1 INTRODUCTION

1.1 What is the Review about?

In November 1996, the Minister for Industry, Science and Tourism announced a review of Commonwealth business programs. Specifically, the Review is to examine the efficiency and effectiveness of these programs in order to:

- recommend principles that should apply to business programs;
- assess whether current programs are consistent with these principles, achieve their intended objectives and contribute to the Government's policy objectives; and
- recommend changes, if required, including the expansion, termination, phasing down or redesign of programs, and the transfer of programs between portfolios.

The Review's terms of reference are broad. They cover both financial assistance and indirect support, such as information provision and promotion, provided to businesses in the primary, manufacturing and services sectors. The Review's Discussion Paper also seeks information on macroeconomic policy, taxation, regulation, education and microeconomic reform. All of these have an impact on business. However, the Discussion Paper indicates that the 'primary task is to devise a set of principles which should apply to business programs — that is, how and where Government should intervene in an industry policy sense'. This submission concentrates on these principles and their implications for future government support to business.

1.2 Why is the Commission making a submission?

Efficient industry policy can contribute to productivity growth and improve Australia's standard of living. For example, at the firm level, it can encourage more innovative and flexible practices. At the economy-wide level, it can encourage resources to move to those activities that generate the greatest benefit for the community.

As the major independent advisory body on industry policy to Australian Governments, the Commission has a vital interest in improving industry policy. Much of the Commission's work over the last decade has been directed to this end. It has considerable experience and expertise in policy analysis and formulation in all of the industry sectors covered by the Review.

1.3 Approach taken in the submission

This submission is premised on the view that the interests of the community as a whole, rather than those of particular firms or sectors, should be the guiding principle underlying future industry policy in Australia. This is important because business programs which benefit a particular industry need not be in the interests of other industries or the nation.

Thus, there is a need to identify the circumstances in which government support can improve on market outcomes to the benefit of the wider community (section 3). Where support is appropriate, good program design and efficient delivery will help to ensure that the community gets maximum value from the money spent (section 4).

More generally, business programs are only one component of an effective industry policy. A recurring theme in much of the Commission's work is that broad-ranging microeconomic reform is the key to improving productivity and industry competitiveness. While individual reforms may disadvantage some industries or sectors, in most cases, these losses will be more than offset by the benefits of other reforms (section 5).

Indeed, in conjunction with sound macroeconomic policies, broad-ranging reform will obviate the need for many specific industry programs. As the Prime Minister recently stated:

> Industry policy is low inflation, low interest rates, industrial relations reform, [and] other microeconomic reform (Howard 1996).

Before examining these issues, section 2 provides some scene setting information on Australian industry and current business programs.

2 SNAPSHOT OF BUSINESS PROGRAMS

The past decade has seen significant change in the nature of Australian industry and of government support for business. Reductions in border protection and microeconomic reform have encouraged a more outward oriented and dynamic economy, more closely integrated into the global economy. And, as in most developed countries, the services sector has continued to increase its share of economic activity.

In light of these changes, the Review of Business Programs is timely to ensure that existing programs remain relevant and contribute to improved economic performance.

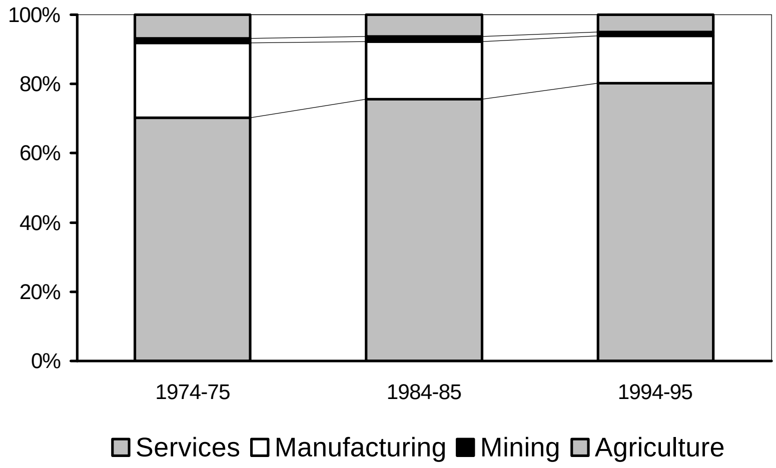
This section looks briefly at recent changes in Australia's industry structure. It then examines the nature and extent of Commonwealth programs supporting industry. More detailed information on Commonwealth industry support can be found in the Commission's 1995–96 Annual Report (IC 1996e, appendices D and F) and an earlier publication on assistance to agricultural and manufacturing industries (IC 1995b). In addition, the Commission recommended changes to industry support as part of its Stocktake of Progress in Microeconomic Reform (PC 1996). It has also recently reviewed State, Territory and Local Government Assistance to Industry (IC 1996g).

2.1 Changing industry orientation

In recent decades, the level of output has increased in all sectors, but the strongest growth has been in the services sector — in particular, finance, communications and community services. As a result, the services sector's share of output and employment has expanded, while manufacturing's share has fallen steadily (IC 1996i). (Figure 2.1 shows the trend in employment shares.)

Taking the past 25 years as a whole, Australia's productivity performance has been significantly below that of the rest of the OECD. But there are encouraging signs of improved performance more recently. Australia's productivity increased at twice the OECD average between 1989 and 1994 (figure 2.2). While cyclical factors are at work, Australia's improved productivity performance has been sustained beyond that typically experienced after past recessions.

Figure 2.1: Employment, by sector, 1974–75, 1984–85 and 1994–95 (per cent)

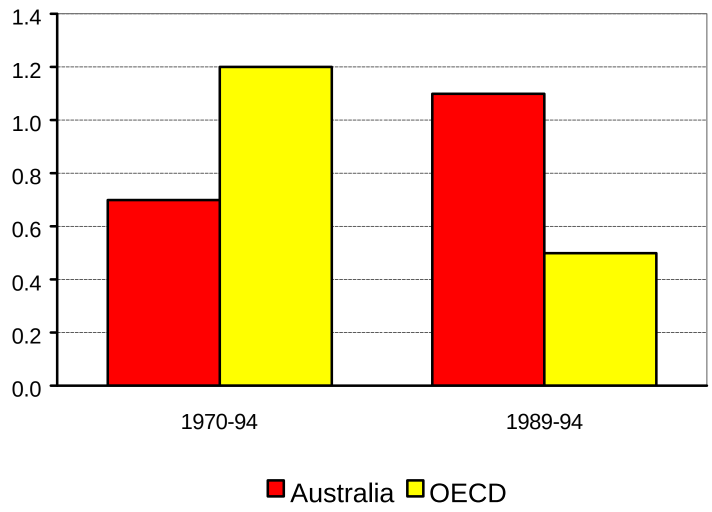


Source: ABS, *The Labour Force, Australia*, Cat. no. 6203.0

Heightened international competition and reductions in border protection have been an important stimulus for productivity improvements in the traded sector and have contributed to a more outward-oriented attitude among domestic firms. Since the mid 1970s, exports of goods and services have increased from 15 to 21 per cent of GDP and imports from 16 to 23 per cent. Tariff reductions have also been a catalyst for more wide-ranging reforms (EPAC 1996).

The tariff reduction program has resulted in a substantial decline in the effective rate of assistance for the manufacturing sector, from around 20 per cent in the mid 1980s to 6 per cent today. Despite this reduction in assistance, manufacturing output has grown, though employment has fallen. Productivity performance in manufacturing has improved — total factor productivity growth averaged 1.7 per cent per annum between 1983 and 1993, compared with 1.4 per cent during the previous decade. And, in the ten years to 1994–95, growth in manufactured exports (8.7 per cent per annum) has been faster than in Australia’s exports in total (6.9 per cent). Exports of ‘elaborately transformed’ manufactures have grown on average at over 16 per cent per annum.

Figure 2.2: Total factor productivity, annual growth (per cent)



Source: IC estimates based on Dwyer (1995, p. 2)

Australia's improved productivity performance has been accompanied by increased expenditure on R&D. While Australia still spends less on R&D than most OECD countries (partly because of its industrial structure), over the past decade its R&D expenditure has grown faster than the OECD average (IC 1995c). In 1994–95, Australia spent about 1.6 per cent of its GDP on R&D, double the rate in 1981–82. Business R&D has grown most rapidly and now accounts for almost half of the total (compared with only 25 per cent in 1981–82).

2.2 Commonwealth industry support

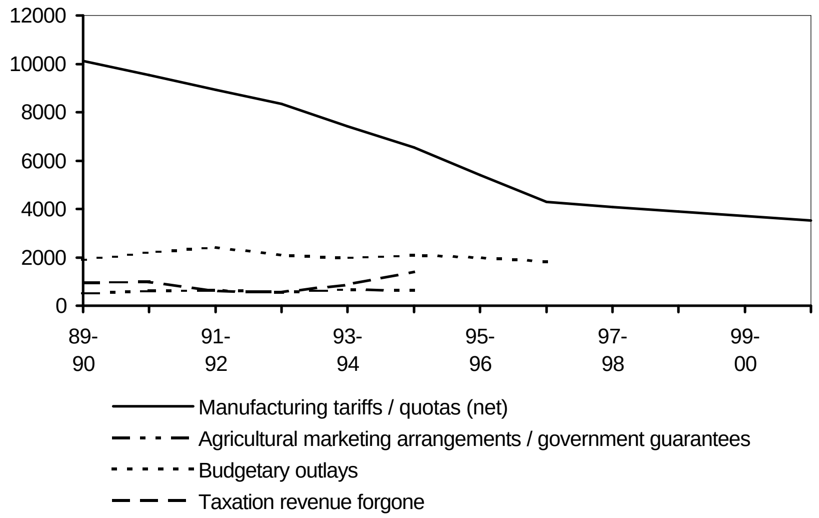
The Commission has estimated that Commonwealth support to industry — measures which discriminate between activities, firms or industries — totalled around $10 billion in 1994–95 (the last year for which relevant data are available for all sectors). Of the total, $6.5 billion was provided by tariffs and agricultural marketing arrangements. The remaining one-third was budgetary support, including nearly $1.4 billion of tax revenue forgone (IC 1996g). Recent tariff reductions are estimated to have reduced total measured support to around $8 billion in 1996–97. Of the remaining tariff assistance, around half supports the passenger motor vehicle and textile, clothing and footwear industries.

Australian businesses also benefit from other government measures which are not readily quantified. Among these are government procurement policies (including the Partnerships for Development program), anti-dumping measures, quarantine restrictions (where these are excessive in relation to the risks involved), and the underpricing of government-owned natural resources and infrastructure.

As noted above, despite substantial declines since the late 1980s, tariff assistance remains the most significant form of support, particularly for the manufacturing sector. As part of its APEC commitment to free trade in the region by 2010, Australia's Individual Action Plan commits the Commonwealth Government to reviewing general tariff assistance by 2000. The Commission is currently reviewing post-2000 assistance arrangements for the passenger motor vehicle and textile, clothing and footwear industries.

As tariffs have fallen, budget measures have accounted for an increasing share of Commonwealth industry support (figure 2.3). Budget outlays and tax revenue forgone currently represent around 40 per cent of the total — double their share in 1989–90.

Figure 2.3: Commonwealth assistance to industry, 1989–90 to 2000–01 ($ million, 1995–96 prices)



Source: IC estimates

Nature and extent of budgetary support

In 1994–95, Commonwealth budgetary support to industry (outlays and tax revenue forgone) totalled nearly $3.4 billion (table 2.1). Of this, budget outlays comprised $2.0 billion, or about 1.7 per cent of total Commonwealth outlays in that year. Outlays on industry support have since declined to $1.8 billion in 1996–97. This is their lowest level in at least eight years. Forward estimates indicate further reductions in 1997–98. More recent information on tax measures is not available.

Table 2.1: Commonwealth budgetary support, by sector, 1994–95 ($ million)

	Agriculture	*Manufacturing*	*Mining*	*Services*	***Total***
Budgetary outlays	645	810	116	461	**2 032**
Tax revenue forgone	170	1 114	–	75	**1 359**
Total	**815**	**1 924**	**116**	**536**	**3 391**

Source: IC (1996e, appendix D)

Budgetary support includes a wide range of measures with different rationales and justifications. The data do not distinguish between support which may improve efficiency (for example, R&D funding) and that which reduces community welfare (in the same way as tariffs). Because of this diversity and data limitations, some caution is needed in interpreting the available data. Also:

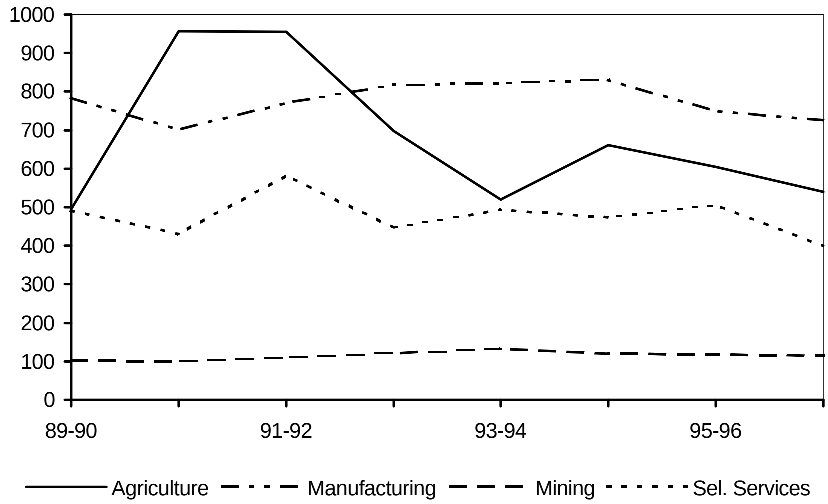
- Certain categories of expenditure have not been included — for example, health and education. While most expenditure in these areas is directed to providers of the services, its purpose is to subsidise the cost of the service to the consumer. Similarly, where labour market program funding is provided to businesses, its benefits are assumed to be passed on to employees/trainees. In addition, apart from support for the film industry, government funding for cultural activities has not been included.
- Where data permit, programs conferring benefits across sectors have been apportioned between recipients. But where disaggregated data are unavailable, expenditure and tax revenue forgone have been allocated to the sector which benefits the most. This is more of a problem for estimates of revenue forgone through such measures as the R&D tax

concession. For this reason, the discussion which follows on budgetary support by sector has been confined to budget outlays.

Budget outlays by sector

The manufacturing sector currently receives the largest share of Commonwealth outlays on industry — around 40 per cent of the total. Agriculture, which received the greatest share in the early 1990s, now accounts for 30 per cent. Budgetary outlays benefiting service industries represented just over 20 per cent, with support for the mining sector being much less significant (figure 2.4).

Figure 2.4: Commonwealth budget outlays on industry, by sector, 1989–90 to 1996–97 ($ million, 1995–96 prices)



Source: IC (1996e)

As a proportion of sectoral product, however, agriculture receives by far the largest budget outlays — 3.2 per cent in 1995–96 (table 2.2). Although generally higher than for other sectors, there have been significant fluctuations in the ratio in recent years, mainly reflecting the volatility of agricultural prices and disaster relief payments. The ratio of budget outlays to sectoral product has been more stable for the other sectors.

Table 2.2: Commonwealth budget outlays: share of gross sectoral product (GSP), 1991–92 and 1995–96

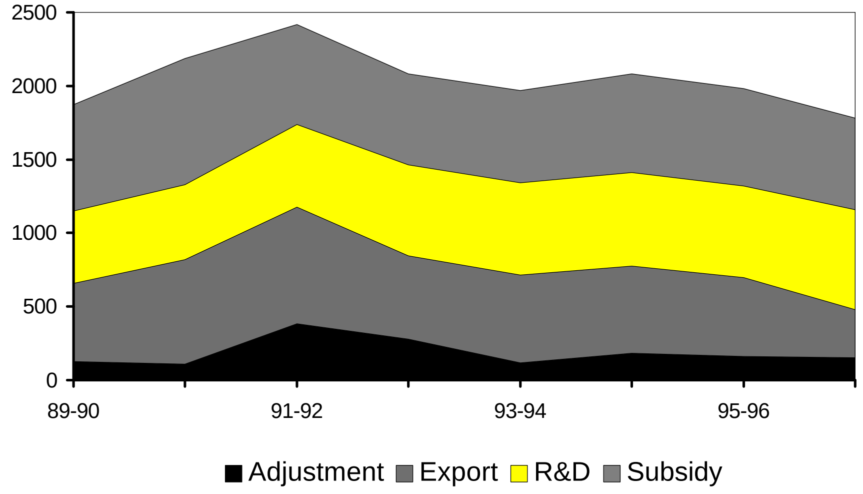
	1991–92		*1995–96*	
	Real outlays $m (1995–96)	*Share of GSP %*	*Real outlays $m (1995–96)*	*Share of GSP %*
Agriculture	893	5.6	605	3.2
Manufacturing	721	1.3	750	1.0
Mining	102	0.6	119	0.6
Selected services	546	0.3	507	0.2

Source: IC (1996e)

Components of budget outlays

Figure 2.5 disaggregates Commonwealth budget outlays on industry into four broad categories: adjustment (mainly rural adjustment assistance), export, R&D and subsidies (figure 2.5).

Figure 2.5: Components of budget outlays on industry, 1989–90 to 1996–97 ($ million, 1995–96 prices)



Source: IC (1996e)

In recent years, outlays on exports, R&D and subsidies have been of roughly similar magnitude. While support for R&D has been increasing, export assistance has declined. In 1996–97, export support is estimated to fall by around one-third. Subsidies and adjustment assistance are also expected to decline, while funding for R&D is budgeted to increase.

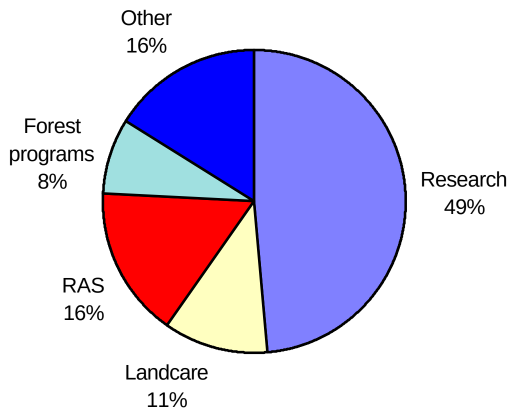
For agriculture and mining, outlays supporting R&D currently predominate. Export support and other subsidies comprise most of the outlays on the services sector. While this has also generally been the case for manufacturing, R&D funding is expected to exceed support for exports in 1996–97 (IC 1996e, appendix D).

Major budget outlay programs

Agriculture

The main programs supporting agriculture are the Rural Adjustment Scheme ($89 million in 1996–97), the National Landcare Program ($62 million) and funding for R&D through rural R&D corporations ($140 million), Cooperative Research Centres ($26 million) and the CSIRO ($100 million). Together, these programs currently account for three-quarters of Commonwealth outlays on agriculture, forestry and fisheries, with research accounting for half (figure 2.6). The importance of the Rural Adjustment Scheme has fluctuated with the changing fortunes of the agricultural sector. It accounted for only 5 per cent of outlays in 1993–94, but for 16 per cent in 1996–97.

Figure 2.6: Budget outlays on agriculture, by type, 1996–97 (per cent)



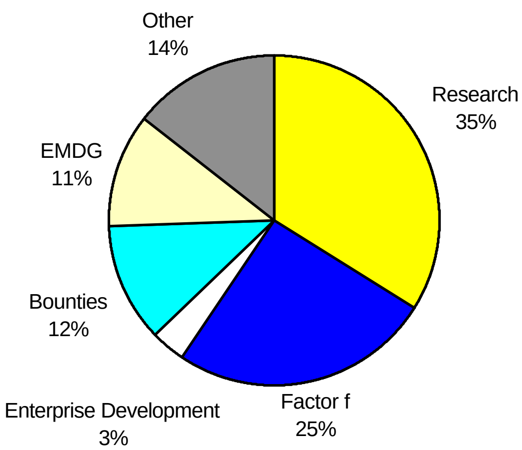
Source: IC (1996e)

Manufacturing

Despite recent cuts, the Commonwealth continues to fund a variety of programs supporting the manufacturing sector (figure 2.7). With declining expenditure on production bounties, and the abolition of the Development Import Finance Facility (DIFF), the major government outlays on manufacturing are:

- R&D support through Industry Innovation Programs (including the new START program) ($118 million in 1996–97), Cooperative Research Centres ($37 million) and the CSIRO ($98 million);
- the Factor f scheme ($190 million) which seeks to compensate manufacturers of pharmaceuticals for the low prices brought about by the Pharmaceutical Benefits Scheme, and also to encourage domestic drug production, exports and research;
- the Enterprise Development Program ($26 million), the major component of which is the National Industry Extension Service; and
- the Export Market Development Grants (EMDG) scheme ($205 million in total, 40 per cent of which is estimated to assist manufacturers).

Figure 2.7: Budget outlays on manufacturing, by type, 1996–97 (per cent)



Source: IC (1996e)

Mining

Research funding for Cooperative Research Centres ($18 million) and the CSIRO ($73 million) accounts for the bulk of government outlays on the mining and energy sector.

Services

In the services sector, the principal funding allocations are for:

- the Australian Tourist Commission ($77 million);
- the Australian Film Finance Corporation ($55 million) and the Australian Film Commission ($28 million);
- research by Cooperative Research Centres ($18 million) and the CSIRO ($43 million); and
- export promotion through the EMDG scheme.

Tax revenue forgone

The Commonwealth Government also uses the tax system to benefit industry. Total tax revenue forgone increased from $840 million in 1993–94 to nearly $1.4 billion in 1994–95. This was principally due to the impact of the 10 per cent investment allowance introduced as a short-term measure from February 1993 to June 1994 ($440 million in 1994–95). There was also a significant increase in the cost of the R&D tax concession. Recent changes (including the reduction in the concession from 150 to 125 per cent) are expected to contain its future cost.

Income tax averaging arrangements for primary producers ($98 million), accelerated depreciation for Australian trading ships ($41 million) and the 100 per cent capital deduction for the film industry ($24 million) were the other major tax concessions in 1994–95.

2.3 State, Territory and local government support for industry

State, Territory and local governments also operate business assistance programs. In its recent inquiry, the Commission estimated that total budgetary outlays by State and Territory governments on assistance to industry were just under $2.5 billion in 1994–95 (IC 1996g). This exceeded the estimated

$2 billion of Commonwealth outlays on industry support in that year. Local governments were estimated to have spent a further $220 million.

The Commission also found that State and Territory governments had forgone an estimated $3.2 billion in payroll tax exemptions for industry in 1993–94. This included selective exemptions provided to some medium and large businesses, as well as the general exemptions which favour small businesses. The administrative costs of applying payroll tax to very small firms would probably outweigh the efficiency gains of a non-discriminatory approach. However, it appears that the current thresholds are well above this level.

State, Territory and local government programs are outside the Review's terms of reference. Nevertheless, the assistance provided to industry by other tiers of government is relevant in considering the need for, and nature of, Commonwealth programs.

3 THE ROLE OF BUSINESS PROGRAMS

Productivity improvement and economic growth are central to improving living standards. They provide for greater employment opportunities and higher income levels. They also provide the means to pursue social goals, such as supporting disadvantaged groups in the community.

Governments can play an important role in facilitating productivity improvement and economic growth by:

- providing a stable and sound macroeconomic environment;
- establishing effective laws, regulations and institutional settings;
- undertaking microeconomic reform to increase the efficiency, flexibility and effectiveness of our industries; and
- addressing ‘failures’ in individual markets for goods, services, capital or labour.

The first three roles are most significant. They are about ‘getting the fundamentals right’. As the Discussion Paper notes, this is one part of the Commonwealth Government’s two phase industry policy strategy. As illustrated in section 5, the Government’s desire to have a vibrant and prosperous economy will be promoted by broad ranging microeconomic reform. Such reform will deliver benefits to virtually all Australian industries.

In contrast, the last role for government is more specific. It is limited in scope, as are the benefits. In essence, it involves government intervention in markets where good fundamentals and market competition alone would not result in the best outcomes for the community. This role underlies government business programs and is therefore central to this Review.

In some instances, government support for business investment and innovation will benefit Australia as a whole, as well as those businesses directly affected.

In other cases, however, the benefits to particular firms or industries may be outweighed by costs imposed elsewhere in the economy.

This in turn points to the need to be clear about the limited circumstances in which business programs can potentially improve on market outcomes. The need for such clarity is recognised in the Review’s terms of reference. It is particularly important in view of some common misconceptions in this area, and the poor performance of some previous programs.

This section looks first at some key rationales for government business programs, drawing on examples from the current suite of programs. It then discusses some practical constraints on the capacity of governments to improve upon market outcomes. Finally, the section draws out some broad implications for how the Review might tackle the assessment of current business programs.

3.1 Reasons for government business programs

The commonly advanced reasons for government business programs can be grouped under the following broad headings:

- addressing market failures;
- compensating for other policy distortions;
- acting as a catalyst for change;
- securing economic ‘rents’ available in overseas markets;
- job creation; and
- improving income distribution, regional development and other social outcomes.

Market failures

Market failure is often given as the reason for government intervention and, in particular, for business programs.

However, examples of significant ‘failure’ are few and far between. While markets rarely allocate resources ‘perfectly’, in time, they will usually deliver reasonable outcomes for most market participants.

Moreover, even when there is potential for governments to improve on market outcomes, often they do not have the necessary information to do so (see section 3.2 below). And government intervention is not costless. Apart from administrative and compliance costs, raising the revenue needed to pay for programs can have significant efficiency costs. Thus, governments must be very cautious about their capacity to deliver better results than the market.

Nonetheless, intervention may be warranted where there are significant ‘externalities’ accompanying business activity or major information deficiencies in a market. As the discussion that follows indicates, a number of other generic market failure arguments sometimes used to justify business programs are difficult to substantiate.

Externalities

An economy is a collection of interdependent activities. Because of these interdependencies, changes in one activity will have flow-on effects for other activities in the economy.

In most instances, such flow-on effects are widely accepted as desirable outcomes of the competitive market process. For example, while the price effects of increased demand for workers in one industry may spill over and disadvantage other businesses, this will help to ensure that the workforce moves to areas where it can produce the most wealth for the community. Similarly, the entry of a new firm to a market will increase competition for other firms, and may even result in some closing down. However, the community usually gains through access to cheaper and/or higher quality products.

But sometimes, the activities of a firm or industry have effects on others which are not properly reflected in market transactions. Without government intervention, these ‘externalities’ or ‘spillovers’ can lead to under or over provision of the activity concerned.

In the context of business programs, research and development is the prime example of an activity with substantial positive externalities. The knowledge generated by a firm’s R&D is difficult to quarantine and often has significant benefits for other firms. However, when determining R&D expenditure, firms will only take account of the private benefits. In its recent report on Research and Development (IC 1995c), the Commission saw this divergence between private and social benefits as often being significant. It therefore endorsed the need for government assistance to encourage firms to undertake more research activity. Significant externalities can also occur in areas of resource management. For example, poor land management can increase erosion and water run-off and reduce the quality of adjacent water supplies to downstream users.

Perceived externalities are central to a number of other generic arguments for business programs. Examples include: spin-offs from investment by overseas firms; agglomeration benefits and the so-called new growth theories.

However, as discussed in the Commission’s report on State, Territory and Local Government Assistance to Industry (IC 1996g), the theoretical validity or policy relevance of some of the underlying arguments is questionable. For example, the new growth theories provide little guidance on the size of widely accepted externalities associated with spending on R&D, or investment in education and training. This is because the empirical results from the theories do not differentiate between private and social returns. (For a further discussion of the theories see IC 1993.)

Whether government programs in these sorts of areas have much practical impact is also questionable. For instance, the Commission’s report on Implications for Australia of Firms Locating Offshore (IC 1996c) discusses survey evidence that government incentives are a minor factor in influencing firms’ decisions to locate or invest. Participants in that inquiry characterised such incentives as ‘icing on the cake’ and therefore a windfall gain to recipients. The BIE (1995a) and a number of overseas studies have reached a similar conclusion.

Similarly, the significance of the externality argument put forward in relation to export market development is open to debate. Some pioneering firms may help to establish Australia’s reputation in overseas markets and provide market intelligence to other local firms. However, there is little evidence that such spillovers apply across-the-board to export market development activity, or are generally sizeable. Moreover, for generic goods or services, industry levies to fund export market development can ‘internalise’ any spillovers and thereby obviate the need for government subsidies.

Also, externalities are sometimes confused with economic *multipliers* generated by an activity. Multipliers are summary measures of linkages between activities: for instance, the number of jobs that an expansion in exports or R&D will create in supplier industries. But if this induced activity involves bidding resources away from other industries, then there will be offsetting negative multiplier effects — such as reduced job opportunities in those industries. That is, all activities (and alternative uses of government funds) have multiplier effects. This is why program assessment must have regard to resource use in the economy as a whole, rather than simply considering impacts on individual industries or sectors.

These examples illustrate the scope to significantly overstate the externality rationale. Indeed, in the extreme, externalities can provide a conceptually appealing catchcry to justify the introduction or continuation of virtually any program.

Information deficiencies

For market participants to make sound decisions they need adequate information on the choices available.

Yet information is often far from perfect and can be costly to obtain. In some instances, governments may be well placed to gather and disseminate information that is of benefit to the community, but which is too costly for individuals or firms to collect. This is the rationale for the operations of the Australian Bureau of Statistics.

Information deficiencies provide all, or part of, the rationale for a range of current business programs, including:

- extension and enterprise programs aimed at increasing firms' awareness and use of best practice technologies and processes;
- regional development programs aimed, at least in part, at improving information on the benefits for firms of locating outside the major cities; and
- landcare programs aimed at improving information to landholders on the consequences of poor land management.

Of course, information deficiencies do not automatically mean that governments should intervene. Often, firms and markets can develop mechanisms to overcome such deficiencies. For example, brand naming and warranties are ways to compensate for consumers' lack of detailed knowledge about the quality of particular products. And there are many private consultants who can advise on appropriate land management.

However, there are some residual information-related problems which markets may not address well. For example:

- Like R&D, suppliers of information often face difficulties in appropriating all of the benefits the information provides. For example, a firm generating or purchasing information on best practice may have difficulty in preventing other firms benefiting through demonstration effects.
- Firms may not fully appreciate the benefits of best practice information and techniques. Such 'asymmetry' will lead the purchaser to undervalue the information, compounding the underprovision problem. Also, firms may not properly use the available information.

In assessing whether such information problems warrant specific business programs, several considerations are relevant.

Obviously, the significance of the problem is paramount. For example, there is evidence that the partial withdrawal of public extension for agriculture led to increased use of private extension services (IC 1996g). This illustrates the need to limit government involvement to areas where there is evidence that reliance on private markets would lead to significant underprovision by the private sector and inadequate uptake of such information.

Also, where the information problem is significant, there are alternatives to government funded business programs. For instance, information on the role and value of best practice can be conveyed through the higher education system.

The proportionately high cost for small firms of obtaining information should not automatically be construed as a market failure requiring program style intervention. Small firms face relatively high per unit costs for many inputs. Thus, rather than signalling a market failure, this may simply imply something about the optimal business size for the market concerned.

Indivisibility and risk

Some projects are too large for individual firms to undertake alone. Others may be very risky for firms to undertake, either alone or in concert with other firms. Hence, there is a concern that some large and risky projects will not proceed even if they are in the community interest. In this regard, there is often particular emphasis on the problems faced by small and medium enterprises (SMEs) in attracting finance.

To deal with this perceived market failure there are often calls for government programs to:

- foster joint venturing;
- make available equity capital for risky ventures; and/or
- subsidise the cost of capital for risky ventures.

The Commonwealth currently provides tax concessions for investments by Pooled Development Funds in SMEs.

However, by themselves, indivisibility and risk are not good reasons for government intervention. Firms and institutions can, quite independent of government, seek out joint venture partners to spread the cost of large projects. And the financial markets offer a range of devices to allow firms to pool risk. These opportunities should increase with the growing sophistication of the financial markets, and as deregulation opens up more opportunities for joint ventures and financing on the international market.

Hence, for governments to contemplate intervention, there must be impediments to efficient risk pooling and joint venturing. That is, there must be more fundamental problems in how markets function.

Relatively high financing costs faced by small firms do not provide evidence of such a fundamental problem. These higher costs mainly reflect features of small business operations that increase costs for lenders, including: higher failure rates; proportionately higher costs of obtaining information on, and monitoring, firms' activities; and the less liquid nature of equity investments (see IC 1991).

Compensating for other policy distortions

Another rationale for government business programs is to compensate for the adverse effects on industries of other government policies: For example:

- The Factor f scheme for the pharmaceutical industry is in place partially to offset the effects on the local industry of drug price suppression under the Pharmaceutical Benefits Scheme (PBS).
- In the past, governments assisted the rural sector partly to compensate producers for the adverse effects of tariff protection provided to manufacturers.

In an environment where other distorting policies cannot be altered, compensating support may sometimes improve overall resource allocation.

However, it is a risky approach. Designing compensatory policies is very informationally demanding. In this context, the Commission's recent report into the Pharmaceutical Industry (IC 1996b) concluded that the Factor f scheme had over-compensated some firms for the impact of the PBS on drug prices, and under-compensated others.

More broadly, compensating for the distortions caused by other policies can reduce the pressure to reform those policies. The most efficient approach is to directly address the policy causing the problem. Thus, the Commission's Pharmaceutical Industry report argued that reform of the PBS listing process would be preferable to an ongoing Factor f style scheme.

A catalyst for change

Using government support mechanisms as a catalyst to improve business practice and culture is another common rationale for business programs. For example, enterprise and extension programs are seen as fostering a 'best practice' culture. Similarly, export assistance programs are often seen as a means to encourage firms to participate in export markets and to adopt the 'leading edge' technology and management processes employed by the most efficient firms.

The importance for economic growth of exposure to international market disciplines and the pursuit of best practice is not in dispute.

However, many firms already have strong commercial incentives to explore profitable opportunities in overseas markets, and most face incentives to seek out productivity-enhancing technologies and processes.

This suggests that the absence of an export or best practice culture may reflect more fundamental information problems, or impediments elsewhere in the economy that retard exports or the uptake of better business practice. As argued above, addressing any such problems at their source will be preferable to providing compensatory assistance to promote change. Indeed, if the cause of the problem is not addressed, 'catalytic' assistance may have limited impact. An example would be where inflexible industrial arrangements preclude the adoption of best practice working arrangements.

Capturing rents in overseas markets

For many years economists have acknowledged some minor exceptions to the general presumption in favour of free trade. For example, where a country's producers are large enough to influence prices in a particular market, governments can increase overall export returns by assisting them to restrict export supply.

In recent years, however, 'strategic trade' theorists have suggested that such cases deserve more attention. They argue that, in some circumstances, government assistance can help firms establish a dominant international market position and earn 'economic rents' that exceed the cost of the initial assistance and any imposts on domestic consumers. According to this view, government assistance is a mechanism for capturing these rents from overseas producers.

There has been much debate about the policy relevance of these theories, particularly as the form of government intervention necessary for a country to capture any rents will depend on the behaviour of overseas firms and their governments. This, of course, is difficult to predict in advance.

However, there is general consensus that, if other countries provide retaliatory assistance to their producers, all rent seeking countries will lose. Partly for this reason, one of the architects of the theories — Paul Krugman — has downplayed their policy relevance. In any event, Australia's small size will be a considerable barrier to achieving international market domination in most scale intensive industries. (For a further discussion of the strategic trade theories see IAC 1989b.)

Job creation

Business programs are often seen as being justified on employment creation grounds. The argument is that the programs boost economic growth and thereby lead to more jobs in the economy.

But the impact of business programs on total employment is unlikely to be significant. This is because business programs are mainly about increasing activity in selected areas by redistributing resources from other activities. Hence, increased job opportunities induced by special assistance from government will often be at the expense of jobs elsewhere.

Providing a business environment which facilitates high and sustainable growth is the key to boosting total employment. This requires both good macroeconomic policies, and microeconomic reform to make industry as a whole more productive and better able to respond to emerging market opportunities. In this context, reforms that improve the flexibility of the labour market and the effectiveness of retraining programs are of particular relevance.

Income distribution and social objectives

Governments have an important role to play in facilitating adjustment, helping those adversely affected by change, promoting regional development and in redistributing income more generally.

However, the role of specific business programs in promoting such objectives is less clear.

As a general rule, the Commission has argued for general measures rather than specific programs to meet social objectives. For example, the social welfare system and generally available retraining programs are appropriate means to assist producers or employees adversely affected by change. The use of more specific measures carries with it the risk of ‘horse trading’ over the level of assistance and can lead to considerable inequities. There is also the risk that transitional assistance schemes will become permanent. The retention of ‘temporary’ quotas on passenger motor vehicle imports from 1974 to 1988 illustrates this point.

Nevertheless, the Commission has acknowledged that there will be circumstances where more specific measures or programs are warranted on either efficiency or equity grounds. Thus, the Commission has typically recommended phased rather than abrupt tariff reductions.

Using specific measures to meet more general social objectives puts a premium on good policy design (see section 4) so as to minimise the risk of unwanted side effects. In its submission to the review of the Rural Adjustment Scheme (IC 1996h), the Commission noted the need to ensure that sector-specific welfare support does not create major inequities and/or adverse incentives through its interaction with the social security system.

Summing up on rationales

The over-riding objective for government business programs must be to improve overall community welfare. Thus, the focus of business programs cannot be simply on 'promoting industry', or particular sectors. In this context, the development and growth of particular industries or sectors needs to be seen as an outcome rather than an objective.

Against this criterion, only a few of the rationales commonly put forward for government business programs have merit. Programs are most likely to be warranted where there are significant externalities or information deficiencies. And where such market failures exist, generally available rather than firm- or sector-specific programs are required.

Business programs will not generally be an appropriate vehicle for pursuing wider employment creation or social objectives.

3.2 Constraints on governments seeking to improve on market outcomes

Even when there is a sound rationale for government business programs, there are invariably costs and constraints that partially offset the benefits of those programs or, in the extreme, lead to negative outcomes.

Costs of intervention

As already noted, government action entails financial and administrative costs. These costs are integral to assessments of whether or not to take action. For example, analysis in the Commission's recent inquiry into Book Printing (IC 1996f) suggested that the benefits from the book bounty are probably outweighed by the scheme's administrative and compliance costs. In its Draft Report, the Commission therefore proposed that the bounty be terminated.

It is also important to recognise that raising taxes to pay for programs has efficiency costs. The Commission's recent Stocktake of Progress in Microeconomic Reform (PC 1996) reports evidence that the efficiency cost of revenue raising via income tax could be more than 20 cents for each dollar raised.

Information problems

The development and implementation by government of successful business programs requires much sophisticated information and skilled analysts to interpret it. For example, as discussed in section 4, proper assessment of proposed programs must take account of such things as:

- the nature and magnitude of the problem being addressed;
- the impacts of alternative policies to deal with the problem; and
- the impact of not doing anything.

Obtaining relevant information can be costly, or even impossible. This increases the probability that intervention will be inappropriate, or based on what is good for particular firms or industries rather than for the community as a whole. This is because information on the benefits to particular firms or industries will typically be more comprehensive than that on the costs to the wider community. This is a manifestation of the wider political problem that the beneficiaries of government incentive schemes tend to be concentrated and well organised, whereas those who bear the cost are often widely dispersed and poorly organised.

Encouraging lobbying

The availability of government support for industry, even for good reasons, inevitably encourages greater lobbying for political and financial favours. The costs of such activity, which provide no offsetting benefit to the community, can be significant for both business and government. Such wider systemic impacts should be an important consideration for government in determining its broad approach to program support for business.

Incentives for program administrators

The incentives for those developing and implementing business programs can induce outcomes which are not compatible with maximising community welfare. For example:

- Government budgetary processes mean that administrators often have incentives to spend all funding available for a program in a particular year, even if some of the money would have been better redirected elsewhere.

- The performance of program administrators is likely to be based in the first instance on how well they have served the users of a program. In the extreme, this can lead to the problem of ‘regulatory capture’.
- To avoid the appearance of failure, governments can be tempted to provide extra assistance to ‘at risk’ activities that have previously benefited from government support. For the same reason, there may also be a tendency for administrators to target low risk activities.

International obligations

Australia is a signatory to a number of international trade agreements which limit the forms of support provided to business. These include agreements entered into as part of the World Trade Organisation agreement (including the General Agreement on Tariffs and Trade (GATT) 1994) and the Australia New Zealand Closer Economic Relations Trade Agreement. Both of these agreements seek to limit industry assistance within member states, particularly assistance that distorts international trade. For example:

- The GATT Agreement on Subsidies and Countervailing Measures prohibits any export subsidy outside agriculture.
- The Agreement on Trade-Related Investment Measures prohibits the use of measures such as local content requirements.

Australia has also given a range of undertakings to reduce existing trade barriers, and not to introduce any new ones, as part of its APEC commitments. (For a more detailed discussion of Australia’s international agreements, see IC 1996g.)

As the recent challenge to Australia’s export facilitation arrangements indicates, those commitments cannot be ignored with impunity.

Accountability through public reporting a key

The problems discussed above do not condemn all business programs to failure. For example, the Commission (1995c) found that generally available tax concessions for R&D have been beneficial for Australia. This is despite the absence of information on the precise extent of market failure in this area.

However, to minimise the possibility of implementation constraints leading to adverse outcomes, there is a need for thorough evaluation of, and public reporting on, business programs and regular, independent reviews. (These matters are discussed in more detail in the next section.) Apart from delivering better outcomes for specific programs, public reporting can help to build public confidence in industry policy as a whole. An important message emerging from the Commission's inquiry into State, Territory and Local Government Assistance to Industry is that secrecy in process and outcomes can lead to public suspicion that 'deals are being done', even when this is not the case.

3.3 Implications for this Review

Against the rationales enunciated above, the current suite of business programs is a mixed bag. For example:

- Support for R&D targets universally accepted market failures. The question here is not whether governments should intervene, but rather whether the current mix of measures and business programs can be improved upon. In this regard, one concern is the increasing emphasis on firm-specific R&D subsidies. In its report on Research and Development (IC 1995c), the Commission alluded to a range of problems with the firm-specific approach, including excessive administrative discretion, a focus on picking likely successful firms rather than targeting market failure, and the concentration of assistance in the hands of a small number of firms.
- There is an in-principle case for some enterprise and extension programs. However, the significance of the underlying market failure is likely to vary considerably according to the type of information and the industries involved. Thus, there is an issue of the appropriate balance between budget and user funding for such programs.
- The efficiency case for firm-specific export assistance is relatively weak (see appendix A for further details).

Differences in the strength of the in-principle case for various business programs raise a broad strategic question on how best to approach future reform of those programs.

It would be possible to evaluate every single program in detail. However, given that some programs target areas where the government's role is questionable, this approach may be unnecessary.

An alternative approach would be to terminate, without detailed review, programs which do not measure up against some threshold tests emerging from the previous discussion, namely:

- Are there clear externalities, information deficiencies or policy impediments that warrant government involvement?
- Are there significant costs if nothing is done, and do they exceed the costs of government intervention?
- Is a business program the only, or the best, way to address the problem?

More detailed review of ways to improve program effectiveness could then be limited to a smaller group of programs.

4 EFFICIENT PROGRAM DELIVERY

Government business programs must be well designed and delivered effectively. This section sets out some mechanisms to achieve these objectives. In so doing, it discusses relevant recommendations in the Burgess Report (1994) and the Report of the Small Business Deregulation Task Force (Bell 1996).

4.1 Characteristics of good program design

Targeting

Causes not symptoms

Programs should address the causes of problems, not the symptoms, and target those causes as directly as possible. By spreading government assistance more widely, poor targeting will increase the budgetary cost of meeting a program's objectives. It can also worsen resource allocation if it encourages an expansion in activities not affected by the underlying problem.

For similar reasons, programs should seek to avoid assisting activity that would have occurred anyway. This simply provides a windfall gain to firms receiving such assistance. The Burgess Report and DIST (1996) discuss mechanisms to help ensure that government support only goes to incremental activity (the so-called 'additionality' principle). An obvious example is attempting to link support directly to changes in activity levels.

However, targeting can be costly for both government and firms. Compliance costs for firms and administrative costs for government typically increase with the degree of targeting. The efficient level of targeting must have regard to these 'transactions' costs. Thus, for example, transactions cost considerations provide a justification for:

- Across-the-board tax concessions for R&D, even though these undoubtedly support some activity that would have occurred anyway (see IC 1995c).
- Not replacing tariffs with bounties. Because bounties assist domestic production without raising prices to consumers, they target the objective of supporting domestic activity more directly than tariffs. However,

compared to tariffs, bounties are administratively complex. Hence, when the level of support to firms is low, the extra administrative and compliance costs are likely to outweigh the benefits of better targeting — see, for example, the Commission's report on Book Printing (IC 1996f).

The benefits of targeting must also be set against other desirable attributes for programs, such as transparency. For instance, Partnership for Development type programs — which require government suppliers to meet industry development commitments — ostensibly assist activity that may not otherwise occur. However, the level of assistance provided to local production is difficult to ascertain. The BIE estimated that partnership agreements in the IT sector had increased suppliers' costs by as much as $80 million. Yet government departments perceived the arrangements as having little impact on contract costs (BIE 1994).

Target market failures and policy impediments, not firms or sectors

Government programs should, as far as possible, avoid favouring some firms over others. Favouritism, or 'selectivity', undermines competitive processes by disadvantaging an assisted firm's competitors. Thus, it typically results in less efficient outcomes. For example, the Commission (IC 1996b) found that the exclusion of some companies from the Factor f scheme for the pharmaceutical industry had reduced the value of the scheme. And, as discussed in the Commission' report on State, Territory and Local Government Assistance to Industry (IC 1996g), transparency is often a casualty of selective support programs.

This is another way of saying that government programs should target the sources of market imperfection rather than particular firms or industries affected by those imperfections. Thus, broadly-based programs will generally be preferable to sector or firm-specific programs.

For similar reasons, it will be generally inappropriate to limit access to programs to firms of a particular size. This is because the key rationales for program support do not usually relate explicitly to size. For example, the factors that lead to market underprovision of R&D apply to large and small firms alike.

Hence, the Commission has concerns about explicit targeting of small and medium enterprises (SMEs) as advocated by Burgess (1994) and others. If there are market imperfections that apply only to SMEs, these should be tackled directly, rather than by limiting access to programs designed to correct for more general market failures.

The Commission also disagrees with the proposition that program support should be targeted at firms in the traded sector (or with strong links to that sector), and with the underlying inference that the traded sector is more important to the economy than the non-traded sector. Greater efficiency benefits the community irrespective of where in the economy it occurs.

Eligibility criteria

Effective targeting will be facilitated by eligibility criteria which encourage the ‘right’ applicants to come forward and which ensure that:

- The level of government support is linked to the size of the problem being addressed. Where government provides a service to business, there should be user contributions to reflect the private benefit to assisted firms. (Cost sharing can also help to maintain the pressure on government to deliver programs efficiently.)
- Support is available to firms for an appropriate duration. For example, support to firms under industry extension programs should generally only be temporary, whereas support for R&D should be available on an ongoing basis.
- Where there is a budget constraint, the projects selected are those that provide the greatest net benefit. This involves more than assessing which firms have the most extensive linkages with the rest of the economy as advocated by Burgess in relation to enterprise programs. As discussed in section 3, it is important to distinguish between simple multipliers and genuine externalities. Net benefit should be judged primarily in relation to externalities.

These issues are discussed in greater detail in DIST (1996).

Maintaining market incentives

Programs should aim to maintain market incentives and disciplines. This recognises the advantages of markets in reflecting information on individual preferences and encouraging innovation and economy in resource use.

This leads to three broad requirements:

- Programs should not reduce the incentives for firms to operate efficiently by providing excessive levels of subsidy to assisted activities.
- Programs should not alter relative prices any more than is necessary to address the underlying problem. Hence, subsidies (or tax concessions) for particular activities should generally be denominated in percentage terms; and

- Delivery of programs providing a service to business should be contestable (see below).

Minimising compliance costs

All government programs involve compliance costs for users and administrative costs for government.

While it is important to avoid unnecessary imposts on business, compliance costs must be assessed in conjunction with the other benefits and costs of business programs, rather than in isolation. Hence, as recognised in the Bell Report, the need to target funding to meet program objectives and to maintain public accountability for the use of funds limits the degree to which compliance costs can be reduced.

The Commission notes the recommendation in the Bell Report that this Review develop guidelines for the administration of government programs that minimise the compliance burden on small business while maintaining appropriate accountability procedures.

However, the Regulatory Impact Statement (RIS) approach (see box 4.1 below) already provides a framework for program designers/reviewers that includes consideration of compliance costs, including for small business. Thus, any new compliance costs guidelines emerging from this Review should be compatible with, and not duplicate, the RIS approach. Examples of such ‘supportive’ guidelines might include:

- Employ the simplest policy consistent with underlying objectives and have clear eligibility criteria. This will help to minimise confusion and facilitate self assessment by firms of the likelihood of receiving support.
- Seek industry input into program design and monitoring. Program monitoring (see below) can also help to identify unwarranted compliance costs.
- Relate the stringency of compliance requirements to the amount of support available to successful applicants.

There may also be opportunities to take advantage of new electronic technologies to reduce the paperwork burden.

Coordinating and rationalising programs and delivery agencies is another means of reducing compliance costs. The problems created by the multiplicity of programs and delivery networks were raised in submissions to the Burgess Review and also to the Commission’s inquiries into State, Territory and Local Government Assistance to Industry (IC 1996g) and Medical and Scientific

Equipment Industries (1996j). Submissions to the latter inquiry also revealed that the multiplicity of programs contributes to a lack of knowledge in the industry about relevant support programs.

As noted by the National Commission of Audit (1996), 'first stop shops' providing a single gateway to a range of programs can reduce duplication in the delivery of information. Similarly, co-location of program delivery agencies in 'one stop shops' can reduce administrative complexity and duplication of effort.

Transparency

Well designed and run programs are transparent. Transparency usually goes hand in hand with clear and simple eligibility criteria that limit administrative discretion in the allocation of support to firms. Transparency also requires effective reporting requirements (see below).

Transparency implies that levels of assistance provided to firms should be readily apparent. Arrangements that involve direct budgetary outlays will usually fare better against this criterion than those providing support through government forgoing revenue. However, the Commission's report on the Pharmaceutical Industry (IC 1996b) raised concerns about the clauses in the Factor f scheme which grant confidential status to the amount of assistance given to individual firms and exactly what they have done to secure that assistance. Arrangements such as Partnerships for Development, where assistance is indirectly funded through an undisclosed price premium on government contracts, also fare poorly against the transparency criterion.

4.2 Supporting institutional and administrative arrangements

The institutional and administrative arrangements for delivering government business programs have an important influence on the efficiency of outcomes.

Broad management and delivery arrangements

Clear objectives and lines of accountability will help agencies delivering government business programs to mesh the needs of government and clients. It will also make it easier to hold those managing programs accountable for their performance. And clear objectives can help to highlight duplication across programs and thereby identify opportunities for rationalisation.

Ideally, responsibility for policy formulation and evaluation and for program delivery should be separate. Government agencies built up to oversee and provide business programs naturally have an interest in the continuation of those programs, even if the community interest dictates otherwise. For this reason, the Commission’s Draft Report on State, Territory and Local Government Assistance to Industry argued that broader industry policy evaluation should reside with central agencies such as Treasury or Finance. These agencies are better placed to take a ‘whole of government view’ and to consider alternative uses for the funds involved.

While there is a case for the Commonwealth devolving responsibility for some functions to lower levels of government, it should retain policy responsibility for major business programs. This is because the underlying market failures have national rather than local ramifications. However, this is not to deny a potentially important role for the States in *delivering* programs on behalf of the Commonwealth (see below).

Evaluation, monitoring and reporting

Evaluation techniques and procedures

Effective evaluation of proposed and existing business programs is crucial to achieving good outcomes.

The cornerstone of the evaluation system should be thorough benefit-cost analysis. Programs should only be initiated (or continued) if the expected returns to the community exceed those from spending the money on other programs (or not spending it at all). Implicit in the latter requirement is the need for those undertaking analyses to address the ‘do nothing’ option explicitly. Non-business program options should also be considered. For example, as discussed earlier, where business programs are proposed to compensate for other policies, modifying those policies may be preferable.

Valuing some program benefits and costs can be difficult and involve significant judgment.

But valuation difficulties are not a reason to dispense with systematic and consistent analysis. Even if some components lack precision, the rigour of such analysis is preferable to the nebulous and needs-based assessments that have supported the introduction of some business programs in the past.

Through Regulation Impact Statement (RIS) requirements (see box 4.1 and IC 1996d), a framework is already in place requiring those proposing new programs, or reviewing existing ones, to undertake such analysis. RISs have been required for all submissions to Cabinet affecting business since 1986. Oversight of these requirements rests with the Office of Regulation Review. The Government is currently considering a number of improvements to the RIS regime in response to the recommendations of the Bell Report. One issue for this Review is whether there are gaps in the current (or amended) RIS requirements as they apply to proposed business programs or the review of existing ones.

Box 4.1: Key characteristics of the RIS approach

A RIS should include:

- a clear statement of the objectives of the government program or regulation based on the nature and magnitude of the problem;
- alternative approaches for dealing with the problem;
- assessment of the expected benefits and costs to the community of each alternative approach;
- analysis of the impact of the proposal on business, consumers, government and the community as a whole. Ideally, the RIS process should lead to selection of the option that maximises the community's net benefit;
- public consultation; and
- the establishment of future review mechanisms.

As noted above, separating responsibility for policy evaluation and review from program administration would help to discipline the evaluation process. Introducing a requirement for government agencies to publish analyses supporting the introduction of new programs would also help. Such reporting should be part of a wider suite of program monitoring and reporting requirements.

Monitoring

Monitoring serves a variety of ends including:

- ensuring that programs remain relevant;
- assessing program performance against objectives; and
- identifying problems in program design and delivery, and means of overcoming them.

More generally, the lessons learned from monitoring individual programs can often be applied more widely.

Regular monitoring should be a requirement for all Commonwealth business programs. It should focus on results achieved from the money expended. The intensity of the monitoring should be related to the level of expenditure involved. Responsibility for ongoing monitoring should lie, in the first instance, with the agencies responsible for managing program delivery.

To complement ongoing monitoring, there is a need for periodic, independent reviews of programs. This is a way of bringing wider community interest considerations to bear and should be premised on the evaluation requirements discussed above. Such reviews should be triggered by inserting sunset provisions in all programs.

Reporting

Public reporting of assistance provided by business programs and the results achieved should be the norm. By increasing transparency, public reporting can help to assure the community that taxes are being well spent. In so doing, it will reinforce the disciplines on those designing and managing programs to act in the public interest. Public reporting can also provide useful information to potential users of programs.

The level of detail of public reporting should be linked to the amount of public money involved in a program.

However, there are a number of core requirements which reports should address, including:

- the objectives of the program;
- the criteria and approval processes used to assess applications for support;
- evidence from program monitoring that the benefits of the program exceed its costs; and
- information on those receiving support.

‘Business confidentiality’ should not be used to justify non-disclosure of the financial assistance that individual firms receive from budget-funded programs. As the Commission argued in its report on State, Territory and Local Government Assistance to Industry, firms that accept public support should do so in the knowledge that details of that support will be made public. Similarly, in its report on the Pharmaceutical Industry, the Commission argued that in any new Factor f type scheme, payments to companies should be public.

Improving the efficiency and quality of service delivery

Where programs involve the provision of a service rather than financial support (for example, industry extension), service delivery should be contestable. Contestability involves removing the monopoly of the managing agency over the delivery of the program. It provides the opportunity for private sector firms and other government agencies to tender for the right to deliver programs.

Encouraging competition will help to reduce the cost of program delivery and increase quality. Most studies point to cost savings of 10 to 30 per cent from competitive tendering.

In tendering for the delivery of business programs, the lessons emerging from the Commission's recent report on Competitive Tendering and Contracting by Public Sector Agencies (IC 1996a) are pertinent:

- structure competitive tendering and contracting (CTC) to ensure effective competition so that the best providers are chosen;
- use it to encourage agencies to review whether their activities are effective in meeting agency objectives;
- focus CTC on outcomes rather than processes; and
- support CTC through cultural change in agencies and a new mix of skills.

The principles for governments to apply in assessing the scope for competitive tendering and contracting are discussed in detail in the Commission's report. The bottom line is that, if contracting is to deliver the potential gains, it must be intelligently implemented. Further, as noted in PC (1996), there will be greater scope for competition in service delivery when there is competitive neutrality between public and private providers.

In making Commonwealth business program delivery contestable, managing agencies should look at the scope to devolve delivery to State governments. Combining the delivery of some Commonwealth and State business programs may allow for the realisation of economies of scale. It may also facilitate the creation of one stop shops for government programs. As discussed earlier, these shops are one way of reducing compliance costs.

Finally, the Commission reiterates that user contributions towards program costs will help to encourage cost effective and high quality service delivery.

5 THE WIDER ROLE OF GOVERNMENTS

It is important that this Review consider the potential contribution of business programs to promoting industry development and economic growth in the context of the other ways that governments can meet those objectives. As noted earlier in this submission, the role of government in promoting industry development and enhancing growth and job prospects is many faceted.

Sound macroeconomic management is central to provide an environment conducive to private decision making and to avoid the resource misallocation costs that accompany high inflation.

Over the past decade or so, there has also been growing awareness in Australia — not least in the business community — that broad-based microeconomic reform can significantly raise the productivity of Australian industry and the economy generally. The Discussion Paper asks what reforms are of critical importance and what further actions are required. An indication of the priorities for action is provided below.

In combination with sound macroeconomic management, microeconomic reform is likely to be of greater, and more enduring, benefit to efficient industry development than are government business programs. Microeconomic reforms may also obviate the need for some business programs — particularly where such programs have been designed as second-best solutions to inflexibilities in the economy that reforms are now beginning to address directly.

5.1 How will broad-based microeconomic reform benefit industry?

Microeconomic reform is about improving the incentives for producers to be more productive and flexible, to minimise costs and to price their goods and services appropriately. Increasing the exposure of industries to competitive pressures will help to ensure that these incentives are in place. However, microeconomic reform also seeks to rid the economy of disincentives such as inappropriate regulations that penalise success and discourage the entrepreneurship essential to the wealth creation process. Reform is also concerned with providing better signals to consumers about the true cost and quality of goods and services so as to improve consumption decisions.

In seeking to enhance choice and improve incentives for people to do better in the range of activities and institutions that make up our economy, the objective of microeconomic reform is to improve living standards. The Commission therefore sees the scope of reform as being very wide. Cost-effective and high quality health care and education are at least as important to community wellbeing as the provision of economic infrastructure and other goods and services. And if Australian industry is to be able to respond positively to global change, fair and effective social support mechanisms for those most vulnerable to change are crucial.

Past reforms are benefiting industry. To cite but one example, greater competition in electricity generation and distribution is reducing costs. An Australian Chamber of Manufactures survey of Victorian manufacturers who have availed themselves of the contestable market shows average price reductions of over 10 per cent. In New South Wales, average business costs for electricity have fallen in real terms by 23 per cent since 1992–93 according to the Independent Pricing and Regulatory Tribunal.

Yet all of the Commission's work indicates considerable scope to reap further productivity gains across many areas of the economy. For example:

- World best practice indicators point to further potential improvements in the performance of much of Australia's economic infrastructure. For instance, best practice rail freight rates overseas are one third lower than Australia's best; and the highest rates charged in Australia are 60 per cent above Australia's best practice rates (BIE 1995b).
- Labour markets are not functioning as well as they could. Persistent unemployment remains Australia's most pressing economic and social problem. Around 800 000 people are looking for work, over a quarter of whom have been unemployed for a year or more. The unemployment rate of 15–19 year olds not in full-time education currently stands at over 20 per cent. Of the two million part-time workers, one-quarter would prefer to be working more hours.
- In response to wide-ranging concerns about the quality and efficiency of service delivery, Australia's education, health and community services are being examined to determine where improvements in performance can be made. Government expenditure on these services is a large and growing part of the economy — around 12 per cent of GDP in 1994–95. So the potential benefits from even small improvements in productivity are large. Benchmarking of government service provision undertaken by the Commission on behalf of COAG has revealed major variations in the cost and effectiveness of service delivery across jurisdictions (SCRCSSP 1997).

Last year, the Commission was asked to undertake a Stocktake of Progress in Microeconomic Reform (PC 1996). This provided an opportunity to take stock of what already has been achieved, and to identify what more needs to be done. The Commission's stocktake identified many areas, including in the provision of industry assistance and business programs, in which immediate action or further review could lead to improved performance. The scope of the reform program and priorities for action, as seen by the Commission at that time, is summarised in table 5.1. It should be noted that governments have already acted in some areas along the lines recommended.

The stakes for industry are high

A number of recent modelling studies have estimated the gains to Australian industry and the economy generally from microeconomic reform. These models have limitations. Not least is the difficulty of measuring real world adjustment costs. Equally, though, many feel that existing models underestimate the gains because they inadequately capture the dynamism that reforms can inject into an economy.

All of these studies show that the benefits of reform to industry and the community are significant, widespread and ongoing. This is regardless of the type of economy-wide model used (EPAC 1994b). The estimated long term gains in Australia's GDP range from 5 per cent to as high as 20 per cent (in one study) depending upon the range of reforms modelled, different base scenarios, time frames and assumptions about how the economy operates and adjusts to change. Importantly, all recent studies show that while there are divergent results for individual industries, broadly based reform leads to an expansion in activity in all sectors of the economy. (The nature of the reforms modelled and key results for five modelling exercises are presented in box 5.1. A more detailed analysis of the modelling work is contained in BIE 1996.)

The studies underline the importance of undertaking reform on a broad front. A wider reform effort is likely to produce higher aggregate benefits. In addition, for particular industries, gains from some reforms tend to offset the losses from others which reduces adjustment costs. For example, the modelling shows that contractionary effects of tariff cuts on some import-competing activities are more than offset by the stimulus of lower prices for business inputs and infrastructure services.

Table 5.1: The reform program — key actions

Area	*Key actions* [a]	*Responsibility*
HUMAN RESOURCES		
Industrial relations	• **Facilitate workplace agreements**	Cwlth & states
	• **Ensure enactment of key provisions in Workplace Relations Bill**	Cwlth
	• Review and further consolidate safety net provisions	Cwlth
Other labour market	• Rationalise employment programs	Cwlth
	• Implement workers' compensation and OH&S reforms	Cwlth & states
Education and training	• see SOCIAL INFRASTRUCTURE	
COMPETITION POLICY		
National competition policy	• **Resolve outstanding issues in framework and implement**	Cwlth & states
	• **Bring transparency to exemptions**	Cwlth & states
	• **Ensure legislative reviews are independent**	Cwlth & states
	• Review operation of framework	Cwlth to initiate
Trade Practices Act	• Review elements such as merger policy	Cwlth to initiate
ECONOMIC INFRASTRUCTURE		
General	• **Implement national competition policy** (see above)	Cwlth & states
	• Review ownership, contracting out	Cwlth & states
	• Institute rolling reviews of progress	Cwlth to initiate
Specific areas	• **Reform in transport, especially waterfront, rail and roads**	Cwlth & states
	• Progress electricity, gas, water and communications reforms	Cwlth & states
SOCIAL INFRASTRUCTURE		
Education	• **Review level and form of government support and institutional arrangements**	Cwlth & states
Training	• Review vocational education and training	Cwlth to initiate

Table 5.1 (continued)

Area	*Key actions* [a]	*Responsibility*
Health	• **Review financing and delivery**	Cwlth & states
	• Extend casemix funding	States
	• Apply competitive neutrality principles between public and private providers of hospital services	States
	• Review PBS	Cwlth
	• Enhance performance monitoring	Cwlth & states
Social welfare system	• Review effectiveness, including labour and tax interactions	Cwlth
OTHER KEY REFORM AREAS		
Taxation	• **Comprehensive reform of taxation system a longer term goal**	Cwlth & states
Trade and assistance	• **Continue general tariff phasedown**	Cwlth
	• **Review PMV and TCF**	Cwlth to initiate
	• Review/reform SMAs	Cwlth & states
	• Rationalise budgetary programs	Cwlth & states
	• Review/reform non-tariff measures	Cwlth
	• Implement R&D reforms	Cwlth
Resources and the environment	• Clarify access	Cwlth & states
	• Improve efficiency of environmental protection measures	Cwlth, states, local
	• Review land management	Cwlth to initiate
Regulatory review	• Extend mutual recognition	Cwlth & states
	• Ensure rigorous processes for implementation and review	Cwlth & states
Public administration	• Extend administrative reforms and performance monitoring	Cwlth, states, local
Commonwealth–State financial relations	• **Reduce reliance on tied grants**	Cwlth
	• **Review revenue arrangements**	Cwlth & states

a Bold type indicates priority reforms.
Source: PC (1996)

In summary, by pressing ahead with broad-based microeconomic reform, government can make a substantial contribution to industry development and raise national productivity. This submission argues that business programs which effectively improve on outcomes where markets fail can also help to meet those objectives. However, those which merely prop up inefficient sectors of industry or fail to meet cost-effectiveness criteria, need to be terminated as part of the reform process, as they reduce Australia’s national income.

Box 5.1: Modelling the gains from reform

- The IC (1990) modelled reform in transport, aviation, communications, water and electricity, contracting out by governments and the removal of rural and manufacturing assistance. This projected long term gains in GDP of 6.5 per cent and, assuming flexible real wages, an extra 53 000 jobs.
- The BIE (1990) estimated the benefits from reform over the seven year period from 1988–89 to 1994–95. In addition to those examined by the IC, the reforms modelled included the impact of investment incentives and labour market reforms assumed to result in large increases in labour productivity. The study found that reform would increase GDP by 9.5 per cent.
- Filmer and Dao (EPAC 1994a) analysed the effects of: the reduction in tariffs and subsidies; labour market reform; facilitation of the operation of markets; transport and communications reforms; Government Business Enterprise (GBE) reform; gains from international trade negotiations; support for emerging exporters; and the efficient provision of government services. The model also projected the benefits of reducing the sustainable unemployment rate from 7.3 to 5.0 per cent. It estimated reform would increase GDP by 12.7 per cent. All of the model’s 25 industries experienced growth.
- Reforms modelled by the BCA (1994) included: the replacement of the existing indirect tax system with a broad based consumption tax; improvements in the level and efficiency of government services; further improvements in the efficiency of GBEs; and improvements to labour productivity in the private sector that were assumed to bridge the gap between Australian productivity levels and world’s best practice (except where they were due to economies of scale). The model estimated reform could increase real GDP by 20.5 per cent over a 20 year period.
- The IC (1995a) estimated the growth and revenue implications of the Hilmer and related reforms. Specifically, the IC modelled the impact of reforms in the transport, communications and utilities sectors, and to statutory marketing arrangements, government services, unincorporated enterprises and anti-competitive legislation. The IC results suggested that, over time, there would be a gain in GDP of 5.5 per cent, an increase in real wages of 3 per cent and, if there were to be flexible real wages, 30 000 extra jobs through higher labour force participation rates.

APPENDIX A EXPORT ASSISTANCE

Like other countries, Australia assists exports in a variety of ways. These include:

- subsidised export marketing, intelligence and promotional services provided to firms by Austrade and other agencies;
- grants to firms to increase exports (for example, the Export Market Development Grants scheme); and
- trade facilitation schemes such as export facilitation for the passenger motor vehicle and textile, clothing and footwear industries.

General programs such as bounties, Partnerships for Development, and Factor f, also provide support for export activity.

The main arguments for export support centre around a desire to foster cultural change, and spillovers associated with export activity. There are also second best arguments based on compensating exporters for the costs of tariff protection and other inefficiencies in the economy.

Some also claim that export incentives improve the trade balance and the current account. However, these are mainly a function of aggregate savings and investment behaviour (see IC 1995d, appendix A.) Thus, such considerations are of little relevance in evaluating whether to continue with export incentive programs.

Supporting cultural change

The Commission's Review of Overseas Export Enhancement Measures (IC 1992) explains why countries should try to improve their trade and export performance. Greater trade exposure encourages countries to specialise in the activities they do best, leading to higher national income. It provides for greater scales of production and for the transfer of skills and technology between countries. And the increased competition is a stimulus for productivity improvement in the traded sector, and a catalyst for reforms in non-traded parts of the economy.

But profit maximising firms will have strong commercial incentives to explore opportunities in overseas markets.

Hence failure to achieve an ‘optimal’ export level or to embrace an ‘export culture’ must presumably reflect some market failure, or impediments elsewhere in the economy that retard export performance.

Spillovers

The experience of firms undertaking export development activity may provide a benefit to others, for which exporting firms cannot charge. Hence they may under-invest in export development activity from the community’s point of view. Some argue that this free-rider problem is particularly significant for SMEs, given the cost and risk of initial entry to export markets.

In considering this argument, it is important to distinguish between the costs of undertaking export development activity and any wider benefits that such activity generates.

Information costs of export market development

Specialist advisory bodies may be able to gather and disseminate information on export prospects at a fraction of the cost for individual firms acting in isolation. Particularly for SMEs, a collective approach may therefore reduce the risk of entry to export markets and allow for the realisation of economies of scale.

But given the benefits of collective action, firms have strong commercial incentives to participate in such arrangements. Thus, such advisory services could be provided on a user pays basis (see IC 1992). The role of government could then be more appropriately limited to the provision of generic information to exporters. Where the exported product is homogeneous, there may also be a case for government to provide legislative backing for a compulsory industry levy to finance export market development and other promotion.

Establishing reputation

It may be that some pioneering firms can help to establish Australia’s reputation in overseas markets and provide market intelligence to other local firms. These represent genuine spillover benefits.

However, there is little evidence that such spillovers accompany all export market development activity in all markets, or that they are generally significant. This militates against the provision of export assistance to firms.

Moreover, the way in which some current export schemes aim to target spillovers is questionable. For example, under the EMDG scheme, assistance is limited to SMEs. Yet it is not clear why only smaller firms would generate information or reputation benefits of wider value to business. Nor is it clear that spillovers would exist in well-established markets.

Compensating exporters for other inefficiencies

A decade ago, Australia’s high tariffs represented a significant tax on exports. Apart from this direct impediment to exporting activity, the tariff wall reduced the need for firms to look for export markets and created an inward looking business culture. There may thus have been a justification for export assistance on second best grounds (see IAC 1989a).

However, over the last decade, Australia has reduced its tariffs significantly. There can be little dispute that these reductions have been much more important than export assistance measures in encouraging a more outward looking business culture. This is one reason why it is important not to slow the tariff reduction program.

Further, Australia has now gone some way down the wider microeconomic reform track. Reforms to the labour market, the provision of infrastructure and the like, have improved the competitiveness of Australian exports. This recently led the Commission to conclude that:

> Reductions in the costs imposed on exporters by tariffs, together with the speeding up of microeconomic reform, meet the preconditions for the removal of export market development assistance set by the last comprehensive [Hughes] review (PC 1996, p. 125).

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