Competition: the best price regulator

Gary Banks
Chairman, Productivity Commission*

A few weeks after the introduction of the GST, an article in the *Australian Financial Review* observed that the 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 GSTs introduction to Armageddon.

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* Presentation to CEDA, Hyatt Regency Hotel, Perth, WA, 21 November 2000

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 GSTs 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 USA. 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 WA'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. There were also 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. (I hardly need add that this particularly disadvantaged WA 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; 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 IAC) to successive waves of general reduction in tariffs, combined with the dismantling of quantitative restrictions. It is salutory to recall, given the current anxiety in some quarters about reducing the general 5 per cent tariffs, that in the early 1980's average effective assistance to manufacturing was five times what it is today.

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

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, that 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; and
- 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 US (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, p3)*

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* ('Big Brother's watching — thankfully', 24 June 2000), 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". 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 which 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 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 which 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 which 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 which "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, 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.

The Prices Surveillance Act

The PSA as it is currently constituted is not well designed for this purpose. The legislation had its origins in the prices and incomes policy approach of an earlier time. As a *quid pro quo* for wages restraint, it operated as a wide-ranging discretionary vehicle for fighting inflation on a firm-by-firm basis — arguably never likely to be a very effective strategy.

As a more targeted instrument of competition policy, the PSA has some significant deficiencies, including the absence of a clear legislative statement of objectives, no

requirement to assess the significance and causes of possible instances of 'unscrupulous' pricing, and no requirement to assess the costs and benefits of surveillance relative to other (pro-competitive) options.

While the design of the PSA is somewhat anachronistic, trends in its application have been more in tune with contemporary circumstances. For example, in 1991 there were 75 companies in 24 product categories declared under the PS Act – covering items as diverse as petroleum, beer, biscuits, toiletries and pet food. In 1994, when the Industry Commission made a submission to a wide-ranging PSA review of declarations, there were still 19 product categories covered, of which we assessed that only three or four were justified when assessed against the tests for market power. Today the PSA surveillance activity is currently confined to those four categories: air services, airports, harbour towage and postal services.

In all these activities 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 PS Act, 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 Commission's current inquiries into Part IIIA and telecommunications will allow us to consider the relative merits of these different instruments for dealing with oversight of (natural) monopoly infrastructure services. The remaining issue, of course, is whether there are other circumstances which would still warrant a general PSA-type vehicle and, if so, how it should be designed. The Commission has argued that best practice regulation in this area, as in others, necessitates a sequential process of assessing the extent and causes of an alleged pricing problem followed by explicit consideration of options for dealing with it, including the possibility of no action. The institutional separation of responsibility for assessing the need for prices oversight from the responsibility for implementing it also has much to commend it.

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 don't 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 NCP criteria found that the benefits did not outweigh the costs (a proposition which many WA wheat growers would support); and
- many professions are protected by long-standing licensing and registration requirements that 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 — a review that aroused intense interest in the West — the Commission found that the current restrictions on use of the title 'architect' impose costs on the community, for little or no community benefit that was not otherwise obtainable. In that case the costs were found to be relatively small; in other cases they may be large.

By no means is this list exhaustive. For example, during the WEF 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.

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.