concession is not as effective as it could be in stimulating genuinely new R&D. Ways of improving it were suggested in the Commission's April 1998 report on *Telecommunications, Equipment Systems and Services*, which is still with the Government.

To give another example, in its current inquiry on the impact of competition policy on rural and regional Australia, the Commission is hearing how some local councils have mistakenly adopted lowest cost bids when contracting work, when these have actually represented poor value for money taking quality and reliability into account. And, in some cases, full cost recovery charges for inappropriate infrastructure investments have been imposed when asset values should have been written down.

Myth 4: Microeconomic reform is without social conscience

In his recent article, 'The future greeters', Paul Kelly speaks of

> ... the biggest and most dangerous myth in our current political dialogue — that economic efficiency leading to economic progress, and social inclusion leading to a more caring and tolerant society, are incompatible. This assumption has almost become an article of faith in some quarters. The slogan is entrenched — if you believe in the market, you don't believe in society. It is damaging because it is false and its consequence is to weaken economic liberalism or social inclusion or both.

Societies cannot share what they don't produce. By generating higher levels of national income, reforms directed at improving the productivity of the economy provide the wherewithal to fund the access and equity objectives of governments in education, health and other key services.

That perhaps is an obvious point. But what is becoming more evident is the variety of ways in which reform processes are helping governments better clarify and meet social objectives. For example, in initiating the collection of comparative data on the performance of government service provision — in which the Commission performs a secretariat and research role — governments have been required to specify better their social policy goals. And the public debate generated by publishing performance indicators has contributed to a focus on the quality of outcomes in areas such as education and training, health, justice, emergency management, community services and housing.

Microeconomic reform also involves identifying more efficient and effective ways of achieving quality outcomes for people. Providing more and better social services for the same or less outlay is the essence of efficiency and of social conscience. Failure to embrace efficient provision of services is to cheat not only taxpayers, but also the most vulnerable members of society.

Efficient and equitable delivery of social services and support requires effective targeting and transparent funding. Thus, governments are gradually moving to fund community service obligations from the budget rather than through hidden cross-subsidies embedded in the pricing structures of government business enterprises, which typically penalise business users. Such transparency is often resisted by the beneficiaries who fear, not without cause in some cases, that public exposure could see their assistance cut. But explicit budget financing allows the justification for such support and its level to be assessed against other social expenditures.

Myth 5: Reform hasn't delivered

The last of the myths I want to address is that reforms undertaken over the last decade or so haven't been worth the effort. The facts are that while it is hard to disentangle the separate contribution of reform to changes observed in the economy, there *is* a growing body of evidence of substantial and tangible gains from properly implemented reforms. And that evidence is broadly consistent with initial expectations.

National productivity has clearly been on an uptrend in the 1990s. Multifactor productivity growth in the market sector has been around 2 per cent or more a year, compared with an historical average of 1.5 per cent a year. Labour productivity has shown a similar improvement and has been increasing recently at around 3 per cent a year. This productivity performance has been stronger and more sustained than could be explained on the basis of recovery from past downturns or simply as a correction to longer term trends. Over this period there has been no similar pattern in OECD productivity growth — supporting the conclusion that our performance reflects domestic influences. This is important, because even a small improvement in national productivity growth, if sustained, can have a substantial cumulative effect on national output and living standards. For example, a rise in productivity growth of ½ per cent will generate 30 per cent additional growth in real incomes within 40 years.

Looking below the aggregates, gains for consumers and industry alike are apparent in a range of areas. These were detailed by the Commission in its first annual report. To take one example, in the five years to 1996-97, real electricity prices to consumers fell by 10 to 30 per cent, depending in which State or Territory one lived. Business users, who previously bore the brunt of cross-subsidising residential consumers, fared even better in most States.

Likewise, telephone calls have become noticeably cheaper, particularly in the competitive long-distance market, with real prices dropping 23 per cent in the five years to 1996-97. International benchmarking recently completed by the Commission puts us in the middle of the better performing OECD countries, though with some room for further improvement.

Within workplaces, we are seeing a gradual erosion of the costly and unproductive work arrangements that proliferated under centralised prescriptions within our previously sheltered economy. These developments have been documented in the Commission's recent, detailed studies of work arrangements in stevedoring, meat processing and black coal mining. A further study of work arrangements in the construction industry is in progress.

The upshot of such reforms is an economy which is becoming increasingly productive and adaptable. Whether this will allow us to continue to ride out the turbulence and depressed activity in the Asian markets, with which we were becomingly increasingly connected, remains to be seen. But it is hard to imagine that we could have done as well as we have to date, *without* the economic reforms of the past decade or so.

What has been achieved so far provides encouragement to press on. But we also must be conscious of the need to design and implement reforms effectively.

Dealing with adjustment problems

A particular difficulty for policy makers is that reforms that are needed to make the Australian economy more adaptable — and thus more resilient in the face of change — can give rise to adjustment difficulties of their own. It may take time for people to find alternative employment and for capital to be redeployed. And sometimes this process can be protracted.

Governments accordingly have a key role in facilitating adjustment so as to reduce unnecessary costs in the transition and to help people adjust. Community support for reform efforts is also more likely to endure if adjustment issues are handled well.

I would be the last to pretend that there are easy answers in this area. It is hard enough even knowing whether one is asking the right questions, but some key ones that have preoccupied the Commission include:

- Is the general social security system, which provides a minimum level of income support, adequate for the particular adjustment task?
- Is there more that government could do to change existing policies which may be impeding efficient adjustment?
- Phasing of reform has been a preferred option. But does it simply delay receipt of the benefits and therefore increase adjustment burdens elsewhere in the economy?
- How effective is broad-based reform in providing offsetting benefits to groups adversely affected by a particular reform?
- What are the pros and cons of a more targeted or tailored approach to adjustment problems?

The complexity of such issues demonstrates the importance of processes and institutions which can generate the best possible information for governments on which to base policy choices and explain the basis for those choices to the community.

The Commission is currently investigating the impacts of competition policy and related reforms on regional Australia. It is assessing the extent to which communities are sharing in the benefits of reform and is trying to identify measures that could increase the flow of benefits or reduce the costs. An important element of the inquiry, which will issue a draft report next month, is to identify the drivers of change in regional Australia and to assess their relative impacts.

The questions of how Australia is adjusting to change, the effectiveness of existing labour market programs in easing the burden on individuals and what more could be done to facilitate adjustment, all feature prominently on the Commission's research program. In order to stimulate public discussion and improve our understanding of these important issues, the Commission has initiated a Structural Adjustment Policy project. We have asked a range of prominent policy analysts and researchers to prepare papers for discussion at a workshop to be held in Canberra in May.

The reality is that, like other countries, Australia faces continuous change and must adapt if living standards are to improve. Microeconomic reform remains a key mechanism for further tapping the economy's potential.

The reform imperative

In gauging what needs to be done, a convenient checkpoint is the *Stocktake of Progress in Microeconomic Reform* that the Commission was asked to undertake back in 1996 by the newly elected Howard Government. It identified some 150 items requiring action or further review across all markets and key regulatory areas.

Three years on, there has been significant progress, but some key reform needs identified in that report remain to be addressed. For example:

- The necessary transformation of our industrial relations environment to facilitate more adaptable and productive workplaces, with sustainable job creation, has been further facilitated by the Workplace Relations Act. However, some fundamental issues — such as developing less intrusive safety net provisions, and the interaction of the tax and social security systems on work incentives — remain to be worked through.
- The need for broad-based taxation reform is being addressed sooner than envisaged three years ago but, despite extensive public debate and an election fought on the issue, well known political obstacles remain.
- Processes for reviewing Commonwealth regulation which affects business or restricts competition have been enhanced, but our work shows considerable scope for improvement in departmental compliance.
- There is an unfinished agenda in the traditional areas of industry assistance. Even low tariffs constitute a burden on user industries. There continue to be demands for antidumping and emergency protection measures and firm-specific investment incentives. Because these have wider economic consequences, recent developments in the provision of such assistance will need to be monitored closely.

– That said, the Government's response to the Commission's report on safeguard action for pigmeat producers was a timely reaffirmation that adjustment, not protection, is the only effective path to world competitive industries.

- Economic infrastructure under government control has rightly been a focus for recent reform efforts. Given its importance, the complexity of the reform issues and the backlash in some quarters against the perceived distributional impacts, monitoring progress is a core task. The Commission's draft report on rail reform, to be released tomorrow, finds that past reforms have still not delivered the commercial environment needed for rail to perform to its potential.

When it comes to investigating reforms to improve the performance of Australia's *social* infrastructure — its schools, hospitals, 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.

Effective education and training systems are critical to Australia making the best use of its human potential, including the capacity of people to adjust in a rapidly changing world. But it seems to me that too much of what happens in education is still driven by the providers, not by those with the biggest stake in the outcomes. Indeed, attempting to get basic comparative data on school learning outcomes has been like pulling teeth. And the West Review's conclusion that student choice needs to play a larger role in university funding caused great consternation in some parts of the tertiary sector.

The health and community services sectors have a direct bearing on the quality of life for most Australians and will absorb increased resources as our population ages. Yet the health system, while still performing relatively "well" in aggregate spending terms, has some obvious, but still unresolved, internal tensions. The Commission's report on private health insurance provided a preliminary diagnosis, but its own prescriptions — given the constraints of that inquiry — were only palliatives. Options for systemic reform need to be thoroughly examined.

Improving the performance of Australia's social infrastructure will arguably be harder than in the areas that absorbed so much attention in the 1980s and 1990s. Access and equity issues loom larger and social sensitivities are greater. This places a premium on processes that will help governments and the community work their way through the complex issues and to map appropriate courses of action.

In sum, while Australia has come a long way, there is too much at stake for us to become complacent or, worse, to attempt to turn back the clock. That said, community support or acceptance of reform is clearly a critical pre-condition for further progress. That will require renewed efforts not only to explain the reasons for and benefits of reform, but also to ensure that policy-making processes themselves are well informed by an understanding of the impacts. The Productivity Commission — with its ability to provide independent assessments of the economic and social tradeoffs for the community —will be doing what it can to assist governments in both these important functions.