Australian Government
Productivity Commission

April 2023

Inquiry into promoting economic dynamism, competition and business formation

Productivity Commission submission

Matters arising from public hearing appearance

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Question 1: In which sectors is there a link between productivity and competition?

The main submission addresses this question.

Question 2: What areas are most prospective for seeking to increase competition in order to boost productivity?

The main submission addresses this question.

Question 3: Do you see the AUKUS deal as an economic and industrial policy as much as a defence one?

The Commission has not examined the AUKUS deal.

Question 4: Are there any constitutional barriers or restraints on competition, particularly in the section 51 powers or any other elements?

The Constitution provides various powers to the Australian Government or the states to address competition issues. The Competition Code signed by states gave the Australian Government the power to apply competition law to persons and not just corporations, so the Competition and Consumer Act (CCA) has general application to businesses, incorporated or otherwise.

However, the CCA itself does not cover all instances where problems in competition may arise. In particular, Australian and state and territory government impose an array of regulations that limit competition. Governments also may use models of service provision that reduce competition. The Constitution provides constrained scope for the Australian Government to override state and territory regulations that have an adverse impact on competition. The Australian Government itself has also implemented regulations that impede competition and that are not open to constitutional challenge.

The Harper Review (Harper et al. 2015) provides comprehensive coverage of Australian and state and territory government regulations that limit competition. Many have also been identified in the Productivity Commission's first 5-year Productivity Review, *Shifting the Dial* (PC 2017b, particularly appendix B, chapter 4, and supporting papers 13 and 16) and the recently released second 5-year Productivity Review, *Advancing Prosperity* (PC 2023a, particularly volume 1 and 3).

Among the issues raised by these reports and various other recent Productivity Commission analysis are:

- reform of planning and zoning regulations (which limit competition within given areas)
- reforming occupational licencing
- relaxing limits on health practitioners working to their full scope of practice
- recognition of qualifications from overseas and between jurisdictions (though automatic mutual recognition has addressed many of the latter)

- repealing Part X of the Competition and Consumer Act relating to coastal shipping (PC 2022b)
- reforming regulations relating to pharmacy ownership and location, while also giving pharmacists greater clinical roles
- opening up the capacity for private health insurers and public hospitals to manage chronic disease and its costs by altering legislative restrictions on funding of primary health
- ensuring reinsurance models in community-rated private health insurance provide competitive pressures for insurers to prevent or slow the progress of chronic diseases
- removing remnant shopping hour restrictions
- removing barriers to imports of second hand vehicles
- addressing insufficient recognition of international standards
- reducing barriers to foreign direct investment
- scaling back anti-dumping duties (which limit import competition in certain industries)
- addressing incomplete adherence to competitive neutrality principles in relation to government businesses
- implementing a consumer-centric approach to human services including, where feasible, greater choice of services and providers. The Commission's analysis of human services (PC 2017a) is also relevant to this issue
- increasing incentives for universities to compete on the basis of teaching quality.

Question 5: In the current inflationary environment, do you think some businesses are incorrectly or even dishonestly attributing mark-ups?

The main submission addresses this question.

Question 6: Is there a link between access to capital and productivity growth? Particularly with reference to businesses size?

The Commission has previously considered the issue of access to capital and productivity, concentrating on small and medium businesses as these are those that face the greatest difficulties. As discussed in the main submission, the growth of small firms is a source of productivity growth and innovation across the economy (although larger firms are more likely to drive innovation in Australia).

Nonetheless, it is important for the performance of the Australian economy, and for productivity, that SMEs have access to finance to support their day-to-day operations and fund their growth and investments in innovation and tangible and intangible capital. This is particularly important given the scale of this part of the economy. Outside of the finance, insurance and public services sectors, small and medium enterprises (SMEs) employ about two-thirds of workers and generate more than half of Australia's value added (PC 2021).

The nature and severity of the constraints on access to capital is discussed further below.

Question 7: What impact on competition and productivity is there of businesses becoming larger (especially through vertical integration)?

The main submission highlights pitfalls in reaching conclusions about the effects of industry concentration and business size on competition and productivity. Accordingly, in considering this question, we have focused on vertical integration.

The competitive effects of vertical integration depend on the structure of upstream and downstream markets. Among the most important elements of market structure is the market power of firms in the relevant industries — evident in their ability to raise price above cost without the loss of market share or to exclude competitors — and is brought about by factors such as industry concentration, product differentiation and

cost advantages. Vertical integration that increases market power (for example, by eliminating competitors or raising entry barriers) is more likely to have adverse consequences for consumers (PC 2018).

The Commission considered vertical integration and competition as part of its Review of National Competition Policy. Reducing the incidence of vertical integration for public monopolies (such as electricity, gas, road transport) was important in improving competition (PC 2005).

In private markets, research has found mixed evidence about the effects of vertical integration. It can have detrimental effects on productivity if the business is able to extract economic rent as a result of the integration (Li, Lu and Tao 2017). On the other hand, larger, more productive firms are more likely to vertically integrate and improve logistics and co-ordination between suppliers, leading to a positive correlation between integration and productivity (Forbes and Lederman 2010; Hortacsu and Syverson 2007).

The Commission's main submission also notes the productivity-enhancing benefits associated with economies of scale — which can be easier to achieve with vertical integration.

Question 8: Is there a link between the regulatory burden and productivity growth?

There is limited research measuring the economy-wide costs of regulation (as opposed to examining the impacts of specific pieces of regulation). There is some evidence that suggests greater, or more burdensome, regulation can stifle economic activity and overall growth:

- The Commission's Trade and Assistance Review finds that foreign direct investment is a key source of productivity growth as it increases the stock of capital beyond the level possible if only domestic savings were available to finance investment (PC 2022c, p. 86). It also can spur innovation. Policy setting for foreign investment policy (such as investments having to pass the 'national interest' test, or the new foreign investment screening framework) are likely to have limited the flow of foreign direct investment into Australia, limiting its benefits.
- There are no authoritative measures of the aggregate economy-wide regulatory burden. The usual approach is to develop a comparative indicator based on combining various factors likely to be related to the general ease of doing business in a country (like days to obtain construction-related permits). The World Bank's 'Doing Business' index attempted to measure the extent to which regulations affected the ease of doing business across different countries, although the index was discontinued in 2020 due to concerns about methodology and data irregularities.[1] Studies using this index as a measure of regulatory burden have found a negative relationship between the degree of regulation and overall economic growth (Dawson and Seater 2013; Parker and Kirkpatrick 2012).
  - A study looking at business regulation in 135 global economies over the 1990s to early 2000s estimated that output growth was 2.3% higher for the countries in the lowest quartile of regulatory burden, relative to the countries in the highest quartile (Djankov, McLeish and Ramalho 2006). A similar study estimated that, over the late 1990s, a one standard deviation increase in overall regulation was associated with a 0.4 percentage point decrease in annual per capita GDP growth (Loayza, Oviedo and Serven 2004).
  - More burdensome regulation has also been associated with lower labour productivity, with improvements in the Doing Business indicators found to be positively associated with increased labour productivity in manufacturing and services across Europe (Dall'Olio et al. 2013).

[1] The World Bank released a statement on 16 September announcing the discontinuation of the Doing Business report: https://www.worldbank.org/en/news/statement/2021/09/16/world-bank-group-to-discontinue-doing-business-report. The World Bank is implementing a new metric B-READY.

Question 9: What is best practice to manage something that is new, disruptive and creating competitive tension, but may harm consumers or cause other issues? For example, what are your views on regulatory sandboxes?

We are not aware of any single best practice approach to this issue other than to use a framework that identifies the expected costs and benefits of disruptive technologies, including a careful assessment of risk and uncertainty, and consideration of the longer-run impacts. The recent controversies about AI chatbots exemplifies the challenges when there are diverse views about the magnitude and timing of risks and the degree to which policymakers should adopt the precautionary principle.

Nonetheless, the Commission, the OECD and other commentators identify a range of regulatory approaches, with case-studies supporting where different approaches are appropriate (Deloitte 2018; OECD 2021a; PC 2016).

New technologies can disrupt industries, drive innovation and productivity but raise risks to consumers. Although digitally enabled models often differ from traditional markets and do not fit with existing regulatory frameworks (Attrey, Lesher and Lomax 2020), regulation is essential to mitigate the risks of technological transformation while promoting useful innovation, experimentation and entrepreneurship (OECD 2021b).

The Commission has identified some of the risks posed by disruptive technologies (such as privacy, cybersecurity, public safety, and discrimination) and set out some of the policy options available to governments to manage these (PC 2016 chapter 4). Our recent productivity review also examines many of these issues in relation to digital technologies (PC 2022a).

The OECD taxonomy of regulatory approaches is also a useful framework for considering policy options, with the OECD noting that a combination of these approaches, depending on the environment and circumstance, would be required to harness the full potential of technological development:

- anticipatory governance – the rapid pace of innovation means that governments need to develop anticipatory governance approaches to allow for an earlier identification of risks and opportunities brought by technological developments
- wait-and-see approaches – this is a common reaction at the beginning of the technological development, and consists of observing how the technology develops without taking any regulatory action
- issuing guidance – governments can rely on soft law mechanisms, such as regulatory guidance, to help innovators understand how the regulatory framework applies to a specific technological development, and to reduce the potential regulatory uncertainty about how to comply. It is important to note that guidance often occurs as a complement to wait-and-see approaches
- self-regulation – self-regulation involves a group of economic agents, such as firms in a particular industry or a professional group, voluntarily developing rules or codes of conduct that regulate or guide the behaviour, actions and standards of its members
- co-regulation
- regulatory experiments – a number of jurisdictions are experimenting with innovative regulatory approaches, such as regulatory sandboxes, to support the testing of new technologies and foster policy learning on how the regulatory framework may need to adapt
- outcomes-based regulation – this approach defines measurable outcomes that regulated firms must achieve. In focusing on outcomes rather than on inputs, it offers flexibility to businesses on how to meet to objectives, as long as they can demonstrate that the desired outcome has been achieved
- means-based regulation – also known as command-and-control regulation. This stands in contrast to outcome-based regulation as governments define how businesses must act

- outright ban – a ban to protect existing markets through regulation or to protect citizens against the potentially negative consequences of a technological development.

Regulatory sandboxes are accordingly just one of the many tools available to manage disruptive technologies. Their value is that market participants can supply novel products and services under relaxed regulatory requirements, recognising that absent the sandbox, existing regulations would often preclude their supply altogether. Sandboxes are usually permitted on a small-scale, for a given period, and are closely monitored so as to reduce risks for consumers and others.

The Commission has undertaken detailed work looking at regulatory sandboxes in relation to FinTech (PC 2018), though we also draw your attention to its application to the consumer data right (PC 2023b, p. 50). The Commission notes that a regulatory pause offered by a sandbox for new products and business models, where the risk is clearly not catastrophic, gives firms an incentive to ensure they manage their risks. And where these risks are different from those related to supply by incumbents, this avoids burdening new business with the same regulatory approach in an attempt at some sort of equality of treatment, and as such, avoids quashing innovative new approaches (PC 2016, p. 99).

Question 10: Is there good access or barriers to finance by firm size? Do new firms face barriers to finance due to the risks they pose?

The most relevant Commission reports that consider borrowing constraints are the Commission's research paper into *Small business access to finance* (PC 2021), the Inquiry into *Competition in the Australian financial system* (PC 2018) and the Inquiry into *Business set-up, transfer and closure* (PC 2015). The Commission also draws the attention of the Committee to analysis undertaken by the Reserve Bank of Australia (Bank and Lewis 2021; Connolly and Bank 2018) and the Australian Bureau of Statistics' various data series in *Characteristics of Australian Businesses*.[2]

Small and medium enterprises (SMEs) prefer debt finance: they are three times more likely to apply for debt than equity finance. This is not surprising: equity holders must be even more cautious in providing finance as they have low priority as claimants where a business fails. And debt financing leaves the small business in control of their business. Banks have a preeminent role in providing finance for SMEs accounting for more than 90% of the outstanding debt owed by SMEs. Where banks provide finance to SMEs, they often require property-secured loans. Banks have a limited appetite for unsecured lending to SMEs (PC 2021, p. 2). An emerging issue is that as home ownership rates decline, especially for people most likely to start a business, the capacity to use housing as collateral is likely to be declining.

Research finds that about 16% of SME owners say that a lack of finance hampers their business (PC 2021, p. 20).[3] Moreover, 19% say that a lack of funds significantly hampered their ability to undertake innovation, which is a key source of productivity improvement. On face value, this suggests that credit constraints on SMEs may be a drag on the Australian economy (PC 2021). On the other hand, the perceptions of SMEs that they cannot get the finance they want does not necessarily mean that it would be prudent for a lender to provide it. A key problem is that an SME owner may have a good idea of their risks, but that a lender or equity provider cannot take the risk appraisals of a lender on face value (information asymmetries). This means that while perceptions of finance constraints are useful evidence, they need to be interpreted carefully. The difficulty in appraising default risk for any particular business is the predominant reason that lenders require some collateral for lending — it strengthens incentives for borrowers to only seek finance for

[2] https://www.abs.gov.au/statistics/industry/technology-and-innovation/characteristics-australian-business/latest-release.

[3] This result is from a survey, which asks about the factors that businesses perceive to be hampering their activities, rather than whether businesses actually sought — and were denied — finance.

likely successful investments. And to place things in perspective, most small businesses are successful in obtaining (debt) finance, though this depends on the business cycle (PC 2018, p. 438).

An associated issue is that even if finance is available for SMEs, the costs are higher than for bigger businesses (PC 2015, pp. 17, 119–136). Indeed, credit cards are often used as a source of funds for nascent businesses with interest rates that are multiples of usual collateral-backed lending rates and with strict limits on borrowing amounts. At least in part, the higher rates paid by small business reflects their greater risk. Small businesses are about twice as likely to default on loans as large businesses (Bank and Lewis 2021, p. 48).

Whether access to debt is adequate depends on whether there are regulations that impede lending, suboptimal lending practices, and the difficulty faced by lenders in gauging the default risk of the business. The low access to equity has long been noted and some researchers have suggested it to be a preferred source of funding over credit cards for start-ups (Connolly and Bank 2018, p. 3).

The Commission's Inquiry into competition in the Australian financial system found that existing regulation increased the cost of lending to SMEs for small banks (PC 2018, pp. 32–35). The main reason for this was prudential regulation affecting the amount of capital a bank must hold to protect depositors. This, in combination with the greater risks associated with lending to SMEs, means SMEs pay more for their finance than larger businesses (PC 2018). There has since been some shift in the risk weighting for unrated SME loans (APRA 2023), which may somewhat ease access to finance.

There has also been expansion in some novel debt financing options from non-banks, including borrowing against non-property collateral, such as vehicles, machinery and expected receipts (PC 2021).

The advancements made by lenders in technology and data capabilities, along with government initiatives promoting information sharing, have also created new avenues for SMEs to obtain loans. Although these developments are relatively recent, many lenders are improving their digital processes and considering new ways to leverage data on prospective borrowers to evaluate credit risks. The potential for scalability and the growing number of lenders participating in the market indicates that technological and data advancements will continue to enhance SME access to finance.

Question 11: Are there particular sectors where we might focus on to improve productivity?

The non-market sector is ripe for improvements in productivity. This sector tends to be ignored as output in this sector is inadequately measured, and yet its efficient functioning is critical to many of the services Australians value (care services, health, education and defence). The usual market mechanisms that encourage innovation and productivity are weaker as there is minimal competition, little scope for the exit of poorly performing 'businesses' and few explicit diffusion mechanisms for best-practice.

While it is possible to sometimes encourage the development of markets for some government services (as was the case with the original Job Network and now Workforce Australia), this will not always be possible. Accordingly, new ways to promote productivity are required, such as creating explicit diffusion mechanisms, development of new funding models in healthcare and road provision, and better use of evaluations to test the merit of large public investments. The Commission has set out an agenda to improve innovation in government-provided or/and funded non-market services in its 5-year productivity review(PC 2023c). The broader review canvases a wide range of other policies to improve productivity across the whole economy (PC 2023a).

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