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**Stocktake of
progress in
microeconomic
reform**

Productivity Commission

June 1996

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Forming the Productivity Commission

The Federal Government, as part of its broader microeconomic reform agenda, is merging the Bureau of Industry Economics, the Economic Planning Advisory Commission and the Industry Commission to form the Productivity Commission. The three agencies are now colocated in the Treasury portfolio and amalgamation has begun on an administrative basis.

While appropriate arrangements are being finalised, the work program of each of the agencies will continue. The relevant legislation will be introduced soon. This report has been produced as a joint exercise of the three agencies.

FOREWORD

Microeconomic reform is about making the economy work better for the benefit of all Australians. This is a continuous process and can involve difficult choices. As one area is tackled, new issues emerge. That is why it is valuable to take stock from time to time and reassess priorities.

The Government asked the interim Productivity Commission, as an independent advisory body, to conduct this stocktake of progress in microeconomic reform as one of its first tasks. The Treasurer set the Commission's assignment very broadly, covering all sectors of the economy and all forms of government intervention.

With three months to prepare its report, the Commission's main contribution has been to survey the reform landscape and identify broad directions for action and further investigation.

The report covers longer term reform issues as well as more immediate priorities. It does not, however, seek to provide a level of detail that would come from individual reviews of particular reform areas. For such detail, and where specific action is suggested, readers can be referred in many instances to separate reports by the BIE, EPAC and IC (among other sources). On the longer term issues, further work will be required to develop specific proposals.

The Commission has also sought to avoid duplication with the separate reviews conducted by the National Commission of Audit and the Committee of Inquiry into the financial system. For this reason, it has not dealt in any detail with financial policy concerns.

The Commission has benefited greatly from the participation of a wide range of individuals, organisations and government departments (State, Territory and Commonwealth) who have responded positively to the timeframe of the exercise. The Commission is very grateful for their assistance. All submissions and departmental information papers are available on request.

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ABBREVIATIONS

ABA	Australian Broadcasting Authority
ABARE	Australian Bureau of Agricultural and Resource Economics
ABS	Australian Bureau of Statistics
ACCC	Australian Competition and Consumer Commission
ACCI	Australian Chamber of Commerce and Industry
ACM	Australian Chamber Manufactures
ACOS	Australian Chamber of Shipping
ACSI	Australian Coalition of Service Industries
ACTU	Australian Council of Trade Unions
AIRC	Australian Industrial Relations Commission
AMEC	Association of Mining and Exploration Companies
AN	Australian National
ANCA	Australian Nature Conservation Agency
ANL	Australian National Line
ANTA	Australian National Training Authority
AOPAA	Aircraft Owners and Pilots Association of Australia
APEC	Asia Pacific Economic Cooperation (Forum)
ATC	Australian Tourist Commission
ATO	Australian Taxation Office
AVTS	Australian Vocational Education and Training System
BCA	Business Council of Australia
BIE	Bureau of Industry Economics
BOMA	Building Owners and Managers Association
BOOT	Build-own-operate-transfer (arrangements)
BTCE	Bureau of Transport and Communications Economics
CDs	Compact discs
CES	Commonwealth Employment Service
COAG	Council of Australian Governments

CSIRO	Commonwealth Scientific and Industrial Research Organisation
CSOs	Community service obligations
CTC	Competitive tendering and contracting
DEET	Department of Employment, Education and Training
DEETYA	Department of Employment, Education, Training and Youth Affairs
DEST	Department of Environment, Sport and Territories
DFAT	Department of Foreign Affairs and Trade
DHCS	Department of Health and Community Services
DIFF	Development Import Finance Facility
DIR	Department of Industrial Relations
DPMC	Department of the Prime Minister and Cabinet
DTRD	Department of Transport and Regional Development
EFAs	Enterprise Flexibility Agreements
EFIC	Export Finance and Insurance Corporation
EIA	Environmental impact assessment
EPAC	Economic Planning Advisory Commission
ESAA	Electricity Supply Association of Australia
ESD	Ecologically sustainable development
ESI	Electricity supply industry
FAC	Federal Airports Corporation
FBT	Fringe benefits tax
FIRB	Foreign Investment Review Board
GBEs	Government business enterprises
GDP	Gross domestic product
GNE	Gross national expenditure
HECS	Higher Education Contribution Scheme
IAC	Industries Assistance Commission
IC	Industry Commission
IGAE	Intergovernmental Agreement on the Environment
MCRT	Ministerial Council on Road Transport
MIRA	Maritime Industry Restructuring Agreement
MTIA	Metal Trades Industry Association
NATSEM	National Centre for Social and Economic Modelling
NCC	National Competition Council

NFF	National Farmers' Federation
NFPS	National Forest Policy Statement
NR	National Rail Corporation
NRTC	National Road Transport Commission
NSESD	National Strategy for Ecologically Sustainable Development
NTA	Native Title Act
NTMs	Non-tariff measures
NTPT	National Transport Planning Taskforce
ORR	Office of Regulation Review
PBS	Pharmaceutical Benefits Scheme
PSA	Prices Surveillance Authority
PTCV	Public Transport Corporation of Victoria
QR	Queensland Rail
RIS	Regulation impact statement
SCNPM	Steering Committee on National Performance Monitoring of Government Trading Enterprises
SCRCSSP	Steering Committee for the Review of Commonwealth–State Service Provision
SEAC	State of Environment Advisory Council
SIRA	Shipping Industry Reform Authority
SRA	State Rail Authority of New South Wales
TCS	Tariff Concession System
Teus	Twenty foot (container) equivalent units
TEXCO	Tariff Export Concession Order
TFP	Total factor productivity
TPA	Trade Practices Act
VET	Vocational education and training
WIRA	Waterfront Industry Reform Authority
WTO	World Trade Organization

OVERVIEW

Microeconomic reform is crucial to the future wellbeing of all Australians. Some major reforms have already been introduced, but a substantial reform task lies ahead.

The challenge of global change

Australia faces constant change. It is both domestic and international in origin. Rapid shifts in technology, the growth of our Asian neighbours, the global decline in barriers to trade and investment, and changes in the attitudes and expectations of Australians, are just a few examples.

In an era of change, our economy needs to be flexible and adaptable if we are to maintain and improve our living standards.

That is why microeconomic reform is so important. It is not only a way of making our existing economic and social institutions more effective and productive; it also provides the foundation for the development of an adaptable, innovative economy that can flourish amid inevitable and unpredictable global change.

Microeconomic reform and productivity

Microeconomic reform is about providing incentives for greater productivity. Productivity growth is the key to higher living standards. This means making better use of our resources — natural, financial and human. But microeconomic reform can also deliver better value, quality and choice to the community. Microeconomic reform thus plays a part in enhancing prosperity, opportunity and social support — all of which are integral to community wellbeing.

Microeconomic reform is an evolving process. The lowering of tariffs and the liberalisation of financial markets are among the more important reforms already in place. Opening the economy through these means has provided a spur to productivity within firms, with benefits to consumers.

But it has also exposed more deep-seated constraints on Australia's economic performance, particularly within labour markets and in the economic and social infrastructure provided by governments. While there has been some progress in these areas, a challenging agenda remains.

Wide scope for reform

Against this background, the Commission examined nine areas in its stocktake:

- labour markets and industrial relations
- competition policy
- economic infrastructure
- education, health and community services
- taxation
- trade and industry assistance
- resources and the environment
- regulatory reform
- performance of governments.

(Because of the concurrent inquiry into the financial system, the Commission has commented only briefly on this area.)

The Commission has proposed reforms in each of these areas. Broadly based reform is important, not least because of the interdependence of reforms in delivering maximum benefit to Australians. Reform on a broad front also improves the prospect that those who lose from one reform will benefit from others. It can thereby reduce adjustment burdens and resistance to change.

There are of course limits to what can be achieved immediately. Hence, the Commission has indicated a broad sense of priorities for its proposed reforms.

Several factors bear on priorities. They include: the importance of the sector to the wellbeing of Australians; the extent of current inefficiencies; the pervasiveness of the benefits from reform; the need to coordinate some reforms; knowledge of the precise reforms required; and, not least, community acceptance of the need for reform.

The immediate reform requirements

Making the best use of Australia's human potential is fundamental to ensuring economic progress in a changing world. The immediate policy priority is the further transformation of the industrial relations environment to facilitate more adaptable and productive workplaces. This is a precondition for enhancing human resource use and development in Australia. The Government's intended industrial relations reforms are a necessary and important step in this direction.

To make better use of physical capital, the immediate policy priority is early application of the national competition policy principles to economic infrastructure.

Australia is a large country, remote from many key markets and sources of supply. High quality and competitively priced transport and communication linkages are therefore vital. As a significant player in these and other infrastructure services, government must take the lead in getting the basic structure and competitive environment right. The competition policy framework is now in place, but the challenging task of implementing an effective set of arrangements lies ahead. Some areas of infrastructure, like the waterfront, rail and roads, need particular attention.

There are other reforms that reinforce or contribute to these core priorities and that lend themselves to early action. These include the wider application of competition policy to create one Australian market for goods and services, and the further opening of the Australian market to international competition.

Extending the boundaries of reform

While implementing industrial relations reform and the national competition policy are the immediate priorities, Australian governments must prepare the ground for subsequent reforms. This is essential to sustain reform momentum, reduce delays and lock in benefits to the community.

Again, the priorities relate to tapping people's potential and to investing wisely in physical capital.

To fully develop our human resources, Australia's education and training systems need to be world class. The industries of the future will require highly skilled people. And adaptability in the face of global change demands an accessible general education system of high quality to provide the foundation for the acquisition of new skills.

Yet, measured against some basic principles for achieving effectiveness and efficiency, the education and training sectors have deficiencies that require remedy. Some things can be done immediately, but a broader review is required to develop proposals for and to foster acceptance of more fundamental change.

Enhancing people's wellbeing also means developing Australia's social capital through reforms in health and community services. Those areas too must become more flexible and adaptable if they are to meet community welfare objectives more effectively and support economic change. A mix of some possible early reforms along with a comprehensive review is again required.

Tax reform is also important. The current mix of Commonwealth and State taxes encourages unproductive behaviour. It also discourages saving, making it harder to fund the investment needed for future growth.

The reality is that tax reform currently faces some obstacles. It will almost inevitably need to be linked to a restructuring of Commonwealth–State finances. And rectifying the key inefficiencies in the current regime will require a greater emphasis on indirect taxation. While there is a strong economic case for this kind of broad-ranging reform, recent experience highlights the need for more informed community debate.

To reinforce the momentum for reform, regulatory reform and improvements in public administration are also required. And a number of areas will need to be revisited over time to review progress and reinvigorate the reform effort.

The Commission’s reform agenda is laid out in the pages that follow.

Beyond the issues covered in this report is a longer term agenda, which could include reviews of ‘public good’ areas such as defence and law and order, and the institutions of corporate, legal and constitutional governance that express the basic ‘rules of the game’. Whether better structures and incentives can be developed for these areas should be a matter for public consideration.

Issues in implementation

Implementing reform is seldom easy. Even when the best way forward is known, the distribution of gains and losses from reform can impose major obstacles to implementation. Losses are often concentrated on a few groups and incurred upfront. The gains, while larger, are often more widely spread and accrue further down the track. These are political realities. But dealing with them will be easier if the public is made aware of the wider benefits of reform. Sound processes for implementing and reviewing policy are also essential.

Reform inevitably involves adjustment. With a more flexible economy and a more skilled workforce, supported by effective training systems, the difficulties of adjustment will be less marked. Nevertheless, adjustment can still impose burdens on the more vulnerable in our society. Effective social support is an integral part of building community wellbeing.

The Commission believes that further microeconomic reform is essential if Australia is to meet the challenge of global change. Much has already been achieved. And there will be substantial benefits from the further reforms the Commission has identified. It will require organisations and individuals to make the most of the opportunities presented. Governments must play their part by developing a broad program of reform and implementing it as expeditiously as possible.

THE REFORM AGENDA: KEY ACTIONS

Area	Key actions	Responsibility
<i>HUMAN RESOURCES</i>		
Industrial relations	<ul style="list-style-type: none"> • Facilitate workplace agreements • Ensure enactment of key provisions in Workplace Relations Bill • Review and further consolidate safety net provisions 	<p>C'wealth & States</p> <p>C'wealth</p> <p>C'wealth</p>
Other labour market	<ul style="list-style-type: none"> • Rationalise employment programs • Implement workers' compensation and OH&S reforms 	<p>C'wealth</p> <p>C'wealth & States</p>
Education and training	<ul style="list-style-type: none"> • see SOCIAL INFRASTRUCTURE 	
<i>COMPETITION POLICY</i>		
National competition policy	<ul style="list-style-type: none"> • Resolve outstanding issues in framework and implement • Bring transparency to exemptions • Ensure legislative reviews are independent • Review operation of framework 	<p>C'wealth & States</p> <p>C'wealth & States</p> <p>C'wealth & States</p> <p>C'wealth to initiate</p>
Trade Practices Act	<ul style="list-style-type: none"> • Review elements 	C'wealth to initiate
<i>ECONOMIC INFRASTRUCTURE</i>		
General	<ul style="list-style-type: none"> • Implement national competition policy (see above) • Review ownership, contracting out • Institute rolling reviews of progress 	<p>C'wealth & States</p> <p>C'wealth & States</p> <p>C'wealth to initiate</p>
Specific areas	<ul style="list-style-type: none"> • Reform in transport, especially waterfront, rail and roads • Progress electricity, gas, water and communications reforms 	<p>C'wealth & States</p> <p>C'wealth & States</p>

(Continued on next page)

The reform agenda: key actions *(continued)*

Area	Key actions	Responsibility
<i>SOCIAL INFRASTRUCTURE</i>		
Education	<ul style="list-style-type: none"> • Review level and form of government support and institutional arrangements 	C'wealth & States
Training	<ul style="list-style-type: none"> • Review vocational education and training 	C'wealth to initiate
Health	<ul style="list-style-type: none"> • Review financing and delivery • Extend casemix funding • Apply competitive neutrality in public hospital services • Review PBS • Enhance performance monitoring 	C'wealth & States States States C'wealth C'wealth & States
Social welfare system	<ul style="list-style-type: none"> • Review effectiveness, including labour and tax interactions 	C'wealth
<i>OTHER KEY REFORM AREAS</i>		
Taxation	<ul style="list-style-type: none"> • Comprehensive reform of taxation system a longer term goal 	C'wealth & States
Trade and assistance	<ul style="list-style-type: none"> • Continue general tariff phasedown • Review PMV and TCF • Review/reform SMAs • Rationalise budgetary programs • Review/reform non-tariff measures • Implement R&D reforms 	C'wealth C'wealth to initiate C'wealth & States C'wealth & States C'wealth C'wealth
Resources and the environment	<ul style="list-style-type: none"> • Clarify access • Improve efficiency of environmental protection measures • Review land management 	C'wealth & States C'wealth, States & local C'wealth to initiate
Regulatory review	<ul style="list-style-type: none"> • Extend mutual recognition • Ensure rigorous processes for implementation and review 	C'wealth & States C'wealth & States
Public administration	<ul style="list-style-type: none"> • Extend administrative reforms and performance monitoring 	C'wealth, States & local
Commonwealth–State financial relations	<ul style="list-style-type: none"> • Reduce reliance on tied grants • Review revenue arrangements 	C'wealth C'wealth & States

THE REFORM AGENDA IN DETAIL

The following is a listing of recommendations drawn from the chapters of the report.

Labour markets and industrial relations

Industrial relations legislation

- τ Governments need to facilitate agreements between employees and employers on wages and conditions appropriate to their workplaces. Enactment of key elements of the Commonwealth Government's Workplace Relations Bill would significantly advance the evolution of the federal industrial relations system. Expanding the choice of bargaining agents and refocusing awards to serve as safety nets will allow greater flexibility in workplaces.
- τ The scope to reduce variability in core conditions across awards and the number of core conditions should be the subject of an independent review. The review should have regard to both efficiency and equity issues.

Social welfare and tax systems

- τ The Government should review the interactions between the tax and social security systems and work incentives as a medium term priority. This review should have regard to the related review into the scope to consolidate the safety net conditions of the industrial relations system.

Labour market assistance programs

- τ The Government should terminate ineffective labour market programs and rationalise the range of programs as new evaluation systems allow better assessment of program performance. The Government should also progressively remove the cap on case management services provided by community groups and private providers and ensure greater competitive neutrality between the public provider and its competitors.

Vocational education and training

- τ The institutional and regulatory arrangements for vocational education and training in Australia should be reviewed as a medium term priority. An important function of the review should be to assess the outcomes of reforms to date before setting new directions.

Management skills

- τ Government can increase incentives for the development of management skills and a strong productivity ethos in Australian managers by:
 - continuing to remove barriers to competition in goods and services markets;
 - ensuring that foreign investment and mergers policies allow effective discipline through the threat of takeover;
 - ensuring that processes for business migration and the recognition of overseas skills operate effectively; and
 - assessing whether the corporations law, corporate regulation and accounting standards can be improved to reinforce private incentives for good corporate governance.

Workplace health and safety

- τ Governments should adopt the reform programs recommended by the IC to improve occupational health and safety and workers' compensation outcomes in Australia.

Competition policy

- τ The national competition policy package should be implemented quickly and effectively in accordance with the principles already agreed.
- τ The competition principles should apply across the economy. Exemptions should be granted only after a public, independent review establishes an economic or public benefit case for exemption.
- τ Effective implementation should be encouraged through: a non-legalistic approach to reform; public information on progress; transparency in decision making; and withholding 'competition' payments to States and Territories that breach commitments.
- τ There should be an independent review of the operation of key elements of the national competition policy framework, and outcomes achieved, commencing in 1998.

-
- τ Reviews under the structural reform provisions should not be limited to sectors where competition is introduced or government business enterprises are privatised.
 - τ Access declarations should be limited to natural monopoly facilities of national significance or where access is required for effective competition in related markets.
 - τ Prices oversight should be limited to statutory and natural monopolies and other markets where competition is very weak. This would be the case when a single firm: has a greater than two-thirds market share; has no major rival; faces sporadic or trivial import competition; and is sheltered by substantial barriers to entry or expansion by rivals.
 - τ Access and pricing regulation regimes should be supported by transparent decision-making processes that are consistent across jurisdictions.

Trade practices regulation

- τ Independent reviews of the Trade Practices Act should extend beyond provisions directly relevant to the national competition policy framework, to cover such traditional areas as mergers policy and ‘anticompetitive’ vertical arrangements.

Infrastructure

- τ The key elements of the strategy for improving infrastructure provision are:
 - rigorous application of the national competition policy, including structural separation of public monopolies where appropriate;
 - continuing with administrative reforms including measures to improve pricing, identify and directly fund community service obligations (CSOs), and increase contracting out of non-core services;
 - supporting competition policy through labour market and tax reforms;
 - for competitive or contestable infrastructure services, assessment of the need to retain public ownership; and
 - improvements to infrastructure planning and investment processes.

Specific sectoral reforms

Rail

- τ In subjecting rail authorities and corporations to the Competition Principles Agreement, governments should give particular priority to: achieving competitive neutrality; direct funding of CSOs; structural separation of track

bed and rolling stock operation; and introducing seamless and effective access arrangements to the track bed.

- τ Rail management should seek further savings in areas such as corporate overheads, rolling stock maintenance and signalling and control.
- τ Rigorous application of these reforms is particularly important in areas such as coal freight, where freight rates are unjustifiably high.

Roads

- τ Governments should improve the allocation of road funds by adopting the principles proposed by the EPAC Private Infrastructure Task Force. They should also examine the need for additional public funding or private financing to deal with any backlog of road projects with high social benefit–cost ratios.
- τ Road authorities should increase contracting out of maintenance, subject to meeting the guidelines spelt out in the IC’s recent report on competitive tendering and contracting.
- τ Road authorities should introduce electronic road pricing within congested city networks, as technology permits.
- τ The Commonwealth, State and Territory governments should quickly finalise nationally uniform road laws.

Ports

- τ In subjecting port authorities to the Competition Principles Agreement, State and Territory governments should give high priority to: ensuring competitive neutrality; direct funding of CSOs; removing statutory monopolies for port authorities; and oversighting pricing structures.
- τ Reform to towage and piloting services should focus on options to facilitate contestable outcomes. Licensing of service providers should be minimised. If licences are required, they should be non-exclusive.

Waterfront

- τ Enactment of the Commonwealth's proposed labour market reforms will open the wharves to non-union labour and/or allow competing unions, and end the preference for union labour in cleaning ships. Reintroducing the secondary boycott provisions in the Trade Practices Act will be important in supporting a more competitive labour market on the waterfront.
- τ State and Territory governments should also look to facilitate greater contestability for stevedoring services. This would need to be assessed on a case-by-case basis, but might involve:
 - fixed term franchises for stevedores;
 - encouraging the entry of new stevedores; and/or
 - allowing users to rent wharf space and make their own arrangements.
- τ There should be an immediate review to determine how best to make stevedoring services more contestable.

Coastal and trans-Tasman shipping

- τ As on the waterfront, the proposed labour market reforms will be a significant spur to improved efficiency in shipping services. They will allow shippers to recruit non-union labour and encourage enterprise agreements which expand the scope for multiskilling.
- τ The Commonwealth should extend the single voyage permit system to allow vessels on international voyages to carry cargo between Australian ports for, say, up to a month. No restrictions should apply to foreign vessels crewed by Australian seamen servicing coastal routes.
- τ The Australian Maritime Safety Authority should ensure that relaxing cabotage restrictions in these ways does not increase safety and environmental risks in Australia's coastal waters.
- τ The Commonwealth should proceed with the sale of the Australian National Line, or its assets.

Liner shipping

- τ The Commonwealth should repeal the Part X exemption for liner shipping in the Trade Practices Act. This would leave open the option for conferences to apply to the ACCC for authorisation of current arrangements if they could make a public interest case for retention.

Aviation

- τ The Commonwealth should encourage competition in aviation services by supporting a single trans-Tasman market (including 'beyond rights' for both countries' carriers), and extending Qantas's interlining rights to other international carriers. It should also examine the case for ending restrictions on foreign ownership of domestic airlines.
- τ The Commonwealth should review Australia's position on international airline agreements with a view to providing increased market access to overseas airlines.
- τ Those States which have not already done so should deregulate intrastate air travel.
- τ The Commonwealth should ensure that the conditions attaching to airport privatisations do not create scope for the exploitation of market power through, for example, limiting access to terminal space. Existing cross-subsidies between airports should be removed.
- τ Air traffic, fire and rescue services in publicly owned airports should be allocated by competitive tender.
- τ Air Services Australia should modify the structure of en route charges to eliminate, as far as practicable, cross-subsidies between users.

Electricity and gas

- τ In subjecting their electricity and gas authorities and corporations to the Competition Principles Agreement, State and Territory governments should give high priority to: achieving competitive neutrality with private operators; competitive supply arrangements (especially in gas); effective access arrangements to transmission and distribution facilities; the removal of remaining cross-subsidies; and prices oversight.
- τ State governments that have not already done so should seek to vertically separate electricity supply utilities and consider the scope for horizontal separation of generation and distribution/retail businesses. Structural separation of gas facilities should also be pursued.
- τ Once competitive structures are settled, the States should assess the case for privatising gas and electricity entities (especially in electricity generation).
- τ At the national level, there is a need to quickly progress the gas and electricity grids and the associated access and pricing arrangements. The arrangements should be responsive to changes in technology and the market environment.

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- τ The Queensland Government should commit to linking its transmission system to the National Grid.
 - τ The Commonwealth and Victorian governments should quickly resolve the dispute over the petroleum resource rent tax which is holding up further competition in gas supply.

Water and sewerage

- τ Governments should ensure effective implementation of the COAG water agreement. They should give particular priority to:
 - resolving asset valuation and cost recovery issues for both urban and rural water;
 - identifying CSOs applying in the irrigation sector;
 - facilitating interstate trade in water; and
 - progressing arrangements for allocating water to the environment.
- τ They should also consider extension of the reform process to include groundwater and wastewater management.

Telecommunications

- τ Within the relevant industry-specific regulation, the Commonwealth should subject telecommunications infrastructure to the intent of the Competition Principles Agreement. It should give a high priority to: achieving competitive neutrality between public and private operators; and effective arrangements for access to, and pricing of, network facilities.
- τ In the event that the partial privatisation of Telstra does not proceed, the Commonwealth should consider the case for structural separation of the organisation and report publicly on this matter.

Postal services

- τ Protection for Australia Post's general letter service should be examined as part of a broader independent review of the organisation's operations. Among other things, the review should examine: the impact of previous reforms to increase competition in service delivery; identification and quantification of Australia Post's major CSOs; and the scope to increase competition further. In this latter context, it should consider the rationale for, and impact of, exempting Australia Post from the access arrangements under Part IIIA of the Trade Practices Act.

Review

- τ There should be a series of independent, rolling reviews of individual sectors:
 - an immediate review to determine how best to make stevedoring services more contestable;
 - reviews of the aviation, rail and postal sectors to commence during 1997; and
 - subsequent reviews of progress in coastal shipping, electricity, gas, telecommunications and the waterfront generally.

Education, health and community services

- τ Reforms to education, health and community services should be underpinned by the following general principles:
 - clarity of roles and objectives;
 - providing clients with choice;
 - promoting appropriate consumption;
 - a coordinated approach to customer service;
 - competition in service delivery; and
 - effective performance monitoring.

Higher education

- τ In the medium term, the priority is to review: the appropriate level of government support for higher education; options for more efficient delivery of that support; and institutional reforms to improve service delivery.
- τ Pending such a review, reforms to higher education could include:
 - pursuing greater flexibility in the academic labour market in both administration and teaching;
 - implementing the IC's recommendations to provide greater contestability in the funding of university research;
 - promoting yardstick competition through effective performance monitoring and benchmarking;
 - linking Higher Education Contribution Scheme charges to the cost of the course provided; and
 - allowing tertiary institutions to admit domestic students who do not qualify for a subsidised place on a full fee-paying basis.

Primary and secondary education

- τ In the medium term, the priority is to review alternative approaches to funding primary and secondary education which could promote better and more cost-effective service delivery. The review should also examine the merits and means of paying teachers on the basis of their performance.
- τ Pending such a review, reforms to primary and secondary education should include:
 - better information collection to allow more effective performance monitoring and benchmarking of outcomes; and
 - further decentralisation of responsibility to school boards, including financial management.

Health

- τ In the medium term, the priority is to review alternative approaches to government funding of health care that could promote better and more efficient service delivery.
- τ Pending such a review, reforms to health care should include:
 - extending casemix funding of public hospitals;
 - applying competitive neutrality principles to the public hospital sector;
 - a review of the Pharmaceutical Benefits Scheme; and
 - promoting yardstick competition through effective performance monitoring and benchmarking.
- τ The requirement under the national competition policy framework for governments to review anticompetitive regulations should extend to regulations governing entry to the medical and health care systems and the advertising of services.

Community services

- τ The Commonwealth should establish an independent review to examine the provision and regulation of aged care services.
- τ Through discussions with the States, the Commonwealth should progress the recommendations in the IC's report on charitable organisations.

Taxation

- τ Fundamental changes are required to remove inefficiencies and inequities in Australia's current taxation structure. The introduction of a broad based consumption tax would help overcome some major shortcomings. While the Government has ruled out new taxes in its current term, the Commission sees it as an important longer term goal. Tax reform will be assisted by informed community debate.
- τ Initiatives that should be undertaken in the short term include:
 - examining, in the context of Commonwealth–State financial relations, options to improve the efficiency of revenue raising by the States and Territories;
 - considering indexation of the personal and corporate income tax bases;
 - reviewing Commonwealth and State government taxation of the mining and other resources industries; and
 - commissioning an independent study to assess tax compliance costs.

Trade and industry assistance

Tariffs

- τ General tariff reductions should continue beyond July 1996. There should be a further reduction to 3 per cent in July 1997 — the rate to apply to a range of goods previously entering duty free under the Tariff Concession System — with tariffs for most goods being removed in July 1998.
- τ Foreshadowed Productivity Commission reviews of post-2000 assistance arrangements for the textile, clothing and footwear and passenger motor vehicle industries should proceed in 1996.

Agricultural support

- τ Consistent with the Competition Principles Agreement, statutory marketing arrangements should be terminated unless an independent and transparent review finds that, despite their anticompetitive effects, the arrangements satisfy a public benefit test — that is, they raise national income.
- τ Reforms to market milk arrangements should be extended to all States and to the farm gate level by July 1999. Phasing out of support for manufacturing milk by 2000 should continue. The tariff-quota on cheese imports should be removed, and the within-quota tariff phased out no later than general tariffs.

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- τ The tariff on sugar and the regulatory arrangements for the sugar and rice industries should be terminated as previously recommended.
 - τ The wheat export monopoly should be subject to independent review and retained only in markets where it clearly results in price premiums. Where it is retained, there should be scope for suppliers other than the Australian Wheat Board to provide the monopoly service.
 - τ Western Australia and Tasmania should deregulate their egg industries and Queensland should continue with reform.
 - τ Government guarantees on borrowings by the Australian Wheat Board and Wool International should terminate as scheduled.
 - τ Tariffs on agricultural commodities should be phased out no later than general tariffs.

Budgetary and export support

- τ Budgetary support for industry should be retained only where a clear rationale for government support is established and the measures enhance national income. Provision should be made for subsequent review.
- τ Remaining production bounties should be terminated no later than general tariffs in July 1998.
- τ Recommendations outstanding from the IC's research and development inquiry should be implemented.
- τ Reform of support for the pharmaceutical industry should proceed as recommended by the IC.
- τ The Export Market Development Grants Scheme and the International Trade Enhancement Scheme should be terminated. The range of other export programs in place should be rationalised.
- τ The Government should proceed with its plans to terminate the Development Import Finance Facility.
- τ The export facilitation scheme for passenger motor vehicles and the import credits scheme for textiles, clothing and footwear should be assessed as part of the scheduled reviews of these industries.

Non-tariff measures

- τ Commonwealth export controls should be removed (see *Access to natural resources* section below).

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- τ Packaging and labelling regulations should be reformed as recently proposed by the IC.
 - τ Restrictions on parallel imports of books, sound recordings and software should be terminated. The Australian Government should oppose the inclusion of such restrictions in international agreements.
 - τ Industry development undertakings should not be included in government purchasing contracts.
 - τ Commonwealth, State and Territory governments should recommit to a national approach to the use of government purchasing for industry development, as part of the impending review of the Government Procurement Agreement.
 - τ The scheduled reviews of recent purchasing reforms, and the Fixed Term Arrangement and Partnerships for Development programs, should be replaced by a comprehensive review of government procurement arrangements. The review should also consider whether Australia should sign the World Trade Organization Government Procurement Agreement.
 - τ The scheduled independent review of the anti-dumping system should examine the scope for basing assessments on economy-wide costs and benefits, as well as competition policy alternatives to the current arrangements.
 - τ Other non-tariff measures should be subject to a general review against efficiency criteria, and reformed as necessary.

Foreign investment

- τ Current limits on foreign investment in areas such as banking, aviation, shipping, real estate, telecommunications, and the media should be reviewed.
- τ The scheduled review of foreign investment policy in 1996–97 should examine the role and operation of the Foreign Investment Review Board. The review should aim to make transparent all relevant laws and administrative procedures, including the reasoning behind FIRB recommendations.

Resource access and the environment

Access to natural resources

- τ The Commonwealth Government should: amend the Native Title Act to introduce a more thorough test for gaining the right to negotiate; monitor judicial progress in resolving the status of pastoral leases and, if necessary, expedite test cases to the High Court. State and Territory governments should,

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- as a minimum, integrate their approval processes with the right to negotiate process.
- τ The implementation of the National Forest Policy Statement should be accelerated, with the Commonwealth continuing to be responsible for advancing the agenda.
 - τ Consideration should be given to corporatising government agencies responsible for the management of natural resources used for commercial purposes, such as State forest agencies.
 - τ Commonwealth export controls on coal, bauxite and alumina, natural gas and mineral sands, and on logs and woodchips should be abolished. If controls on logs and woodchips are retained, the term of export licences should be extended beyond the current 12 months limit.
 - τ Governments should ensure effective implementation of the COAG water agreement (see *Infrastructure* section above).
 - τ The Commonwealth, State and Territory governments should clarify outstanding jurisdictional problems over fisheries under the Offshore Constitutional Settlements arrangements.
 - τ The Commonwealth, State and Territory governments should consider introducing a national recreational fishing licensing system and improving the management of recreational fisheries.

Environmental protection

- τ Where feasible, governments should replace prescriptive environmental regulation with outcome-oriented regulation or use economic instruments.
- τ Implementation of the Intergovernmental Agreement on the Environment should be accelerated.
- τ Governments should seek to obtain more comprehensive information about options to address environmental problems. Where such information is incomplete, as in relation to greenhouse gas issues, a ‘staged’ response is likely to be most appropriate.
- τ The Commonwealth Government should commission an independent public inquiry on land management.
- τ Grants from environmental restoration funds should be allocated on the basis of the highest net pay-offs to the community. Decision-making processes should be as transparent as possible.

Regulatory reform

Political commitment

- τ The Commonwealth Government should reinforce its commitment to regulation reform by designating a senior Cabinet Minister, preferably the Treasurer, specifically responsible.
- τ Regulators and governments should make more effort to publicise the gains from reforms.

Intergovernmental issues

- τ The impact of mutual recognition should be monitored more closely. COAG should agree on ways to make its applicability more widely known and should explore the scope to extend its coverage to areas such as services.

Review and reform of specific regulations

- τ The terms of reference for all future reviews of regulation should include the key elements of a regulation impact statement — assessment of alternatives, analysis of impacts, and public consultation. The level of detail of this analysis will need to vary with the significance of the regulation's likely impact.
- τ The scheduled review of intellectual property regulations should examine any unjustified protection of producers, as well as issues of duplication, inconsistency, and complexity in current legislation, and the feasibility of regulating new forms of intellectual property. In addition, it should compare Australia's regulations with those overseas and our international obligations.

Making regulators more accountable

- τ Each government needs to set clearer boundaries between its regulators, in order to reduce duplication and the confusion currently facing those being regulated.
- τ All assessments of regulations should include estimates of the likely compliance costs.
- τ Regulatory agencies should be obliged to provide clients with written details of likely processing/response times, and how any appeal process can be triggered.

Government performance

Commercial activities

- τ Governments should review whether the activities of their business units should continue to be carried out in the public sector and, if so, whether those units would operate more efficiently as separate business corporations.
- τ Governments should extend independent prices oversight by national or State-based authorities to major business units and other government bodies providing monopoly services to the public.
- τ National performance monitoring of GBEs should be extended to major government business units and other government commercial bodies.

Other general government

- τ Governments should apply the following reforms as broadly as possible in the public sector:
 - financial management reforms;
 - commercialisation of functions;
 - purchaser/provider arrangements;
 - competitive tendering and contracting; and,
 - monitoring of outcomes.
- τ Governments should implement the recommendations of the IC's report on competitive tendering and contracting.
- τ The Review of Commonwealth–State Service Provision should continue to develop efficiency and effectiveness indicators to provide comprehensive coverage of service provision areas. Governments should improve the coverage and quality of outcomes data across service areas.
- τ The Review of Commonwealth–State Service Provision should proceed as planned to include information on the effectiveness and efficiency of Commonwealth services such as aged care, child care and some federal courts. Consideration should be given to extending national performance monitoring to private service areas receiving substantial government funding.
- τ The introduction of national performance monitoring for local government services in common should be treated as a priority by COAG. Performance measures should include both financial and non-financial indicators, the latter including quantitative and qualitative indicators.

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- τ Local government service provision should be reviewed through a public inquiry to assess the scope for increased competitive tendering and contracting for service delivery; amalgamation of, and greater cooperation between, local government areas to reduce costs; improved financial management and information systems; pricing policies which reflect the costs of service provision; improved focus on customer service; and more effective performance monitoring.

Intergovernmental responsibilities

- τ Governments should better integrate independent public inquiry programs and the agendas of intergovernmental forums.
- τ Governments should increase transparency of intergovernmental procedures through improved public reporting of decisions and processes and an annual report on the activities of COAG and Ministerial Councils.
- τ The Commonwealth Government should reduce the significance of tied grants by broad-banding specific purpose payments and/or absorbing them into financial assistance grants.
- τ Governments should agree to establish a joint review to develop options for reducing the extent of vertical fiscal imbalance including:
 - a transfer of revenue raising responsibility from the Commonwealth to State governments; and
 - restructuring the existing tax bases of the States to fill in gaps and reduce the more distorting taxes.

1 WHY MICROECONOMIC REFORM?

1.1 The productivity imperative

Microeconomic reform is a key to achieving better productivity. Why is productivity so important? Leading American economist Paul Krugman puts it this way:

Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker. World War II veterans came home to an economy that doubled its productivity over the next 25 years; as a result, they found themselves achieving living standards their parents had never imagined. Vietnam veterans came home to an economy that raised its productivity less than 10 percent in 15 years; as a result, they found themselves living no better — and in many cases worse — than their parents (Krugman 1992, p. 9).

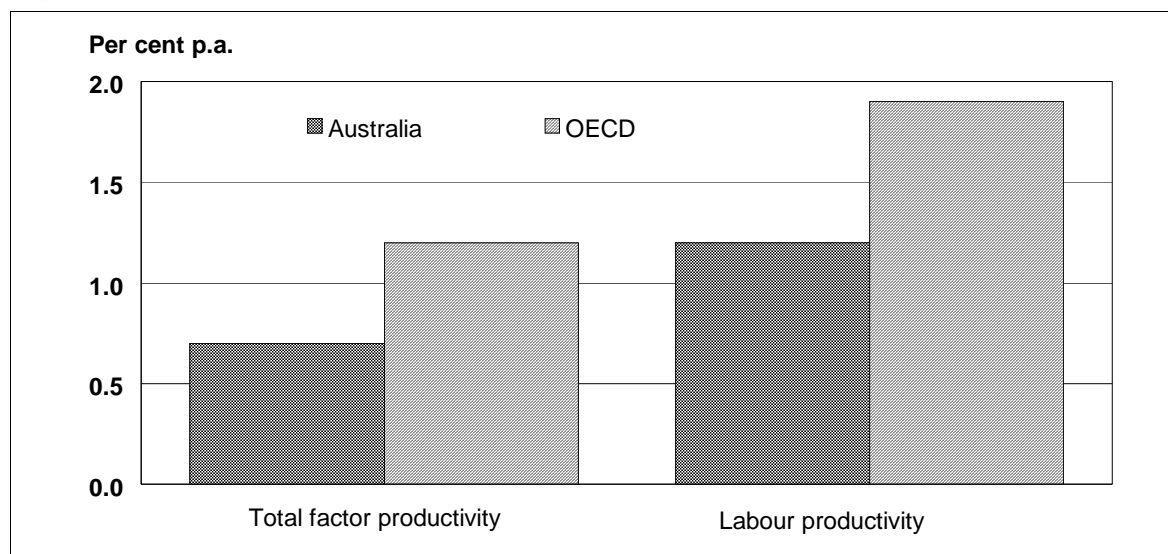
Over the past 25 years, Australia's productivity performance has been significantly below that for the rest of the OECD (figure 1.1). And of course the OECD itself compares poorly relative to the increasing number of dynamic Asian economies. With slower productivity growth, Australia's place in the international 'league table' of per capita incomes has dropped from 10th to 20th over the same period.

GDP isn't everything. By some other indicators of wellbeing, such as environmental amenity, Australia continues to rank highly in international comparisons. International rankings themselves need not matter if we are performing as well as we can, given the particular circumstances of our society and economy.

But from that perspective there are clearly some important performance gaps. Unemployment has been persisting at around 8–9 per cent and long term unemployment is disturbingly high. Too many lack the education, skills and training they need to gain employment in a competitive and rapidly changing world. Sections of our community continue to live in poverty. And there is growing dependency on welfare. We clearly need to do better.

For Australians to achieve higher living standards and reduce the economic and social costs of unemployment, the Australian economy will have to be more flexible and grow more rapidly. That essentially means achieving greater output from our available human and capital resources.

Figure 1.1 **Australia's comparative productivity performance, 1970–94**



Source: Dwyer (1995), based on OECD data.

Gains in productivity can come from people and capital moving into different activities that generate higher real incomes. They can also come from people doing the same things better — working harder and working ‘smarter’. In a rapidly changing world, both mechanisms need to operate effectively.

In explaining productivity growth, the economics literature variously assigns importance to technological improvements and the quality (and quantity) of human and physical capital. These are clearly important. But a more basic requirement, often taken for granted in the literature, is to have the right incentives in place for people to work harder and smarter, to acquire new skills and to seek new opportunities. That is where microeconomic reform comes in.

The role of microeconomic reform

Australia's productivity performance has been handicapped by government policies and practices over many years that have weakened or distorted incentives to be cost-conscious, innovative and productive.

It is not that Australians are inherently any more lazy, accident prone, sick on Mondays, militant in industrial relations, spendthrift, prone to welfare dependency or tax evasion than any other nationality. The point is that the rules in place have provided incentives for ‘inefficient’ behaviour and many people have responded accordingly.

Microeconomic reform is about changing the incentives facing people, to encourage them to be more productive, to minimise costs and to price their goods and services

appropriately. The expression itself derives from its concern with achieving change at the grass roots or ‘micro’ level of individuals in households, workplaces and markets.

Microeconomic reform questions go to the heart of daily life. For example:

- Why should it be illegal to have newspapers delivered to the home by someone other than the designated newsagent, even when the householder is dissatisfied with the service provided by that agent?
- Why should homebuyers in some States be forced to use a lawyer for conveyancing, when in other parts of Australia they can use equally competent but cheaper service providers?
- Why should a taxi passenger pay an extra \$2 per trip because governments limit the number of taxi plates?
- Why should people have to wait for months for surgery in public hospitals?

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 ultimate objective of microeconomic reform is to improve living standards. Its scope is therefore very wide. Cost-effective and high quality health care and education are as important to community wellbeing as other goods and services. And if Australia is to be able to respond positively to the threats and opportunities of global change, it is also crucial that we have fair and effective social support mechanisms for those more vulnerable to change.

Making better use of markets

Many of the policies and practices in need of reform have shielded individuals and organisations from competition. In some cases this was intended to protect particular interests; in others it was seen as a more effective way of getting things done. But in both cases, these policies removed an important source of pressure for higher productivity growth.

Getting more competition across the economy is now seen as a key to better performance. It provides a powerful stimulus for private and public firms to operate efficiently and respond to what consumers want. It encourages firms to search continuously for improvements in the way they operate, and is therefore vital to the process of productivity improvement through time. Competition is also central to ensuring productivity gains are shared with the wider community through lower prices.

That said, there is reason to be careful about how market incentives are introduced into some activities. For example, in areas such as health, there is community concern that access to services should not be denied those on low incomes. In such situations, the task is to find arrangements that promote improvements in efficiency yet recognise these values. Similarly, while market-based mechanisms are increasingly recognised as playing a role in better environmental outcomes, they do not hold all the answers.

Governments have important roles to play in the economy. But their roles are evolving in response to changing circumstances and requirements. What was necessary last century, or even ten years ago, may no longer be appropriate today. The role that governments have been required to play has changed dramatically in areas such as banking, airlines, telecommunications and public housing. The reform task is largely directed at helping governments devise better ways of meeting their legitimate economic and social objectives.

Through microeconomic reform, governments can improve the incentives for Australians to work smarter and use resources more productively. But much rests with firms, their managers and employees, to work within this framework to improve their performance. This is where ultimate responsibility for innovation and productivity resides.

1.2 Progress on microeconomic reform

The history of microeconomic reform in Australia is characterised by substantial achievements, but also significant setbacks, frustrations and missed opportunities.

Major reforms have been made over the past decade or so by all tiers of government. In a number of cases these had their origins in earlier reviews. Threshold decisions in the mid to late 1980s to float the currency, deregulate financial markets and reduce trade barriers have helped to guide Australia towards a more flexible, competitive and outward-looking economy (box 1.1).

As the economy has been exposed to international competition, this has revealed inefficiencies across all sectors of domestic activity which had not previously been addressed. As tariffs have been lowered and Australian industry expected to become more competitive, the search for greater productivity has extended into the provision of infrastructure and other services and into capital and labour markets. Inefficiencies in these areas, be they excess charges or poor quality and reliability of service, feed directly and indirectly into the cost of doing business.

International competitive pressures have also led Australian governments to look more closely at the performance of those areas of the domestic economy that do not face such competition. In this respect, the national competition policy package agreed by COAG in April 1995 is a landmark achievement. It now has to be effectively implemented. That will require hard work, commitment and a degree of compromise on the part of all governments involved.

Box 1.1 Major microeconomic reforms

- Tariffs and other forms of industry support have been reduced substantially. Major initiatives were: the establishment of the Tariff Review in 1971; the 25 per cent across-the-board tariff cut in 1973; and the phased reductions that commenced in 1988 and 1991, which have seen most tariffs reduced to a ceiling of 5 per cent. While tariffs for textiles, clothing and footwear and passenger motor vehicles remain higher, they have been reduced substantially over the last decade.
- Financial markets were deregulated, interest rate and exchange controls abolished, and banking opened to new entry in the early 1980s.
- In infrastructure, significant steps have been taken by the Commonwealth, States and Territories to improve telecommunications, transport and energy infrastructure, including in electricity (particularly through the establishment of the national electricity market), airlines (abolition of the Two Airline policy), telecommunications (with the introduction of domestic competition), coastal shipping and the waterfront.
- New standards of performance and accountability for government business enterprises have been introduced and improvements sought in efficiency in the general government sector (including in government purchasing).
- Company taxation has been substantially reduced and full dividend imputation and capital gains tax introduced.
- Steps have been taken to rationalise business regulation through mutual recognition of regulation between the Commonwealth, States and Territories and to strengthen regulatory review processes.
- Efforts have been made to reduce overlap and promote cooperation among levels of government. Crucial were the Special Premiers' Conferences and subsequent establishment of the Council of Australian Governments in 1992.
- Labour market reforms have been introduced by the States and Commonwealth to restructure awards, support a move towards enterprise-based agreements, and to improve the flexibility and skills of the workforce, including through immigration.
- There have been reforms to social security (especially through changes to means tests) to target and increase welfare assistance to the most needy.
- Reforms to the education system have included the introduction of Austudy and the Higher Education Contribution Scheme.

Despite significant achievements, progress in reform has not been uniform either across sectors or across government jurisdictions. In some areas, reform has been comprehensive. In others, it has barely started or has proceeded at a frustratingly slow pace, leaving much unfinished business. Some States have advanced further and faster than others. While the States are lagging in some areas, in others — such as industrial relations reform and privatisation — some have progressed further with market-oriented reform than has the Commonwealth.

Progress would have been greater had Australian governments not passed up some important opportunities (documented later in this report). For example:

- In October 1994 the previous Commonwealth Government revoked an earlier agreement to allow New Zealand airlines access to the Australian domestic market.
- Regulations prohibiting parallel importation of legitimate copyrighted sound recordings, books and computer software have been retained. The PSA found that, largely as a result of these restrictions, average CD prices in Australia, excluding sales tax, were one-third higher than in the United States.
- Coastal shipping policy still restricts entry of foreign vessels despite numerous inquiries pointing to the costs for Australian industry. The accord between the maritime unions in Australia and New Zealand continues to provide a monopoly for Australian and New Zealand crewed vessels on the trans-Tasman route, adding greatly to shipping costs.
- The Queensland Government is not proceeding with the Eastlink electricity connection with the southern States, thereby delaying substantial benefits to many people in Queensland.
- The Australian Capital Territory Government has introduced new restrictions on retail shopping hours for major town centre supermarkets. This will reduce customer choice and convenience and increase prices. Any gains to employment in small suburban shops are likely to be offset by losses in major supermarkets.

Most contributors to this stocktake acknowledged the reform efforts of governments, particularly in areas such as GBE reform and competition policy. They said that reform was improving performance, although there was concern about the slow pace of reform and poor implementation in some areas.

There was a consensus among business that Australia cannot afford to rest on its laurels. For example, the Australian Chamber of Commerce and Industry (ACCI) argued that:

Accelerating the pace and broadening the horizon of the microeconomic reform program is probably the single greatest policy priority confronting Australia over the coming decade.

As businesses, as governments, and as a nation, we must close the gap with international best practice, wherever it is to be found, rather than just congratulating ourselves on our progress against our own past practice (Sub. 16, p. 1).

The Business Council of Australia (BCA) saw the need for:

... a more strategic, coherent urgent and comprehensive approach to microeconomic reform for the future. No other issue could be more important in determining the success of Australia's future economic performance and the re-building of business and investor confidence to expand employment growth (Sub. 38, p. 6).

Many argued that greater competition is essential to ensure that the productivity benefits and cost savings from reform are passed on to business and throughout the economy in lower prices.

Welfare groups expressed concerns about the social consequences of reform and how it is being implemented. Nevertheless, the need to pursue higher productivity was acknowledged. For example, the Australian Catholic Social Welfare Commission commented:

In an increasingly integrated global economy, a nation's capacity to achieve economic growth depends on improving its competitiveness. The key to this is improving productivity, that is using our resources more efficiently ... Becoming more efficient in our use of resources involves economic reform of some kind (Sub. 18, p. 2).

1.3 The gains from reform

There is a growing body of evidence of substantial and tangible gains from properly implemented reform in Australia (box 1.2).

The evidence from other countries is similar. A recent survey of all of the major studies of the benefits to the United States from regulatory reform in airlines, railroads, trucking, telecommunications, television, banking, security brokerage, petroleum and natural gas showed gains to consumers from lower prices and better services of at least \$33 billion to \$43 billion a year. Contrary to some expectations, gains were shared by employees and producers as well as consumers (Winston 1993).

Box 1.2 **Gains from reform**

- Air fares have fallen by one-fifth in real terms since deregulation. With more affordable travel, passenger numbers are up 57 per cent.
- Telephone bills are cheaper for households and business, services are more reliable and there is greater choice in the equipment available. In 1994–95 alone, reductions in Telstra's charges saved consumers about \$500 million. Price reductions were greatest in the most competitive markets — STD, international and mobile services.
- Taxpayers have benefited from the greater commercial orientation of government business enterprises. Payments to governments around Australia have increased in real terms from \$1.6 billion to \$3.9 billion in the six years to 1994–95.
- Real average electricity prices fell 13 per cent between 1988 and 1995.
- Amalgamations and other local government reforms in Victoria saved council ratepayers \$263 million, or an average 18 per cent in 1995–96.
- In New South Wales the reduction of cross-subsidies in electricity and water has saved business over \$600 million since 1992–93.
- Railways have moved to more cost reflective prices. Non-urban passenger fares rose 18 per cent in real terms and average freight rates fell by around 12 per cent in the five years to 1994–95.
- The competitive tendering and contracting program in Western Australia has led to savings of about 25 per cent. Competitive tendering of bus services in Victoria has saved in excess of \$10 million a year and avoided a major capital program to replace ageing buses.
- Over 8600 federal workplace agreements have been formalised since October 1991. According to a 1994 survey by the Department of Industrial Relations, 80 per cent of managers at workplaces with agreements said that productivity had increased in the past year compared to only 56 per cent of managers at workplaces without agreements. Also, nearly half of all workplaces with agreements indicated profits had increased as a result of their agreements.

Evidence from economic simulation models

While individual reforms in Australia have produced demonstrable gains, these might not seem significant in isolation. But collectively they offer the prospect of a substantial boost to living standards.

A number of recent modelling studies have estimated the economy-wide gains to Australia from microeconomic reforms. These models have limitations. Not least is the difficulty of capturing real world adjustment processes. On the other hand, many

feel that existing models underestimate the gains because they inadequately capture the dynamism that reforms can inject into an economy. Nonetheless, such studies have played an important role in alerting the community to the potential benefits of microeconomic reform.

All of these studies show that the benefits of reform are significant, widespread and ongoing. This is regardless of the type of economy-wide model used (EPAC 1994c). The estimated long term gains in Australia's GDP range from 5 to 20 per cent (box 1.3 and BIE 1996a).

Box 1.3 Modelling the gains from reform

- The IC (1990a) modelled reform in transport, aviation, communications, water and electricity, contracting out by governments and the removal of rural manufacturing assistance. The results suggested long term annual gains in real GDP of 6.5 per cent and the generation of an extra 53 000 jobs.
- The BIE (1990a) 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.
- For EPAC, Filmer and Dao (1994) analysed the effects of: the reduction in tariffs and subsidies; labour market reform; facilitation of the operation of markets; transport and communications reforms; 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 taxation 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 anticompetitive legislation. The IC results suggested that over time there would be a gain in real GDP of 5.5 per cent, an increase in real wages of 3 per cent and 30 000 extra jobs (see also box 3.2).

The studies underline the importance of undertaking reform on a broad front. They also help to demonstrate that such reform can reduce adjustment costs. 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. This is because the gains from some reforms tend to offset the losses from others. For example, the contractionary effects of tariff cuts on some import-competing activities are more than offset by the expansionary effects of lower prices for business inputs and infrastructure services.

Some recent modelling work has shed light on why the benefits of reform have not been as evident in Australia's overall growth performance as they have been in individual areas of reform. Much of the answer lies in the past recession obscuring better underlying performance. Without reform our record could have been worse. Modelling undertaken by Filmer and Dao (1994) and EPAC (1996a) also indicates that the benefits may take longer than expected to show up in aggregate growth and employment performance. For example, while increased productivity can initially reduce the demand for labour, in time it reduces unit labour costs, stimulates new investment and hence boosts output and employment.

Nevertheless, there is evidence that Australia's productivity performance may be improving as a result of microeconomic reform. In contrast to the poor relative performance of earlier years, Australia's total factor productivity increased at twice the rate of the OECD between 1989 and 1994 (Dwyer 1995). While this reflects cyclical factors both in Australia and other countries, there are also clear signs of a structural shift in performance.

1.4 Getting implementation right

While the potential gains from reform are evident, not all reforms produce positive results. Some changes — for example, the amalgamation process in higher education and the now abandoned training guarantee levy — are widely held to have headed in the wrong direction. In most instances, however, failure to produce results can be traced to inadequate attention to implementation. In this regard, Australia can learn from its mistakes as well as the mistakes of others. For example, the United Kingdom experience points to the pitfalls of privatisation without properly addressing market structure and competition issues. And there is Australian evidence that the quality of service has suffered when contracting processes have been inadequate.

The Commission sees four key requirements for successful implementation.

First, it requires well informed policy making processes. Careful analysis of reforms and the provision of information to the community on the benefits and costs before action is taken, make it harder for sectional constituencies to override the national interest. Many participants saw the provision of such information and the publicising of reform successes as highly desirable. The BCA saw a real danger that a ‘fear’ mentality could build up to frustrate reform unless an enlightened public education program is developed in consultation with business and the wider community.

Many successful reforms have been preceded by a period of community learning. For instance, the work of the Tariff Board from the mid-1960s, in measuring and documenting the costs of tariff protection, laid the groundwork for subsequent initiatives to open the Australian economy to the international marketplace. And the foundation for financial deregulation was laid by community debate accompanying the Campbell and Martin inquiries.

Nonetheless, there is much in the view that the general benefits of competition are so demonstrable that the onus of proof should rest with those who wish to retain regulatory barriers to competition in any particular instance. This is the logic of the current review of legislation under the national Competition Principles Agreement. Business groups expressed similar concern about the problem of ‘paralysis by analysis’.

Second, successful reform requires proper accountability. Those overseeing reform must assign responsibilities clearly, and specify timetables for the various steps in a reform process. There is also a requirement for specific coordinating mechanisms where reforms require action by more than one government. The Commission sees a leading role for COAG in this regard.

Third, effective implementation requires monitoring of performance and publicising developments during and after a reform program to ensure objectives are met. In this context, monitoring by the NCC of the implementation of the national competition policy is vital. The Commission also considers that continuing performance monitoring and the benchmarking of best practice, both between areas within Australia and internationally, can help to inform the community about significant performance gaps. Benchmarking can reveal factors that add to the cost of doing business. Where competition is lacking, benchmarking has proven valuable as a form of yardstick competition. Many submissions argued that the continuation of high quality benchmarking is essential.

Fourth, there is a need to maintain policy credibility and consistency. Allowing too many exemptions reduces the potential gains from reform and reopens opportunities for reinstating inefficiencies.

1.5 Helping with adjustment

Successful implementation of reform also requires that governments are aware of, and account for, any accompanying adjustment costs. If the transition process is ignored or not well handled, unnecessary costs can reduce the overall community benefits. The losses experienced by those adversely affected are a concern in their own right, and can be a powerful impediment to achieving necessary change. Community support is more likely if there is fair treatment of those adversely affected.

The pain of adjustment is most acute for those who become unemployed as a result of structural change. Equally, where resources are unemployed, production opportunities are forgone and this affects us all. But there are other less obvious costs. Uncertainties created by change or the prospect of change can dampen motivation and reduce productivity. Increased demands on the social welfare system and the voluntary welfare sector bring additional costs.

In any microeconomic reform process, there will be losers as well as winners. This is unavoidable, because reform often means unwinding previous policy distortions which themselves created winners and losers. Australia's delay in adjusting to change in the past has produced a backlog, exacerbating the adjustment task today. This is why we need a more flexible economy, so that adjustment will occur more continuously.

Some of the reforms addressed in this report have particular relevance in smoothing adjustment. For example, better education and training systems and more flexible labour markets will help those displaced by change find new jobs more quickly.

Moreover, as already noted, if reforms are implemented on a broad front, groups adversely affected by a particular reform are more likely to receive offsetting benefits from others. Broad based reform can also reduce the incidence of 'double' adjustment costs. For example, making labour markets more flexible helps firms cope with pressures arising from greater competition. And reforms to improve the efficiency of GBEs can lessen the impacts of moves to user pays pricing.

Nonetheless, there will often be a requirement to assist those adversely affected by change. This does not imply, however, that there is a justification for special adjustment assistance to facilitate microeconomic reform. Problems with 'horse trading' over amounts of assistance, and duplication of existing general social welfare and labour market programs, would mitigate against such a policy on efficiency grounds. It would also have undesirable equity implications given that specific adjustment assistance is not generally available for those coping with other sorts of adjustment pressures.

For these reasons, the Commission believes that the primary form of assistance should be the social welfare system and generally available adjustment programs in the retraining area. The latter can reduce dependency on social support compared to direct income maintenance. But they need to be well aligned. The social welfare system needs to be fair and effective in providing relief. But governments also need to ensure that its interaction with the taxation system does not create poverty traps.

Phasing of reforms may go some way towards easing adjustment pressures. However, delaying reform in one area can add to the adjustment burden on business and their employees elsewhere in the economy.

Like benchmarking of performance, analysis and monitoring of the adjustment process can help facilitate future reform. Knowledge of the likely adjustment process and incidence of costs accompanying a particular reform can also help to diffuse alarmist and unwarranted claims about adverse impacts. For example, studies by the IC (1992e) and the Tasman Institute (1995) on the introduction of user pays pricing for water, show that public debate has ascribed significant costs to a wider group than is actually the case.

The Commission sees merit in undertaking more such studies in the future. Community groups are also keen to move in this direction, particularly supporting studies of the way households respond to reforms such as changes in water and electricity prices. They would like more work done on how employees with different skills and incomes adjust to change. The linking of models projecting economy-wide benefits from reform (such as Monash) with the NATSEM distributional model is getting closer. This should enhance understanding of the distributional effects of reform proposals. Political realities, as well as concern for social equity, suggest that such analysis may be just as important for reform and its effective implementation as has been the more traditional efficiency analysis of microeconomic reform.

2 LABOUR MARKETS AND INDUSTRIAL RELATIONS

Employment, wages and working conditions are central to daily life and aspirations and are crucial to the productivity and competitiveness of Australian industry. This, combined with some distinctive characteristics of labour, has led to a history of considerable government involvement in labour markets.

The extent of labour market regulation has gone further in Australia, however, than in almost any other industrialised country.

The need for Australia's workplaces to be more adaptable and responsive to global change has caused Australians to reconsider these traditionally highly centralised arrangements. There is widespread agreement on the need for more flexible and decentralised industrial relations.

But having effective labour markets that promote productivity involves more than the industrial relations framework. Other matters on the reform agenda are:

- incentives for the acquisition of useful skills and the responsiveness of the vocational education and training system;
- the effectiveness of labour market assistance programs;
- addressing the adverse effects of the tax and social welfare systems on work incentives;
- regulatory arrangements to minimise and respond to workplace injury and disease; and
- incentives for Australian managers to lift their game.

2.1 Reforms to date

Industrial relations reforms

All Australian governments have recently sought to bring a greater enterprise and productivity focus to employer–employee relationships.

At the federal level, however, this intention has been conditioned by a commitment to maintain the award system and a pre-eminent role for both trade unions and the Australian Industrial Relations Commission (AIRC). The Minerals Council of Australia said:

... genuine labour market reform is still required with changes to the federal industrial relations system having not gone far enough. The system is complex and unresponsive and as a result many Australian workplaces are still constrained by restrictive work practices, demarcation disputes, controls on recruitment, industrial action, a legislative bias towards unions, and an award regime of hours, leave, allowances and penalty rates which restricts flexibility and productivity (Sub. 40, p. 14).

The industrial relations framework of the federal system has been evolving. Award restructuring processes initiated in the late 1980s, union-negotiated Certified Agreements introduced in 1988 and the scope for Enterprise Flexibility Agreements since 1994, have introduced greater flexibility into the system (box 2.1). These developments have brought significant change and achieved benefits over a relatively short period.

Nevertheless, the current federal system still has the following key features:

- a complex system of around 2700 awards which prescribe a wide range of wage and employment conditions;
- a system oriented towards occupations and industries rather than individual workplaces — many firms are covered by multiple awards;
- reliance on tribunals, unions and employer associations to determine workplace regulation, rather than managers and employees assuming responsibility for negotiating individual workplace practices;
- a prominent role for registered unions — individual unions are given monopoly rights to represent certain classes of employees (including non-union members), unions can veto or at least challenge the wishes of the workplace parties, even where this involvement is uninvited, and there are ‘closed shops’ in some workplaces; and
- a lack of effective sanctions against secondary boycotts.

Peak business groups and others argue that centrally determined awards are so dominant that enterprise bargaining is still largely about ‘add-ons’ and there is little scope for trade-offs in award conditions. While there are opportunities to reach mutually rewarding and productivity-enhancing deals, the ACCI (1995, p. 2) has spoken of agreements as being ‘nothing short of a tribute to employers and unions steering a path through what are extremely complex and litigious agreement procedures’.

The Commonwealth Government's recently introduced Workplace Relations Bill is the next important national step in the evolution of the industrial relations system.

The States also have been active in promoting enterprise bargaining (box 2.2). However, some attempts were partially offset by federal legislation in 1993 allowing unions to have workers moved more easily from State to federal awards.

Box 2.1 Key developments in the federal industrial relations system to early 1996

Year Initiatives in the federal system

- 1987 Two tiered wage system introduced with the second tier offering wage increases of up to 4 per cent in exchange for productivity improvements which met the AIRC's restructuring and efficiency principle. Agreements settled at enterprise level but required ratification by the AIRC. Matters typically addressed included: greater flexibility in working hours (for example, span of hours worked at ordinary time rates, changed overtime rates); removal of some restrictive work practices (for example, through job sharing, greater casual employment and task broadening); and wage differentials.
- 1988 Structural efficiency principle introduced to allow wage increases based on commitments to award restructuring. Award based, so negotiations took place at the industry/union level. The most common changes arising from award restructuring were: reductions in the number of job classifications; establishment of new skills-related career paths; and multiskilling. Also introduced enterprise flexibility clauses into awards.
- 1989–1993 The *Industrial Relations Act 1988* introduced Certified Agreements, albeit heavily constrained by a 'public interest' test and confined to unionised enterprises. While seeking to devolve responsibility to the bargaining parties, legislative changes in 1992 gave the AIRC an important role in determining if agreements satisfied statutory tests, including a 'no disadvantage test'. Effectively, non-union enterprise bargaining continued to be excluded.
- 1994 The *Industrial Relations Reform Act 1993* which came into operation in March 1994 extended the scope for enterprise bargaining by introducing Enterprise Flexibility Agreements (EFAs). These allow workplace agreements to be negotiated in non-unionised workplaces. EFAs do not require that unions be parties to agreements but unions can challenge their ratification. The AIRC must be satisfied that the terms and conditions in an agreement do not disadvantage employees when compared with the relevant award.

Box 2.2 Recent developments in selected States

Western Australia

The Workplace Agreements Act was proclaimed in 1993–94.

'The Act provides a framework for preparing individual and collective employment agreements in tandem with the existing award system. It also provides improved flexibility in the labour market through an enterprise-based bargaining system with the aim of increasing organisational efficiency' (Western Australian Treasury, Departmental paper 4, p. 12).

South Australia

The *Industrial and Employee Relations Act 1994* commenced in August 1994.

'Since the commencement of the legislation, enterprise agreements have either been achieved or are under way in at least 30 State Government agencies and have also been achieved in more than 180 private sector organisations covering a total of 30 000 employees. When added to the 'old Act' agreements, more than 55 000 employees are now covered by enterprise agreements (representing between 20 and 25 per cent of the workforce).

'For the first time South Australia's enterprise agreement laws allow access to enterprise bargaining for enterprises which are not unionised. This has been especially beneficial to the medium and small business sectors who were effectively barred from accessing workplace reform and improved productivity through enterprise agreements in the past. The South Australian Industrial Relations Commission was also required to review existing awards to ensure that they had contemporary provisions and that they interfered with the conduct of work as little as possible ... in the passenger transport sector an agreement was reached with the Public Transport Union to give work-site committees the ability to amend the award as appropriate to local circumstances' (South Australian Department of the Premier and Cabinet, Departmental paper 5, p. 11).

Victoria

Under the *Employee Relations Act 1992*, agreements (either individual or collective) became the focus of the industrial relations system, interference by tribunals and unions was limited, rights to freedom of association enshrined and industrial action, except when negotiating an agreement, made unlawful.

'The second phase of the reform process occurred in 1994 when awards were abolished and a new minimum wage and conditions safety net introduced. The system therefore is one based on agreements supported by an up-to-date safety net to protect low paid workers. The system has been designed so that the legislative framework is relatively uncomplicated, employers and employees can readily determine their rights and they can reach agreements without recourse to legal advice. Also, union privilege has been removed, union representation is not integral to the system and demarcation disputes about competing union influence are a thing of the past' (Victorian Department of Premier and Cabinet, Departmental paper 2, p. 12).

Other labour market reforms

Reform efforts have recently been mounted in other areas of the labour market.

- Social security is an important safety net for those unable to obtain work. There has been a concerted effort to target welfare payments more closely to those in need. A recent study suggests that this has produced a system which is more efficient at redistributing income to the poor than the British social insurance-based system (Falkingham and Harding 1996). In conjunction with the tax system, however, social security arrangements can create disincentives to accept employment — especially for low-skilled recipients eligible for family entitlements. In May 1994, the Commonwealth Government sought to better address disincentives to work by reducing the withdrawal rate for benefits so that recipients would gain rather than lose financially when undertaking additional work. It also increased penalties for failure to accept a job offer, or attend an interview or a training course.
- When announcing a significant increase in spending on labour market assistance programs in May 1994, the Commonwealth also introduced: some competition in the delivery of employment services to the unemployed; training wage arrangements, which for the first time applied to adults; and improvements to post-program monitoring systems.
- Training reform is recognised by governments, business and unions as an important part of the national microeconomic reform agenda. The term Training Reform Agenda describes the development of training policies and associated institutions between the late 1980s and 1994 (box 2.3).
- All Australian governments have gone some way toward reforming their occupational health and safety legislation and regulation and arrangements for workers' compensation and rehabilitation.

2.2 Performance gaps

Overall performance

Various indicators of the overall performance of the Australian labour market are relevant. These include participation rates, increases in real hourly earnings, mobility, skill levels and the level of industrial disputation.

Unemployment rates and productivity growth are, however, prime indicators of performance. On this score, Australian performance is not what it should be.

Even though employment increased by nearly 600 000 in the past five years, 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 2 million part-time workers, one-quarter would prefer to be working more hours. And over the longer term, despite recent gains, Australia's productivity performance has been relatively poor even by OECD standards (chapter 1).

There is clearly more than the regulation of employer–employee relations behind this performance. Nonetheless, most Australian governments agree that workplace relations have a major impact on labour market outcomes and have therefore been reforming the regulatory and institutional structures which govern labour relationships in workplaces and enterprises.

Box 2.3 The Training Reform Agenda

Vocational education and training (VET) provision is a large and rapidly growing area of government activity. Total government expenditure in real terms increased by 25 per cent over the five years to 1994 to reach over \$2.5 billion. The training policies and institutions developed under the Training Reform Agenda are now collectively referred to as the Australian Vocational Education and Training System (AVTS). The Australian National Training Authority assumed responsibility for the implementation of AVTS from 1 January 1995.

The Commonwealth Department of Industrial Relations (DIR, Departmental paper 18, attachment E) listed the major priorities under the Training Reform Agenda as:

- developing a national system, rather than separate State systems, of vocational education and training — offering national registration of training providers and accreditation of training courses and national recognition of qualifications;
- introducing competency-based training, national competency standards and national curriculum;
- developing a more diverse and competitive training market, including the establishment of a national training system;
- introducing new entry level training arrangements under the AVTS; and
- implementing measures to promote access and equity, including extending access to structured, publicly recognised training throughout the workforce and recognition of skills acquired through prior learning.

Performance indicators for Technical and Further Education Colleges and government-funded private providers are being developed by the Steering Committee for the Review of Commonwealth–State Service Provision (1995). Key tasks are to improve the comparability of data on inputs, activity and outputs of the VET sector and to collect comparable industry and student outcome data.

Workplace reform

The pace of enterprise bargaining is accelerating in the federal system. DIR reports that over 8600 federal workplace agreements have been formalised since October 1991, with over 6300 of these being formalised since March 1994. And agreement making, although concentrated in the manufacturing sector, is increasing in the construction industry and the health and community services sector. Sixty-two per cent of wage and salary earners covered by federal awards now have formal enterprise agreements. There is also some evidence that the 'quality' of agreement making is gradually improving (box 2.4).

The overall growth in enterprise agreements is attributable to increased numbers of union-negotiated Certified Agreements. Only 185 Enterprise Flexibility Agreements had been ratified by early June 1996. Given that union membership is around 25 per cent in the private sector, this type of agreement could be used by potentially many thousands of workplaces.

Industry and case studies indicate variable progress in the implementation of workplace reform and ongoing scope for improvement (box 2.5).

Major factors working against the spread of 'true' enterprise bargaining and greater flexibility in the federal system appear to be:

- the complexity and cost of the mandated agreement-making processes;
- barriers to trading off award conditions for higher wages; and
- the potential for (in some eyes, the certainty of) uninvited intervention by third parties.

These inflexibilities raise the costs of adjusting to all types of economic change.

Quantifying the economy-wide costs of all current inefficiencies in the labour market is not easy. Labour is a derived demand and so reflects product market conditions throughout the economy as well as purely labour market factors. However, work by EPAC (Dowrick 1993) and others points to the productivity benefits of freeing up highly regulated labour systems.

The gains from workplace reform rarely come easily. Lifting productivity requires hard work and considerable goodwill from negotiating parties. Nevertheless, more flexible and efficient labour markets have an important role in closing the significant performance gaps that exist in infrastructure and many goods and services markets.

Box 2.4 Quality indicators for enterprise agreements

DIR reported that agreements cover a variety of productivity initiatives:

- Some 80 per cent of agreements contain one or more productivity initiatives such as modifications to work organisation, and changes related to the use of equipment, many of which are designed to overcome restrictive work practices.
- Around 15 per cent of agreements contain provisions for performance/productivity related remuneration (Departmental paper 18).

When surveyed in 1994, managers at workplaces with agreements were more likely to say productivity had increased in the past year than managers at workplaces without agreements (80 per cent compared to 56 per cent).

The ACCI (1996) report on enterprise agreements in the first quarter of 1996 found:

the quality of agreements continues to gradually improve, with businesses introducing creative measures on issues such as absenteeism, working hours, quality assurance, overtime, performance measurement, annualised salaries, training and classifications.

Box 2.5 Workplace reform — some examples of progress and scope for improvement

Meat processing

The IC (1994d) reported that the pace of workplace reform had been painfully slow and continued to inhibit growth in this \$6 billion industry. An attempt to develop a shared commitment to workplace reform is continuing two years later (DIR, Departmental paper 18, attachment F). NFF-commissioned research shows that, if adopted industry-wide, workplace practices proposed by Australian Meat Holdings in its Queensland plants to replace arrangements under the Meat Industry Award tally system would increase GDP in Australia by about \$176 million a year (Sub. 37).

Agri-food and related industries

The BIE (1996f) study found a low takeup of workplace reforms. Less than half of the case study firms had implemented a workplace reform measure. The one-third of firms which had implemented an enterprise agreement were more likely to report productivity improvements than their counterparts. BIE analysis showed firms were more prepared to undertake major new investments once an enterprise agreement was in place.

Tourism accommodation

The IC (1996e) found that while the two major federal awards covering the tourism industry had become more flexible, penalty rates remain an issue. These awards were mostly free of the major impediments to efficiency which arise when there are contests over job and union demarcation, multiple awards covering a single employer, complex provisions which are hard to understand and narrow job classifications. The same cannot be said of many of the State awards covering the tourism industry. There has been a low takeup of enterprise bargaining in tourism industries.

Industrial relations reform is unlikely to hold all the answers to Australia's unemployment problem. But current monopolies and inflexibilities do not make the task of those seeking work or improving productivity any easier. Achieving greater flexibility in the terms and conditions for the long term unemployed, especially Australian youth, is an urgent task given the persistence of unemployment.

At the time this microeconomic stocktake was requested, the Treasurer also asked the IC to advise, in a separate study, on a work program directed at identifying restrictive work practices and significant labour market arrangements which add to the costs of doing business. The studies have the same reporting date.

Other performance gaps

- The previous Government's unfair dismissal legislation is widely perceived to have raised the costs and risks of hiring workers.
- Occupational health and safety and workers' compensation arrangements are not adequately serving the interests of workers, employers or the community — each year, occupational injury and disease kill up to 2700 people and cost the Australian community at least \$20 billion (IC 1995g).
- Commonwealth and State governments together outlay over \$2.5 billion for vocational education and training, and improvements have been achieved. However, arrangements remain complex, inflexible and bureaucratic and continue to inhibit private sector competition in the provision of vocational education and training.
- While involving only moderate expenditure by OECD standards, Australia's social welfare and tax systems can act to discourage unemployed people from re-entering the workforce, particularly the least skilled, because of poverty traps and open-ended benefits. The maximum tax rate for high income earners is now less than 50 per cent and the company tax rate 36 per cent, but some social security recipients face effective tax rates of over 100 per cent (Harding and Polette 1995).
- Australian managers are still learning the skills needed in the more competitive environment in which Australia now operates. For example, Kitay and Lansbury (1995) found that against a range of indicators, Australia's human resource management falls well short of international best practice. In its international benchmarking of Australian labour productivity across five industries, the McKinsey Global Institute (1996) identified 'low management aspirations and a lack of innovation' as prime causes of poor performance.

2.3 The reform agenda

Participants' views

Federal industrial relations reform is vital according to many participants. Peak business groups argued that subjecting the labour market to the sorts of reforms experienced in other sectors is long overdue. The Australian Chamber of Manufactures stated:

It is illogical to impose rigorous competition rules to product and service markets and to exclude the labour market ... However, we can ensure that the labour market is freed up to enable Australian industry to increase its competitiveness and productivity (Sub. 28, p. 6).

Business groups contended that there are still significant rigidities in Australia's system of awards and enterprise bargaining. Most argued for 'true' enterprise bargaining under which employers would have much greater freedom to negotiate conditions with their employees. For example, the ACCI advocated:

... a more effective system of labour relations based on bona fide enterprise negotiations which emphasises improving the inherent competitiveness of the firm (Sub. 16, p. 10).

Under such arrangements, union involvement would be dependent on decisions by individual employees, rather than prescribed by legislation. Some spoke of the need to move towards a 'seamless' employment structure with no 'them' and 'us'. Participants pointed out that such arrangements would also mean that the award system would effectively collapse to a set of minimum conditions. Summarising such a package, Professor Judith Sloan, a participant in one of the Commission's roundtable meetings for the stocktake, has concluded that:

The first-best approach to labour market reform in Australia is to abolish the systems of compulsory arbitration, eliminate awards, remove the protective devices affecting trade unions and employers' associations and to abolish any statute-based restrictions on bargaining. In short, we should move to a lightly regulated bargaining environment where enforceable agreements might be registered, but not certified, and be subject to a small number of minimum entitlements (1994, p. 22).

Professor Sloan, among others, has also called for the implementation of parallel Commonwealth and State legislation to avoid 'forum shopping'.

In contrast, union and community groups argued that abandoning the award system and adopting the 'radical' approaches advocated by business groups would inevitably result in reduced pay and conditions for some workers, particularly the lowly paid with limited bargaining strength. The Australian Youth Policy & Action Coalition referred to the award system as:

A system which sets in place minimum standards and conditions, protects from exploitation, discrimination and unacceptable working conditions and provides young people with dignified and meaningful work (Sub. 13, attachment).

The Australian Catholic Social Welfare Commission argued:

Questions remain as to how best to obtain benefits of labour market flexibility and increased productivity without returning to a negotiating system based on industrial conflict; how to ensure that wages do not fall to the degree that an increased proportion of people in employment become part of an emerging 'working poor'; and, how to prevent rising inequality between industrially powerful and industrially weak workers (Sub. 18, p. 5).

At the same time, there was recognition by union and community groups of the role of flexibility in enhancing productivity and reducing unemployment. In roundtable discussions with the Commission, the ACTU referred to the benefits from enterprise bargaining initiatives in recent years.

In regard to the Workplace Relations Bill, the MTIA commented:

The arrangements put forward by the Coalition Government go part of the way to improving the efficiency and flexibility of the current arrangements (Sub. 27, p. 4).

Business groups raised a number of other concerns, including the need to amend the unfair dismissal laws, and to reduce bureaucracy and increase competition and flexibility in the provision of training and retraining programs. The BCA also argued:

An independent analysis is necessary of the effectiveness of the various labour and training programs that have mushroomed in recent years and an assessment undertaken of what must be done in these areas to improve Australia's competitive performance (Sub. 38, p. 5).

Professor Peter Dawkins argued:

Labour market reform has been lagging behind most other areas of microeconomic reform, and ... there are strong arguments both on grounds of potential productivity benefits from an increasing enterprise and workplace focus of industrial relations (from workplace agreements and individual contracts) and the possible employment creating effects for greater wage flexibility especially at the bottom end of the labour market.

... an important area of analysis is the link between labour market reform and the welfare system (Sub. 42, pp. 1–2).

The Commission's assessment

Industrial relations legislation

Industrial relations reform is a priority for the Government and it has moved quickly to introduce legislation into the Parliament.

There are many provisions in the Government's Workplace Relations Bill, but the Commission considers the key ones to be:

- simplifying awards to provide an enforceable safety net of minimum wages and conditions, matters beyond these being for determination by workplace parties;
- removing paid-rates awards and restrictions on the use of particular types of labour and hours for regular part-time work;
- ending monopoly rights and compulsory membership of industrial organisations, facilitating greater choice for workers in selecting their bargaining agent and ending uninvited third party intervention;
- facilitating agreement making by employers and employees by providing the choice of informal over-award arrangements, formalised individual agreements (Australian Workplace Agreements) or formalised collective agreements (Certified Agreements), and facilitating access to agreements in a State jurisdiction where the parties so consent;
- restoring secondary boycott provisions to the Trade Practices Act; and
- implementing a new unfair dismissal scheme to provide 'a fair go all round'.

Enactment of key elements of the Workplace Relations Bill would be a significant advance in the evolution of an efficient regulatory framework to better facilitate agreements between employees and employers on wages, conditions and work practices.

These initiatives should not be seen as the end to the reform process. Cross-country evidence suggests that systems which mix centralised and decentralised characteristics risk inferior outcomes (Dowrick 1993). Labour market regulation will need reviewing to address remaining impediments that prevent labour markets responding flexibly and productively to changing circumstances and pressures.

Much prescription will remain, as the foreshadowed list of allowable award conditions is extensive (box 2.6). The Government intends that the role of the award system be confined to providing a safety net of minimum wages and conditions as a matter of equity. Safety nets can also be important in gaining worker and community commitment to productivity-enhancing reforms. But multiple and variable safety nets will operate across and within workplaces.

Key issues are how awards evolve under the guidance of the AIRC and how they operate as safety nets underpinning bargaining. In making or varying awards the AIRC must, among other things, ensure that awards:

- do not contain detail more appropriately dealt with by a workplace agreement;
- do not prescribe work practices or procedures that hinder the efficient performance of work; and
- are easy to understand.

Box 2.6 Allowable award matters

1. Classifications of employees
2. Rates of pay (such as hourly rates and annual salaries) for different categories of employees, including juniors, trainees and apprentices and for those under the supported wage system
3. Piece rates, tallies and bonuses
4. Ordinary time hours of work and the spread of such hours
5. Additional loadings for working overtime, casual or shift work
6. Penalty rates
7. Annual leave and leave loadings
8. Long service leave entitlements
9. Personal/carer's leave, including sick leave, family leave and bereavement and compassionate leave
10. Public holiday entitlements
11. Parental leave (including maternity and adoption leave)
12. Entitlements to allowances
13. Payments related to jury service
14. Dispute settling procedures
15. The basis of employment, including full-time, casual, regular part-time (with pro rata conditions), and shift work
16. Notice of termination and redundancy pay
17. Stand-down provisions
18. Matters incidental to the application of these matters and essential for the effective operation of the award (including the date and period of operation of the award, and facilitative provisions)

Source: Reith (1996).

The approach adopted by the AIRC and the speed at which awards are reviewed will have an important bearing on the benefits from the Government's proposed reforms. Putting awards in plain English will help employees and employers (including small businesses). However, the requirement that pay must be no less than that prescribed under the relevant award may constrain mutually advantageous bargaining.

Many of the core provisions that will continue under awards relate to premiums payable for working 'unsociable' hours (such as penalty, overtime, and shift rates) and on a casual basis. But efficient and fair levels of pay in these circumstances are ones which are sufficient to induce people, *without duress*, to work the relevant hours.

Centrally determined premiums need not bear any relationship to the preparedness of many employees or the unemployed to work these hours. This is likely to vary across regions, occupations and individual employees. Provisions already vary across awards and there are differences between federal and State systems.

The introduction of a training wage for unemployed adults and trainees in 1994 allowed for greater flexibility in wages 'permitting a better matching of labour costs and individual productivity levels, thereby encouraging employment' (DEETYA, Departmental paper 13, p. 4). The Government's new Modern Australian Apprenticeship and Trainee Scheme will allow training options which 'match wage levels with the value of the trainee to the employer by, for example, discounting wages for the time spent in both on and off-the-job training' (DIR, Departmental paper 18, p. 16).

Although potentially controversial, greater variability in minimum wages in combination with productivity improvements would improve the job prospects of the unemployed, especially youth and others with low level skills (IC 1993g). For these people, employment experience and on-the-job training provide opportunities to move up the 'jobs escalator' into higher paying employment. A minimum wage system which takes into account geographic cost differences and allows for wage differentials based on enterprise performance has also been advocated within the labour movement (Costa and Duffy 1991).

From a safety net perspective, this suggests that not all existing wage loadings and award conditions should be considered sacrosanct. It should also be possible over time to reduce the number of safety nets provided.

The current system of over 2700 federal awards provides a more complex and variable set of 'minimums' than is necessary to provide a fair and efficient safety net. The Government should therefore seek an independent review of the scope to reduce variability in core conditions across awards and to reduce the number of core

conditions once the new system has settled down. The adequacy of social security arrangements will also need to be addressed (see below).

Publishing analyses of developments in the award system and in workplace bargaining can provide information that assists in building broad community support for reform. The Government intends that it be possible to publicise information about the content of Australian Workplace Agreements so long as parties to them are not identifiable.

Australia's dual systems of federal and State awards and tribunals contribute to the complexity and regulatory burden for all participants. However, a potentially valuable benefit for employees and employers is the ability to choose a jurisdiction offering a better framework. State and Commonwealth systems for industrial relations now have broadly common objectives but differences remain. The proposal in the Workplace Relations Bill that parties to federal awards be able to enter into agreements under State arrangements is one way of allowing, by mutual consent, greater 'regional' variation than is possible in provisions applying nation-wide. Initiatives to harmonise federal and State industrial relations systems should allow scope for productive differences between jurisdictions.

In sum, the Commission's assessment of industrial relations reform is that:

- τ *Governments need to facilitate agreements between employees and employers on wages and conditions appropriate to their workplaces. Enactment of key elements of the Commonwealth Government's Workplace Relations Bill would significantly advance the evolution of the federal industrial relations system. Expanding the choice of bargaining agents and refocusing awards to serve as safety nets will allow greater flexibility in workplaces.*
- τ *The scope to reduce variability in core conditions across awards and the number of core conditions should be the subject of an independent review. The review should have regard to both efficiency and equity issues.*

Social welfare and tax systems

Government income support and the activities of charitable organisations are integral to the living standards of many Australians. A social welfare system which gives adequate support to the disadvantaged is vitally important in building support for economic reform.

If job opportunities are to be maximised, labour markets should not be required to perform a major social welfare function. High minimum wages and mandated premiums for working non-standard hours and casual work can mean the poor do

not get a chance to work at all. The Government should keep under review the potential for greater reliance on the tax-transfer system to meet better the community's income support objectives.

While it is essential that unemployed people have the opportunity to maintain a basic standard of living, social security systems designed for this purpose should be structured so as to minimise disincentives to gaining work. Certain features of the Australian system mean people can be financially better off not working (box 2.7).

The Government should therefore carefully assess the equity and efficiency implications of:

- linking unemployment payments to previous work experience and earnings, and placing time limits on receipt of benefits;
- uniform unemployment benefits relative to providing some regional variation to reflect costs of living;
- changing assistance measures — for example, how public housing is provided — which unnecessarily impede mobility;
- channelling special assistance to individuals through private welfare agencies — the IC (1995e) recently reported on what could be done to strengthen the contribution which the charitable sector already makes to Australian society;
- encouraging greater reliance on private funding of provision for temporary loss of earnings;
- dealing with poverty traps by simultaneously slowing down phase-out rates and

Box 2.7 Disincentives in Australia's social security arrangements

- High benefits for unskilled workers with a dependent spouse and/or children in relation to potential earnings (a high 'replacement' rate).
- Effectively open-ended benefits (there is no cut off or reduction in benefits for those unemployed for long periods). Cross-country research finds a positive relationship between the duration of benefits and the level of unemployment.
- Unlike most countries, benefits are paid at a flat rate rather than related to previous earnings — resulting in higher replacement rates for the poorly skilled who are disproportionately represented in Australia's long term unemployed.
- No requirement for a previous work history to gain unemployment benefits — benefits in most countries are linked this way and therefore usually exclude younger workers with little work experience.
- Unemployment benefits are uniform across regions despite different costs of living — this can encourage some to move to areas with low employment prospects.

Sources: EPAC (1996d); IC (1993g).

lowering thresholds where full benefits are payable; and

- an income tax credit scheme or a negative income tax to cushion low income earners from tax disincentive effects.

The magnitude and complexity of the task of understanding and reforming the interactions between Australia's tax and social security systems and work incentives means it must continue as a medium term priority for government.

This task is also related to a further review of the core safety net conditions of the industrial relations system. The Commission recognises that, in any significant reduction in the use of the industrial relations system to achieve welfare goals, the community would require assurance as to the adequacy of the social welfare system.

- τ ***The Government should review the interactions between the tax and social security systems and work incentives as a medium term priority. This review should have regard to the related review into the scope to consolidate the safety net conditions of the industrial relations system.***

Labour market assistance programs

The Commonwealth Government will have spent \$2 billion in 1995–96 on programs helping the unemployed to become competitive in the labour market. Much of this has gone on the long term unemployed and those identified as in high risk of being so. The schemes include subsidies to private sector employers to hire and train unemployed people, and funding for community groups to provide work experience and to train and help unemployed people start their own businesses (EPAC 1996d).

A number of reforms to the design and delivery of labour market assistance programs are in prospect. The proliferation of programs in recent years has reduced the effectiveness of the whole system for jobseekers, employers, training providers and case managers. The Commonwealth Employment Service Advisory Committee (1995, p. xi) reported that the complexities and overlap 'baffle all but the very experienced' and are 'an impediment to maximising outcomes'. The Committee recommended that 18 major labour market programs be rationalised to eight.

Evaluations of labour market programs show that, both in Australia and overseas, their effectiveness is mixed (box 2.8). The OECD (1995a, p. 27) review of studies concluded that greater success is likely if programs:

- target groups with similar employment problems;
- fund additional employment;
- provide a marginal subsidy, not fully funded jobs;

-
- incorporate targeted training programs that are implemented close to the workplace; and
 - target job-search assistance and counselling.

International experience also suggests that effectiveness is increased by integrating income support services with those of job placement and referral to labour market programs.

The evaluation framework for Australia's labour market programs has been improved over the last two years (DEET 1995). Post-program monitoring surveys were extended in 1995 beyond the three-month mark to assess outcomes at six and 12 months. There is a longitudinal survey of CES clients under way and the ABS Survey of Employment and Unemployment Patterns, tracking both jobseekers and a control group of employed people, is due to report in September 1996. In addition to this ongoing work, DEETYA is preparing an evaluation of the labour market program initiatives announced in 1994.

The 'success' of programs varies. The Australian Traineeship System, the New Enterprise Incentive Scheme and the Jobstart program appear the most successful judged in terms of the proportion of program participants in unsubsidised employment 12 months after leaving program assistance (83 per cent, 79 per cent and 59 per cent respectively). Most other programs rate around 40 per cent. However, program costs per participant also vary and the overall impacts on employment need to be factored into account (EPAC 1996d). The information yielded by extended program evaluation in Australia, together with the international

Box 2.8 Some factors that can blunt the effectiveness of labour market assistance programs

The type of labour market program, the manner and timing of its implementation, and the period the program is available all have an effect on outcomes. Factors blunting effectiveness are:

- unemployed people being hired on subsidised wages, even though they would have been employed at non-subsidised wages;
- subsidised workers replacing non-subsidised workers;
- employment in subsidised firms being drawn away from non-subsidised ones;
- publicly funding projects that would have been undertaken anyway;
- failure to address skill deficiencies; and
- workers being stigmatised as poor employment prospects because they have participated in labour market programs.

Sources: IC (1993g); EPAC (1996d).

experience, will provide a basis on which the Government can better evaluate the effectiveness of its labour market programs.

In addition to being effective, programs must be delivered efficiently. The Government introduced some competition in the delivery of labour market assistance in 1994. Community groups and the private sector, under the management of a new Employment Services Regulatory Authority, could provide a proportion of 'case management' services to unemployed people. Competitive arrangements were phased in: the targeted proportion for contractors was 10 per cent of clients in 1994–95, increasing to 20 per cent (up to 100 000) in 1995–96. Clients have some choice of provider within these constraints. The public, and major, provider of case management services, Employment Assistance Australia, was established as a separate organisation within DEETYA. Some early indicators of this competitive initiative are positive (IC 1996a). There is scope to progressively remove the market-share cap on contractors and to ensure greater competitive neutrality between the public provider and its competitors.

τ The Government should terminate ineffective labour market programs and rationalise the range of programs as new evaluation systems allow better assessment of program performance. The Government should also progressively remove the cap on case management services provided by community groups and private providers and ensure greater competitive neutrality between the public provider and its competitors.

Vocational education and training

The recent Taylor (1996) review of the ANTA agreement identified four critical issues:

- no strong sense of ownership among the State and Commonwealth stakeholders of ANTA as an organisation;
- a complex and bureaucratic system, in particular, the arrangements for the national recognition of training;
- unclear separation of functions within the States and Territories between the industry regulator and funder of contracts and those responsible for delivering the service; and
- lack of competition and a proper basis on which TAFE can compete.

The IC (1996e) inquiry on tourism accommodation and training reported that the existence of both government-based accreditation and industry-based recognition for courses has the potential to impose unnecessary costs on training providers. Adoption of the Queensland approach was recommended whereby training courses

are recognised by industry bodies and the State Training Authority retains a power of veto over accreditation. The IC also identified potential problems that would need monitoring: the limited involvement of small firms in setting the training agenda; the appropriate mix of job-specific and general content in publicly funded training courses; and credentialism (the requirement for formal qualifications not necessary to perform the job).

National VET data are currently inadequate for performance measurement. However, performance indicators are being developed for the sector by the Steering Committee for the Review of Commonwealth–State Service Provision (1995).

The current form of Australia's new training infrastructure has only been in place for a short time. Both the IC and the Taylor review have recommended that the system be reviewed within three to five years.

τ The institutional and regulatory arrangements for vocational education and training in Australia should be reviewed as a medium term priority. An important function of the review should be to assess the outcomes of reforms to date before setting new directions.

Management skills

A series of studies indicates there is considerable scope to improve the performance of Australian managers. These studies have emphasised the need for better management training and the widespread development of human resource management skills.

While recognising the need for better management training, the BCA has cautioned against excessive government involvement inherent in such proposals as the Council for Management Development recommended by the Karpin (1995) report.

An alternative approach is to look at ways to increase pressures on management to perform better. Competitive pressures create strong incentives for good management although, realistically, change will take time. Incentives provided by competitive markets will reinforce trends already under way for managers to provide better visions for their enterprises, more drive and entrepreneurship, and to unite with their employees in the common purpose of enterprise success.

τ *Government can increase incentives for the development of management skills and a strong productivity ethos in Australian managers by:*

- *continuing to remove barriers to competition in goods and services markets;*
- *ensuring that foreign investment and mergers policies allow effective discipline through the threat of takeover;*
- *ensuring that processes for business migration and the recognition of overseas skills operate effectively; and*
- *assessing whether the corporations law, corporate regulation and accounting standards can be improved to reinforce private incentives for good corporate governance.*

Workplace health and safety

There is considerable scope to reduce the human and economic loss that arises from workplace injury and disease in Australia. The IC reported on reforms to workers' compensation arrangements and occupational health and safety in 1994 and 1995 respectively. Governments should respond fully to the reform agendas outlined in those reports (box 2.9).

Key features of those recommended reform programs include:

- regulatory and institutional changes to reinforce the mutual self-interest employers and workers have in preventing workplace injury and illness and to ensure incentives for rehabilitation and return to work;
- achieving greater consistency between jurisdictions in occupational health and safety regulation and approaches to compensation;
- lessening the scope for competition that inappropriately shifts costs between individuals, firms, workers' compensation schemes and government programs;
- using competition to cut service delivery costs and/or provide better services; and
- bringing greater equity to the compensation of ill and injured workers.

The Heads of Workers' Compensation Authorities of the Commonwealth, States and Territories have recently developed proposals to achieve greater national consistency in workers' compensation.

τ *Governments should adopt the reform programs recommended by the IC to improve occupational health and safety and workers' compensation outcomes in Australia.*

Box 2.9 Reforms to improve workplace health and safety and workers' compensation

In reforming their policies on *occupational health and safety*, Australian governments should:

- streamline but strengthen regulation with fewer, simpler rules;
- allow greater flexibility for workplaces to manage injury and disease;
- beef up enforcement of the key legal responsibilities;
- strengthen financial incentives for safer workplaces;
- overhaul cooperation arrangements between Australian governments;
- provide greater contestability and transparency in research funding; and
- make occupational health and safety agencies more accountable for their performance.

Full details are provided in IC (1995g).

Reform of *workers' compensation* arrangements in Australia should encompass:

- holding employers liable for a large part of the cost of compensating workers suffering work-related injury or illness for forgone earnings and other costs;
- tapering benefits for injured or ill workers to reinforce incentives to behave in a safety conscious manner and for rehabilitation and return to work;
- moving to nationally consistent arrangements so as to improve the equity and efficiency of current arrangements and curtail cost shifting (to the injured, to 'safe' firms via cross-subsidies, to workers' compensation schemes and to taxpayers through calls on health and social security funding);
- establishing the option of a nationally available workers' compensation scheme — this would allow private and public insurers and self-insuring firms to compete with State schemes and address the administrative 'cross-border' problems faced by firms operating in more than one jurisdiction; and
- speedier and less costly dispute resolution procedures.

Full details are provided in IC (1994a).

Relevant BIE, EPAC and IC reports

Bureau of Industry Economics

Setting the Scene, Micro Reform — Impacts on Firms, BIE (1996a)

Agri-food Case Study, Micro Reform — Impacts on Firms, BIE (1996f)

Economic Planning Advisory Commission

Medium-Term Review: Opportunities for Growth, EPAC (1993b)

Wage Bargaining Systems and Productivity Growth in OECD Countries, Dowrick (1993)

Enterprise Bargaining Systems: International Case Studies, EPAC (1993d)

Human Resource Management and Workplace Change, Proceedings of an EPAC Roundtable held in Canberra on 6 February 1995, EPAC (1995b)

The Changing Australian Labour Market, Norris and Wooden (1996)

Future Labour Market Issues for Australia, EPAC (1996d)

Industry Commission

Impediments to Regional Industry Adjustment, IC (1993g)

Workers' Compensation in Australia, IC (1994a)

Meat Processing, IC (1994d)

Charitable Organisations in Australia, IC (1995e)

Work, Health and Safety, IC (1995g)

Competitive Tendering and Contracting by Public Sector Agencies, IC (1996a)

Tourism Accommodation and Training, IC (1996e)

3 COMPETITION POLICY

Competition is the key to improving performance, flexibility and productivity across the economy. It provides enduring incentives for firms to lift their performance and serve their customers well.

The role of competition policy is to address barriers to competition in markets, including anticompetitive regulations. Pro-competitive regulation is also required to foster competition in some ‘non-contestable’ markets.

Until recently, GBEs and unincorporated enterprises and the professions were exempt from the Trade Practices Act (TPA). While these sectors were often covered by similar State and Territory legislation, there were inconsistencies across sectors and between States.

The April 1995 COAG agreement on a national competition reform package was an historic initiative. It will open up previously sheltered areas of the economy to competitive pressures, and support various regulatory initiatives to create national markets operating under one set of rules. Overall, the package should be one of the key drivers of reform over the coming years. The task now is for all governments to implement the package quickly and effectively.

3.1 The national competition policy package

The national competition policy package (box 3.1) will:

- extend competitive conduct rules in the TPA to all State and local government GBEs and unincorporated businesses;
- enhance the competitive pressure on GBEs through prices oversight, application of competitive neutrality principles and procedures for structural reform of public monopolies;
- provide a process for third party access to nationally significant infrastructure facilities; and
- encourage competition through a program of review of anticompetitive regulations.

The new competitive conduct rules are to apply nation-wide from July 1996, with the review and reform of anticompetitive regulations completed by 2000.

To underpin future reforms, the policy package establishes a new institutional framework.

- The Australian Competition and Consumer Commission (ACCC) has absorbed the functions of the Trade Practices Commission and the Prices Surveillance Authority. It can also accept undertakings under the new access regime for essential facilities.
- The National Competition Council (NCC) advises on access declarations and prices oversight of State and Territory GBEs, and undertakes reviews under the

Box 3.1 **The national competition policy package**

In April 1995, COAG agreed to implement a package of measures to extend competition policies to previously exempt sectors of the economy.

The Commonwealth's *Competition Policy Reform Act 1995*:

- amends the competitive conduct rules (Part IV) of the TPA and extends their coverage to State and local government business enterprises and unincorporated businesses;
- creates a new section (Part IIIA) of the TPA establishing a national regime for access to services provided by 'nationally significant' infrastructure facilities;
- amends the Prices Surveillance Act to extend prices oversight to State and Territory owned business enterprises; and
- creates two new institutions — the ACCC and the NCC — responsible for overseeing and providing advice on implementation of the policy package.

There are three intergovernmental agreements in the package.

- The *Conduct Code Agreement* sets out the basis for extending the coverage of the TPA and consultative processes on modifications to the competition law and appointments to the ACCC.
- The *Competition Principles Agreement* establishes principles on: structural reform of public monopolies; competitive neutrality between the public and private sectors; prices oversight of government business enterprises; a regime to provide access to essential facilities; a review program for legislation restricting competition; and consultative processes for appointments to the NCC.
- Under the *Agreement to Implement the National Competition Policy and Related Reforms*, the Commonwealth will provide payments to States and Territories which give effect to the intergovernmental agreements, and meet reform commitments in electricity, gas, water and road transport.

Sources: IC (1995k); COAG (1995).

Competition Principles Agreement. The NCC will also review progress on implementation of the Agreement as a condition for the ‘competition’ payments to the States and Territories.

- In addition, States and Territories may establish their own access and price regulation regimes. They must, however, provide for a single access regime for essential facilities crossing a State border.

Implementation of reforms to give effect to this framework across the economy offers the prospect of very substantial gains. The IC (1995a) estimated the potential gains to be around 5 per cent of GDP (box 3.2).

However, the success of the new competition policy arrangements will depend in large part upon the effectiveness of the Commonwealth and State institutions and processes, and political commitment to the intent of the arrangements. The substantial task of ensuring successful implementation still lies ahead.

Box 3.2 The gains from national competition policy

In a report produced for COAG, the IC estimated the revenue and economy-wide effects of implementing reforms recommended in the Hilmer Report, along with a set of related reforms (IC 1995a).

The estimated economy-wide benefits of the reforms considered were:

- a \$23 billion increase in real GDP, with around half attributable to reforms improving GBE performance. Major contributors to the GDP increase included the electricity and gas, telecommunications and rail sectors; and
- a \$9 billion gain to consumers, equivalent to \$1500 for each Australian household; an increase in real wages of 3 per cent; and 30 000 extra jobs.

The report recognised limitations in the methodology used and underlying assumptions, and discussed the sensitivity of the results.

However, some of the subsequent criticisms of the modelling have substance. For example, it did not allow for productivity improvements in areas such as telecommunications in the absence of reform. The modelling also assumed that all the cost savings from contracting out came from productivity savings rather than partly from lower wages.

The modelling could be refined in the light of these criticisms, using additional evidence available after the report release. For example, a more thorough analysis of the gains from contracting out is contained in IC (1996a). Nevertheless, even after such revisions, the estimated gains from microeconomic reform would still be considerable.

3.2 Implementation issues and tasks

Neither the importance nor the difficulty of the implementation task should be underestimated. For instance, an immediate concern is the pressure coming from pharmacies, newsagencies, the legal profession, and statutory marketing bodies for exemption from aspects of the competition policy framework. Unless supported by a rigorous public interest test, selective exemptions will not only maintain higher costs in the sectors concerned, but also undermine application of the principles more generally.

Effective and speedy resolution of the following key implementation issues is also crucial. Specific suggestions to progress these issues are set out in section 3.3.

The Competition Principles Agreement

In implementing the Competition Principles Agreement (box 3.1), jurisdictions must address a range of issues.

The *competitive neutrality* provisions of the Agreement require governments to consider the appropriateness and costs and benefits of a range of matters including: corporatisation; introduction of taxation equivalents; debt guarantee fees; and equivalent regulation to private sector competitors. The aim is to eliminate provisions that provide publicly owned enterprises with a competitive edge over private sector counterparts. The principles can apply to government business units within departments as well as to GBEs.

The *structural reform* provisions leave jurisdictions free to determine their agendas for reform of public monopolies.

However, where jurisdictions introduce competition or privatisation to a sector previously supplied by a public monopoly, they have agreed to: remove any responsibilities for industry regulation from that public monopoly; and undertake a review. The matters to be reviewed are set out in the Agreement and include: the merits of horizontal and vertical separation; the most effective way of implementing competitive neutrality principles; assessing the need for, and means of, delivering CSOs; and reviewing regulation of price and service quality.

Access to essential facilities

In some markets, effective competition requires that competitors have access to certain ‘essential facilities’ that cannot be duplicated economically. For example, a

competitive electricity supply market requires that generators have access to the electricity transmission grid.

The Competition Principles Agreement seeks to promote consistent access regimes for essential facilities. The Commonwealth has put in place a national regime (under Part IIIA of the TPA) and, while the States and Territories have some scope to establish their own regimes, they must meet criteria set out in the Agreement.

Prices oversight

Legislated monopolies, natural monopolies and firms in poorly contested markets have scope to overcharge consumers. In these circumstances, some form of prices oversight may be warranted to limit abuse of market power. Prices oversight will also help ensure that the benefits of newly introduced competition in one sector of a market (for example, electricity generation) are passed on to consumers rather than extracted by a natural monopoly service (for example, electricity transmission or distribution grids).

However, prices oversight is unlikely to be beneficial where suppliers are not in a position to dominate the market. Recent IC reports have found that unwarranted prices surveillance is detrimental to consumer choice, adds to business costs and adversely affects production and investment without a commensurate pay-off to the community (IC 1994c,e).

The competition policy package puts new arrangements for prices oversight in place. Prices surveillance processes will be streamlined, less obtrusive prices monitoring introduced, and prices surveillance and monitoring extended to State and Territory GBEs. The ACCC will be responsible for prices oversight of declared private enterprises and major Commonwealth enterprises. Prices oversight by the ACCC of State or Territory owned enterprises will be possible if the owner-government has agreed or where the NCC has recommended, on request of another government, that this is appropriate.

3.3 The reform agenda

Participants' views

There was strong support from business for general application of the national competition policy. In a recent address, the Chairman of the BCA said:

Implementation of the National Competition Policy will provide a higher non-inflationary growth ceiling, more jobs and lower inflation.

It has the capacity to touch every part of the Australian economy and bring with it broad based community benefits spread across all States and Territories (Salmon 1996, pp. 3–4).

More specifically, the ACCI argued that:

Maintaining the commitment on national competition policy reform will call for action on two fronts:

- firstly in the near term, ensuring the integrity of the new policy framework is maintained, by participating governments honouring the spirit of the agreements, especially in having any requests for exemptions or authorisations subject to rigorous, open, transparent and public inquiry processes; and
- secondly, in the medium term, further strengthening the national competition policy framework by dealing with a number of the outstanding issues, most notably structural reform of government business enterprises, and regulation review and reform (Sub. 16, p. 7).

Interest groups such as the Council of Small Business Organisations of Australia have expressed concern about the impact of the policy on their constituents, as have community groups in relation to the ensuing distributional impacts. The Public Interest Advocacy Centre pointed to the importance of accounting for consumer welfare and other social issues in public interest tests. It argued that incorporating such effects ‘is a challenge for microeconomic reform, not a nuisance’ (Johnston 1996, p. 13).

Also, at the business roundtable, there were concerns expressed about the application of access regimes to private infrastructure facilities. Business groups argued that care is needed to ensure that arrangements do not create undue uncertainty about control over assets and thereby deter investment.

Nevertheless, most accepted the general premise of only permitting exemptions from competition policy if a public process demonstrates this is in the national interest. Indeed, the BCA expressed disappointment about the number of exemptions provided for government activities.

Some participants advocated revisiting the principles underlying aspects of the TPA. The MTIA stated:

The general aims of the new competition policy regime ... must underpin the broader objective of integration in the global economy. To this end, there are instances when the survival and expansion of a domestic industry in an internationally competitive framework can only be built upon the aggregation of domestic participants (Sub. 27, p. 6).

The Commission's assessment

Australia has embarked on an important policy innovation with potential for substantial gains in productivity and living standards. The Commission broadly endorses the framework provided by the national competition policy package, and emphasises the importance of quickly resolving outstanding implementation issues in accordance with the agreed competition principles. As the ACCI emphasised, 'just do it'.

The framework should be applied across-the-board. Exemptions, unless supported by a rigorous and transparent public interest test, will encourage others to seek special treatment and thereby undermine the policy more generally.

Effective implementation will require a cooperative and common sense approach, as evident in the COAG processes to date:

- It is important to avoid a legalistic approach in which agreements are kept only in a minimalist fashion.
- Compliance with the competition principles should be promoted through: public information on progress; transparency of decision making; and encouragement to achieve meaningful reform.
- Where States and Territories breach their commitments, 'competition' payments should be withheld to demonstrate the importance attached to those commitments.

Given the magnitude of the task ahead and the number of issues yet to be resolved, implementation of the package and outcomes achieved should be monitored and reviewed. Not all of the outcomes of future implementation endeavours can be predicted. Indeed, for some issues there may be no uniquely 'correct' approach. It is therefore important to have processes which reveal the need for any modifications to strategies as implementation proceeds.

The NCC will play a major role in monitoring implementation. However, its limited ability to undertake work outside an agreed work program may limit its effectiveness in the broader task of assessing the operation of the policy framework.

It would therefore be desirable to supplement monitoring by the NCC with an independent review of the outcomes achieved from key elements of the competition policy framework. This review should cover: access rules; competitive neutrality; prices oversight arrangements; public benefit testing; complaints mechanisms; and structural reforms. It should occur prior to any reviews of the institutional arrangements underpinning the package. The intergovernmental agreements make provision for a review of the operations of the ACCC and the NCC in 2000.

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- τ *The national competition policy package should be implemented quickly and effectively in accordance with the principles already agreed.*
 - τ *The competition principles should apply across the economy. Exemptions should be granted only after a public, independent review establishes an economic or public benefit case for exemption.*
 - τ *Effective implementation should be encouraged through: a non-legalistic approach to reform; public information on progress; transparency in decision making; and withholding 'competition' payments to States and Territories which breach commitments.*
 - τ *There should be an independent review of the operation of key elements of the national competition policy framework, and outcomes achieved, commencing in 1998.*

While the Commission's overall message on competition policy is to get on with the job, there are some general principles which should guide particular implementation issues.

Competition Principles Agreement

Under the structural reform provisions, reviews of public monopoly arrangements are only triggered by the introduction of competition or privatisation.

There is a case for a wider set of reviews, including in areas such as telecommunications and post that have already been subject to recent reform (see chapter 4).

Access to essential facilities

Many access regulation issues remain to be resolved.

Granting access to network assets can increase competition in downstream and upstream markets. However, access regimes may also impose costs, particularly if they create uncertainty for future investment. To avoid this access arrangements should be:

- interpreted so that rights of access are declared only where the efficiency benefits to the community exceed the costs;
- administered in a transparent fashion; and
- consistently applied across Commonwealth, State and Territory regulatory bodies (box 3.3).

Box 3.3 **Implementing access regulation**

In its report on *Access and price regulation*, the IC argued that access declarations should be limited to natural monopoly facilities of national significance and where access is required for effective competition in related markets. While granting access where more than one facility exists may be appropriate in individual cases, this should be kept separate from the declaration process.

The IC also argued that transparent administrative procedures will help ensure that access is beneficial:

- Requiring lodgement on the public register with the ACCC of the conditions of privately negotiated access agreements may provide some constraint on monopoly pricing by facility owners/operators.
- ACCC processes for regulating access prices and conditions should be open to public scrutiny prior to the final determination.
- The NCC's assessment of 'effectiveness' and the declaration processes should be public and transparent. In particular, applications for declarations and recommendations of 'effectiveness' should be advertised, and public submissions invited. The NCC should publish its recommendations and the reasons for them.

Achieving consistency between the NCC and ACCC is important. This requirement also extends to State and Territory regulatory bodies as differing approaches could undermine the gains from facilitating access to essential facilities.

Source: IC (1995k).

Applying these principles will help ensure that the new access arrangements are restricted to areas where there are clear economic benefits from facilitating access.

Consistency in approach to access and pricing issues by the NCC, the ACCC, and relevant State regulatory bodies will help prevent fragmentation and distortions in national trade and commerce. Transparency will require clear guidelines, so that market participants can predict likely outcomes from decision-making processes.

Prices oversight

Here too, there are important implementation requirements and issues to be resolved, including the need:

- to develop processes and criteria which limit prices oversight to statutory and natural monopolies, and other markets where competition is very weak (box 3.4);
- for the NCC and the ACCC to take efficient resource allocation as their primary objective;

- for governments to assess and act on proposals to achieve a consistent approach to prices oversight across jurisdictions, being developed by the NCC; and
- to resolve problems of overlap between the Commonwealth, States and Territories in relation to prices oversight of enterprises supplying services on interstate networks.

Box 3.4 **Criteria for prices oversight**

Surveillance of prices can improve economic efficiency where pro-competitive reforms would be ineffective.

However, the IC (1994c) argued that surveillance should be used more sparingly and be refocused. It said that surveillance should be limited to circumstances where a single firm:

- has a greater than two-thirds market share; *and*
- has no major rival; *and*
- faces sporadic or trivial imports (import penetration persistently below 10 per cent of the market); *and*
- is sheltered by substantial barriers to entry or to expansion by rivals.

The Commonwealth has since ended surveillance for some goods and decided on less onerous price monitoring for others.

Giving the ACCC a price monitoring function is intended to reduce the use of more costly price surveillance and thereby provide greater flexibility in prices oversight.

However, the circumstances in which formal monitoring is envisaged are very broad and may catch firms subject to effective competition. The same threshold market share used in broader investigations for price surveillance should also apply to price monitoring. Price monitoring should be adopted if there is doubt about the other criteria for price surveillance. It could also be used as a transitional measure for firms previously subject to other forms of price regulation.

Source: IC (1994c).

- τ *Reviews under the structural reform provisions should not be limited to sectors where competition is introduced or GBEs are privatised.*
- τ *Access declarations should be limited to natural monopoly facilities of national significance or where access is required for effective competition in related markets.*

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- τ *Prices oversight should be limited to statutory and natural monopolies and other markets where competition is very weak. This would be the case when a single firm: has a greater than two-thirds market share; has no major rival; faces sporadic or trivial import competition; and is sheltered by substantial barriers to entry or expansion by rivals.*
 - τ *Access and pricing regulation regimes should be supported by transparent decision-making processes that are consistent across jurisdictions.*

Trade practices regulation

The TPA was introduced more than two decades ago at a time when there was much less domestic and international competition in the Australian economy. While the Act has been modified and updated over the years, there are provisions or processes, not directly addressed in the national competition policy framework, which may no longer be appropriate in today's much more competitive environment.

This suggests a need to extend review of the TPA beyond issues directly relevant to the national competition policy framework.

This is already happening to an extent. For instance, there are reviews in train or in prospect to simplify the consumer protection provisions of the TPA and to assess the relevance of product safety and information provisions.

Another area of the Act warranting review is the mergers and acquisitions provisions. Mergers can improve productivity by allowing firms to reap economies of scale and to better combine resources. And the threat of takeover imposes a discipline on managerial performance. However, mergers may also concentrate market power, leading to higher prices and reduced quality.

Under Part IV of the TPA, the ACCC is required to oppose a merger that is judged to 'substantially lessen competition in a substantial market in Australia', unless authorised by it as providing net public benefits. The ACCC's task in trading off costs and benefits is a difficult one, requiring fine judgment about degrees of competition and their implications.

In 1992 the ACCC's predecessor, the Trade Practices Commission, issued Draft Merger Guidelines to assist firms in understanding how the new competition test would be implemented. While these are broadly appropriate, there is scope to make changes which would reduce costs and uncertainty for industry (box 3.5).

Box 3.5 Major IC proposals on merger regulation

In revising its Draft Merger Guidelines, the ACCC should examine the implications of easing 'safe harbours' requirements, where mergers can proceed without scrutiny. There would be merit in:

- raising the threshold market share for a merged firm from 40 to 50 per cent;
- replacing the threshold test in which the post-merger concentration ratio for *four* firms is 75 per cent or more (with the merged firm having at least 15 per cent of the market), with one in which the *three* firm concentration ratio is 75 per cent or more (with the merged firm having at least 20 per cent of the market); and
- introducing an additional 'safe harbour' rule: where total *arms length* imports have accounted for at least 10 per cent of sales for three years, the merger should be free from scrutiny.

Further, there is a need to improve the scope, effectiveness and transparency of the authorisation process, and to review the role of enforceable undertakings. Other matters include:

- broader treatment of market definition and regular publication by the ACCC of merger case studies to show how the market is delineated; and
- the identification and measurement by the ACCC of entry barriers, with greater emphasis given to the role of sunk costs.

Consideration should be given to increasing the time period for judging the effectiveness of the threat of entry from two to possibly five years.

Source: IC (1996i).

There are also questions about the efficacy of provisions in the TPA restraining 'anticompetitive vertical arrangements' such as exclusive dealing and resale price maintenance (Tirole 1988; Katz 1989). These provisions mean that transactions within a firm are treated differently from transactions between firms. Hence there is an incentive for firms to vertically integrate to avoid the provisions.

τ Independent reviews of the Trade Practices Act should extend beyond provisions directly relevant to the national competition policy framework, to cover such traditional areas as mergers policy and 'anticompetitive' vertical arrangements.

Relevant EPAC and IC reports

Economic Planning Advisory Commission

Medium-Term Review: Opportunities for Growth, EPAC (1993b)

Issues in Competition Policy, EPAC (1993c)

Industry Commission

What Future for Price Surveillance?, IC (1994c)

Petroleum Products, IC (1994e)

The Growth and Revenue Implications of Hilmer and Related Reforms, IC (1995a)

Does Pacific Power have Market Power?, IC (1995h)

Implementing the National Competition Policy: Access and Price Regulation, IC (1995k)

The Electricity Industry in South Australia, IC (1996c)

Merger Regulation, IC (1996i)

4 INFRASTRUCTURE

Infrastructure is central to economic performance and living standards. It has a major bearing on the costs of firms, as well as providing essential services to the community. Infrastructure investments can also have ‘spillover’ benefits for productivity and growth more generally.

Because Australia is a large country remote from major markets, efficient infrastructure provision is especially important. Indeed, with the right policies, infrastructure could become a source of competitive advantage for Australia in the region. As the BCA argued:

... in the competitive global market, abundant low-cost infrastructure will be a key driver for business competitiveness and investment. The strategic thrust of reducing the cost of doing business must be to bring our infrastructural costs and efficiency into line with — or to surpass — the world’s best. In other words, what we need to do is to ensure that our infrastructure is a source of competitive advantage (Sub. 38, p. 1).

Improving infrastructure provision is also important to complement reforms in other input markets and, in particular, to help ensure that the benefits of those reforms are passed on to users.

As a major player in the infrastructure sectors, government must take the lead in working towards world class outcomes. Responsibility lies not only with the Commonwealth and the States, but also with local government.

As in other areas of the economy, harnessing competition is the key to improving efficiency in infrastructure provision. In this context, implementation of the national competition policy framework and reforms to increase competition in the labour market will be crucial. But harnessing competition is not the whole story to improving efficiency. Ownership and broader investment issues are also relevant, as are planning and regulatory issues.

This chapter provides an overview of the key issues and directions for action. (A more extensive treatment is presented in appendix B.) Many of the initiatives to improve efficiency are well known and have wide support. However, there has been considerable variation in the extent and pace of reforms across Australia. Thus governments need to intensify and accelerate their reform efforts.

4.1 Reforms to date

The economic infrastructure sectors account for 13 per cent of GDP, with most of their outputs used by other activities in the economy. Transport activities account for around half of the sector by value, the remainder being in electricity, gas, water, and post and telecommunications.

While there has been increasing private involvement in infrastructure, governments still own and operate 90 per cent of Australia's infrastructure assets.

Over the last decade, there has been substantial reform to GBEs that operate these assets. Some have been administrative in nature, for example, corporatisation of GBEs and pricing reforms. More recently, the focus has shifted to increasing competition in the supply of services (section 4.3).

As well as making service delivery more efficient, the reforms have led to greater emphasis on better meeting users' needs.

The dividends from these reforms have been considerable. Between 1989–90 and 1993–94, total factor productivity of electricity, gas and water; transport and storage; and communication GBEs grew by 28, 25 and 51 per cent respectively (EPAC 1995e). These high rates of growth have contributed to a narrowing in the performance gap between Australian GBEs and world best practice, and produced tangible benefits for users and taxpayers (box 1.2 in chapter 1).

4.2 Performance gaps

Despite these improvements, there is still a long way to go to achieve internationally competitive outcomes in most infrastructure sectors (figure 4.1 and box 4.1). This is particularly the case when variations between the best and worst Australian performers are taken into account. In turn, this points to the significant differences in the pace of reform across Australia.

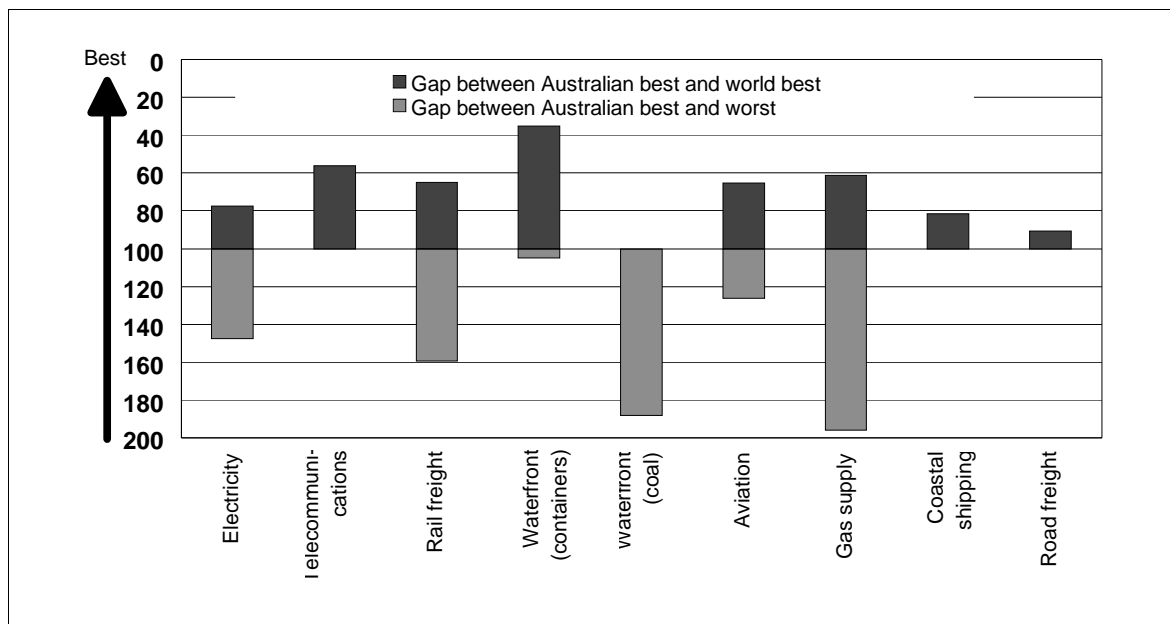
In large measure, this patchy performance reflects significant restrictions on competition. For example, in identifying the need for reform on the waterfront, the MTIA summarised the situation as follows:

Market power is very concentrated ...

- Port Authorities: which are typically monopoly providers of many facilities;
- Harbour towage: tug operation is a monopoly in smaller ports and a duopoly in Melbourne, Sydney and Newcastle;

- Stevedoring: market power has become more concentrated among stevedores since containerisation in 1969, when handling became greatly capital intensive to the exclusion of market players; and
- Labour: the system of centralised labour allocation has meant labour supply has been largely represented by the [Maritime Union of Australia] while firms have been primarily represented by the Association of Employers of Waterside Labour.

Figure 4.1 **Price performance indexes — Australian and best observed**
(Australian best = 100)



Note: The lower the index, the better the price performance.

Source: BIE (1995h).

Box 4.1 **Examples of performance gaps**

- BHP said that the cost of transporting steel from Melbourne is two-thirds higher than from Auckland. According to ICI, it is cheaper to import product from South East Asia into Brisbane or Perth than to move product from Perth to Sydney or Melbourne. And the Plastics and Chemicals Industries Association said that as a result of the trans-Tasman shipping arrangements, freight rates between Melbourne and Singapore are only half those from Melbourne to Auckland.
- It generally takes 50 to 100 per cent longer to unload a container ship in Australia than in a comparable overseas port (BIE 1995d).
- BHP said that the absence of competition for government rail services in Queensland has led to coal freight rates in that State three times those on the company's Pilbara to Port Headland line in Western Australia, for a journey of half the distance.

This system has allowed port authorities, employers and unions unarrested rent seeking. This has affected both waterfront costs and set upper limits on the volume of trade (Sub. 27, p. 5).

Constraints on competition have reduced incentives for efficient service provision. They have also helped to perpetuate inappropriate pricing of infrastructure services, including underpricing or overpricing of services, and cross subsidies between groups of users.

But restrictions on competition are not the only reason for poor performance:

- In sectors such as electricity, gas and road transport, the subordination of the national interest to parochial regional concerns has stymied or delayed the development of national markets.
- There are still significant gaps in the integration of the different transport services.
- There are deficiencies in Australia's stock of infrastructure assets in sectors such as roads.

4.3 The reform agenda

Participants' views

Business participants said that rigorous implementation of the national competition policy and labour market reform are vital components of a package to improve the delivery of infrastructure services. They argued that these reforms will improve the efficiency and quality of service provision and lead to lower prices.

Business groups put particular emphasis on reforms to improve the efficiency of the waterfront, ports and shipping services:

- The National Farmers' Federation said that the top reform priority was to increase productivity in container handling.
- Liner Shipping Services said that reform on the waterfront has 'gone backwards' since 1995 and that the Commonwealth Government should provide an industrial relations environment conducive to efficient behaviour by management and employees.
- Others spoke of the need to deal with impediments to the entry of new stevedoring companies, and to end cabotage for coastal shipping and the trans-Tasman shipping arrangements. The Plastics and Chemicals Industries Association estimated that open competition on the trans-Tasman route would lower costs by close to 20 per cent.

But the concern to see greater competition and labour market flexibility also extended to other sectors. For example, the ACCI spoke of the need for a genuinely competitive national rail market. BHP said that this would require: clear guidelines for access to rail infrastructure; encouraging new entrants to rail freight; and developing a seamless rail freight system. Others supported further pro-competitive initiatives in domestic aviation, post and telecommunications.

In electricity, major users commented on the importance of enhancing national competition through finalisation of the national electricity market. However, they emphasised that this is only part of the required package, with application of competition policy also being important to improve electricity efficiency within States. The Pulp and Paper Manufacturers Federation argued that outside Victoria and New South Wales, electricity reform has been ‘lamentable’. The BCA suggested that the Commonwealth use the leverage provided by the ‘Hilmer competition payments’ to encourage reform in this area. And BHP, among others, advocated disaggregating generation and distribution in all the eastern States and opening these sectors to competition.

The story was similar in gas, with users emphasising the need for free interstate trade and structural breakup of vertically integrated utilities.

However, the Australian Gas Association raised concerns about the way in which the gas grid is to be regulated:

The current COAG Gas Reform initiative is placing considerable emphasis on access to transmission pipelines and distribution networks. However, the reform process must recognise that a truly competitive gas market will require greater supply competition and diversity as well (Sub. 24, p. 2).

Business participants also emphasised that reform to improve the efficiency of infrastructure goes beyond implementing competition policy and reforming labour markets:

- A number spoke of the need for regulatory reform to create national systems in road and rail.
- Others argued for new investment to deal with outdated or inadequate transport infrastructure, noting that reduced Commonwealth funding for the States has contributed to current gaps. They therefore saw reform of Commonwealth–State financial relations as another element in the infrastructure package.
- Some referred to additional disciplines on performance from private ownership of infrastructure. The ACCI argued for privatisation of discrete elements of the electricity industry, contestable parts of national and state rail systems, port authorities and some mail delivery activities.

Finally, business stressed that the benefits of infrastructure reform must flow to users through lower charges, as well as to governments through higher dividends. The BCA argued that:

Significant benefits from microeconomic reform appear to have been captured by governments in the form of ‘user charges’ and or dividend requirements ... If benefits are ‘creamed off’ by government by way of indirect forms of taxation, Australia’s international competitiveness is retarded, public expenditure remains excessive, and community support for reform and change is eroded (Sub. 38, pp. 2–3).

In this respect, the Council and others raised particular concerns about the perceived exploitation of the market power of GBEs through upward revaluation of infrastructure assets.

The Commission’s assessment

The gains achieved in infrastructure over the past decade have come partly from administrative reforms. These have included: better objective setting; creating a competitively neutral environment for GBEs through subjecting them to, for example, taxes, charges and dividend requirements; contracting out non-core functions to the private sector; and pricing reform to better reflect the true costs of service provision. There is a need to push ahead with these reforms.

But more important have been recent initiatives to make the supply of services more contestable, including:

- removing regulatory barriers to entry;
- structural separation of contestable and natural monopoly activities of some GBEs; and
- regulating those activities where competition is lacking to ensure that market power cannot be employed to exploit users or deter competition in related, but contestable, market segments.

Continuing and extending these initiatives is the key to improving the delivery of infrastructure services in the future. In some parts of Australia, and in some sectors, there is still a long way to go.

Rigorous implementation of national competition policy provides the basis for improving performance. It is crucial that the principles in the policy be applied to all infrastructure sectors, and in a consistent fashion across sectors. This will require much hard work and commitment from the various parties.

There are conceptual and practical issues that will require resolution either prior to implementation, or as the competition policy framework evolves (see chapter 3).

And, as indicated by the sectoral discussion below and in appendix B, when it comes to application ‘one size *does not* fit all’. For example, the benefits from promoting competition through structural separation and the costs involved, are unlikely to be uniform across sectors.

Reforms elsewhere will increase the effectiveness of infrastructure reforms. For example, changes to the taxation system and Commonwealth–State financial arrangements could reduce any incentive for State governments to use charges for monopoly infrastructure services as de facto taxes (see chapter 10). By reducing the threat to State government revenues from competition policy, such reforms might therefore encourage more rigorous application of the policy. Similarly, greater flexibility in the labour market will help infrastructure providers respond to the pressures of a more competitive market.

Privatising some infrastructure may provide opportunities to lock in, or build on, the gains from competition. With public ownership it is difficult, if not impossible, to replicate the incentives for better performance arising from the threat of takeover or insolvency. And even with corporatisation, it is very difficult to prevent governments intervening in the day-to-day commercial operations of their GBEs.

Of course, in the absence of competition, privatisation may simply transfer monopoly rights to the private sector with no benefits to users. Indeed, one of the practical problems with privatisation is the temptation for governments to increase sale prices by offering assets with monopoly restrictions attached. *Thus, the Commission emphasises that privatisation is a complement to promoting competition in the supply of infrastructure services, not an alternative.*

In turn this suggests that, where infrastructure services are inherently competitive or contestable, or have been rendered so through structural reforms, there is a strong *a priori* case for privatisation. In these circumstances, governments should be looking to give effect to the full range of competitive market disciplines, including competition for ownership. This approach is supported by various studies which indicate that private suppliers perform better than government ones where markets are contestable (see, for example, Galal et al. 1994, and Megginson et al. 1994).

However, where an infrastructure market is not contestable, the case for privatisation is more ambiguous. The same studies provide a mixed assessment of whether a private monopoly performs better than a public one. Moreover, there is the practical question of whether any gains from injecting ownership disciplines are outweighed by the costs of regulation necessary to prevent the abuse of monopoly power. Thus case-by-case assessment of the ownership issue is crucial.

More generally, the Commission stresses that whatever the market structure, privatisation should be driven by a concern to improve the efficiency of service delivery. Swapping a future revenue stream for cash up front, is not a sufficient justification for selling publicly owned assets.

Pending any privatisation of infrastructure, there is a need to reassess public sector infrastructure planning and investment processes. Getting the flow of new infrastructure right is no less important than managing existing assets effectively. The EPAC Private Infrastructure Task Force report (EPAC 1995d) stressed the need to:

- get the infrastructure planning and regulatory framework right, including through government commitment to best practice project evaluation;
- properly allocate responsibilities for delivering new infrastructure between the public and private sectors, including case-by-case assessment of the merits of BOOT-type private financing schemes; and
- secure the best providers through transparent and competitive tender procedures.

τ *The key elements of the strategy for improving infrastructure provision are:*

- *rigorous application of the national competition policy, including structural separation of public monopolies where appropriate;*
- *continuing with administrative reforms including measures to improve pricing, identify and directly fund CSOs, and increase contracting out of non-core services;*
- *supporting competition policy through labour market and tax reforms;*
- *for competitive or contestable infrastructure services, assessment of the need to retain public ownership; and*
- *improvements to infrastructure planning and investment processes.*

Specific sectoral reforms

Broad reforms to give effect to these general principles in individual infrastructure areas are spelt out briefly below. There is a more detailed treatment in appendix B for most sectors.

Most of the reforms have been discussed extensively and have wide support. In a number of areas, the Commonwealth's recently announced Legislation Review Schedule will provide a further opportunity to identify necessary reforms. However, considerable variation in the extent and pace of reforms across Australia, coupled

with some evidence of slippage, points to the need for all levels of government to intensify and accelerate their reform efforts.

In helping to set priorities, the biggest pay-offs are likely to come from improving the pattern of road investment (see EPAC 1995d), increasing competition in rail, electricity, gas and telecommunications, and from pro-competitive and labour market reforms on the waterfront (see for example, IC 1995a and Filmer and Dao 1994).

τ *Rail*

- In subjecting rail authorities and corporations to the Competition Principles Agreement, governments should give particular priority to: achieving competitive neutrality; direct funding of CSOs; structural separation of track bed and rolling stock operation; and introducing seamless and effective access arrangements to the track bed.
- Rail management should seek further savings in areas such as corporate overheads, rolling stock maintenance and signalling and control.
- Rigorous application of these reforms is particularly important in areas such as coal freight, where freight rates are unjustifiably high.

τ *Roads*

- Governments should improve the allocation of road funds by adopting the principles proposed by the EPAC Private Infrastructure Task Force. They should also examine the need for additional public funding or private financing to deal with any backlog of road projects with high social benefit–cost ratios.
- Road authorities should increase contracting out of maintenance, subject to meeting the guidelines spelt out in the IC's recent report on competitive tendering and contracting.
- Road authorities should introduce electronic road pricing within congested city networks, as technology permits.
- The Commonwealth, State and Territory governments should quickly finalise nationally uniform road laws.

τ *Ports*

- In subjecting port authorities to the Competition Principles Agreement, State and Territory governments should give high priority to: ensuring competitive neutrality; direct funding of CSOs; removing statutory monopolies for port authorities; and overseeing pricing structures.

-
- Reform to towage and piloting services should focus on options to facilitate contestable outcomes. Licensing of service providers should be minimised. If licences are required, they should be non-exclusive.

τ *Waterfront*

- Enactment of the Commonwealth's proposed labour market reforms will open the wharves to non-union labour and/or allow competing unions, and end the preference for union labour in cleaning ships. Reintroducing the secondary boycott provisions in the Trade Practices Act will be important in supporting a more competitive labour market on the waterfront.
- State and Territory governments should also look to facilitate greater contestability for stevedoring services. This would need to be assessed on a case-by-case basis, but might involve:
 - fixed term franchises for stevedores;
 - encouraging the entry of new stevedores; and/or
 - allowing users to rent wharf space and make their own arrangements.
- There should be an immediate review to determine how best to make stevedoring services more contestable (see below).

τ *Coastal and trans-Tasman shipping*

- As on the waterfront, the proposed labour market reforms will be a significant spur to improved efficiency in shipping services. They will allow shippers to recruit non-union labour and encourage enterprise agreements which expand the scope for multiskilling. In addition:
 - The Commonwealth should extend the single voyage permit system to allow vessels on international voyages to carry cargo between Australian ports for, say, up to a month. No restrictions should apply to foreign vessels crewed by Australian seamen servicing coastal routes.
 - The Australian Maritime Safety Authority should ensure that relaxing cabotage restrictions in these ways does not increase safety and environmental risks in Australia's coastal waters.
- Supported by the reintroduction of the secondary boycott provisions to the Trade Practices Act, this package should help open up trans-Tasman shipping to foreign competition.

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- The Commonwealth should proceed with the sale of the Australian National Line, or its assets.

τ *Liner shipping*

- The Commonwealth should repeal the Part X exemption for liner shipping in the Trade Practices Act. This would leave open the option for conferences to apply to the ACCC for authorisation of current arrangements if they could make a public interest case for retention.

τ *Aviation*

- The Commonwealth should encourage competition in aviation services by supporting a single trans-Tasman market (including ‘beyond rights’ for both countries’ carriers), and extending Qantas’s interlining rights to other international carriers. It should also examine the case for ending restrictions on foreign ownership of domestic airlines.
- The Commonwealth should review Australia’s position on international airline agreements with a view to providing increased market access to overseas airlines.
- Those States which have not already done so should deregulate intrastate air travel.
- The Commonwealth should ensure that the conditions attaching to airport privatisations do not create scope for the exploitation of market power through, for example, limiting access to terminal space. Existing cross-subsidies between airports should be removed.
- Air traffic, fire and rescue services in publicly owned airports should be allocated by competitive tender.
- Air Services Australia should modify the structure of en route charges to eliminate, as far as practicable, cross-subsidies between users.

τ *Electricity and gas*

- In subjecting their electricity and gas authorities and corporations to the Competition Principles Agreement, State and Territory governments should give high priority to: achieving competitive neutrality with private operators; competitive supply arrangements (especially in gas); effective access arrangements to transmission and distribution facilities; the removal of remaining cross-subsidies; and prices oversight.

-
- State governments that have not already done so should seek to vertically separate electricity supply utilities and consider the scope for horizontal separation of generation and distribution/retail businesses. Structural separation of gas facilities should also be pursued.
 - Once competitive structures are settled, the States should assess the case for privatising gas and electricity entities (especially in electricity generation).
 - At the national level, there is a need to quickly progress the gas and electricity grids and the associated access and pricing arrangements. The arrangements should be responsive to changes in technology and the market environment.
 - The Queensland Government should commit to linking its transmission system to the National Grid.
 - The Commonwealth and Victorian governments should quickly resolve the dispute over the petroleum resource rent tax which is holding up further competition in gas supply.

τ ***Water and sewerage***

- Governments should ensure effective implementation of the COAG water agreement (box 4.2). They should give particular priority to:
 - resolving asset valuation and cost recovery issues for both urban and rural water;
 - identifying CSOs applying in the irrigation sector;
 - facilitating interstate trade in water; and
 - progressing arrangements for allocating water to the environment.
- They should also consider extension of the reform process to include groundwater and wastewater management.

τ ***Telecommunications***

- Within the relevant industry-specific regulation (box 4.3), the Commonwealth should subject telecommunications infrastructure to the intent of the Competition Principles Agreement. It should give a high priority to: achieving competitive neutrality between public and private operators; and effective arrangements for access to, and pricing of, network facilities.
- In the event that the partial privatisation of Telstra does not proceed, the Commonwealth should consider the case for structural separation of the organisation and report publicly on this matter.

Box 4.2 COAG water agreement

In February 1994, COAG endorsed a 'strategic framework for the efficient and sustainable reform of the Australian water industry' to be implemented by 2001:

- **Pricing reform:** consumption-based pricing and full cost recovery (including positive rates of return on the written-down replacement cost of assets); the reduction or elimination of cross-subsidies; and making remaining subsidies transparent — for urban water services by 1998 and rural water supply by 2001;
- **Investment reform:** investment in new rural water supply schemes or extensions to existing schemes to proceed only if appraisal indicates it is economically viable and ecologically sustainable;
- **Water trading:** implementation of comprehensive water allocation systems or entitlements, including allocations for the environment, with rights separated from land title, and with trading in allocations or entitlements by 1998 (including inter-state trading where feasible); and
- **Institutional reform:** the adoption of an integrated water catchment approach, separating the roles of water resource management, standard setting and regulatory enforcement no later than 1998, and further development of interagency performance comparisons.

Effective implementation by the States and Territories of the framework is a requirement for the second and third tranches of payments under the national competition policy agreements.

While significant progress has been made in urban areas, issues relating to asset valuation and cost recovery are yet to be resolved. Additional issues confronting the non-urban sector include: facilitation of interstate water trading; the definition of full cost recovery; the identification and measurement of community service obligations; and the appropriate level of environmental water allocations and who should bear their cost.

τ *Postal services*

- Protection for Australia Post's general letter service should be examined as part of a broader independent review of the organisation's operations. Among other things, the review should examine: the impact of previous reforms to increase competition in service delivery; identification and quantification of Australia Post's major CSOs; and the scope to increase competition further. In this latter context, it should consider the rationale for, and impact of, exempting Australia Post from the access arrangements under Part IIIA of the Trade Practices Act.

Review

Regular reviews of progress in the infrastructure sectors are warranted to ensure that reforms are on track and to identify any backsliding on agreed approaches and timetables.

Box 4.3 **Telecommunications reform**

There have been a number of reviews of telecommunications in Australia during the 1980s and 1990s.

The previous Government announced that, after 1997, the restrictions on the entry of new carriers and service providers to the market would end.

This is also the policy of the Coalition Government. However, other aspects of the arrangements are under review to develop a regulatory framework consistent with the new Government's *Better Communications* policy. It is expected that the new arrangements will: establish the ACCC as the body responsible for regulating competition in the industry; apply the Trade Practices Act to the industry; and revise access and interconnection arrangements.

More broadly, competition rules for the telecommunications sector will continue to be set by specific regulation rather than the national competition policy rules. But this should not stop the Commonwealth showing leadership in rigorously applying the intent of the national competition policy to the industry-specific arrangements to apply post-1997.

Ensuring that Telstra operates in a competitively neutral environment is a priority. This will require identification and direct funding of the organisation's CSOs. Establishing effective access arrangements to cables and related infrastructure is also crucial to prevent wasteful investment in infrastructure.

In the event that the partial privatisation of Telstra does not proceed, consideration should be given to the case for structural break up of the organisation. Under the present structure, carriers seeking access to Telstra's network facilities may have to reveal commercially sensitive information to a rival carrier. Hence, there may be an incentive for them to duplicate facilities to protect their commercial independence.

Ongoing benchmarking and performance monitoring by the Productivity Commission and others, and oversight from the ACCC and other Commonwealth and State government agencies, will partly meet this requirement.

However, the Commission also sees the need for a series of independent, rolling reviews of individual sectors:

- an immediate review to determine how best to make stevedoring services more contestable;
- reviews of the aviation, rail and postal sectors to commence during 1997; and
- subsequent reviews of progress in coastal shipping, electricity, gas, telecommunications and the waterfront generally.

Relevant BIE, EPAC and IC reports

Bureau of Industry Economics (*International performance indicators series*)

Rail, BIE (1992a, 1993c, 1995i)

Road Freight, BIE (1992b)

Waterfront, BIE (1993a, 1995d)

Coastal Shipping, BIE (1994c, 1995f)

Aviation, BIE (1994f)

Electricity, BIE (1994b, 1996h)

Gas, BIE (1994h)

Telecommunications, BIE (1992c, 1995b)

Postal Services, BIE (1995a)

Overview reports, BIE (1994a, 1995h)

Economic Planning Advisory Commission

Profitability and Productivity of Government Business Enterprises, EPAC (1992b), and updates in Clare and Johnston (1993a) and EPAC (1995e)

Economic Effects of Microeconomic Reform, Filmer and Dao (1994)

EPAC Private Infrastructure Task Force, EPAC (1995d)

Industry Commission

Energy Generation and Distribution, IC (1991f)

Rail Transport, IC (1991h)

Intrastate Aviation, IC (1992d)

Water Resources and Waste Water Disposal, IC (1992e)

Mail, Courier and Parcel Services, IC (1992f)

Port Authority Services and Activities, IC (1993c)

Urban Transport, IC (1994b)

Does Pacific Power Have Market Power?, IC (1995h)

The Electricity Industry in South Australia, IC (1996c)

5 EDUCATION, HEALTH AND COMMUNITY SERVICES

Education, health and community services are major contributors to a productive and cohesive society. They are central to extending equality of opportunity and supporting objectives such as social justice and development, and the right to a basic standard of living for all. But these services also have an important bearing on Australia's growth potential. For example:

- Australia's future growth will depend increasingly on making the best use of our human capital. A high quality education system which fosters the skills necessary to prosper in the global market is imperative.
- The economic benefits of a healthy community are self-evident. Similarly, the community services sector has an important role in helping individuals adversely affected by change. Thus these services are a vital complement to economic reforms.
- Public funding for these services is very substantial. Hence more cost-effective service provision can increase governments' capacity to provide support for those most in need, as well as ease the burdens on taxpayers and contribute to public sector saving. The latter will assist Australia's investment and growth performance.

For all of these reasons, education, health and community services are core elements of future microeconomic reform in Australia.

Because of the social justice and development objectives attaching to these services, there has been a tendency to argue that they must be treated differently from 'normal' goods and services. This sometimes extends to the view that it is inappropriate to apply economic concepts like productivity, incentives and competition to service delivery.

Clearly, education, health and community services have special features. But if as a community we are interested in achieving better outcomes for consumers, and increasing our capacity to help the genuinely disadvantaged, we must pay particular attention to the structures and incentives in place in these fields.

Escalating costs and evidence of inadequate outcomes for users have led to a greater focus on improving value for money in service delivery. Recently there has also been some interest in using ‘market’ approaches to further this objective.

But in many ways, it is early days yet. The mix of private-for-profit, not-for-profit, and government providers in these sectors, and the importance of maintaining equity in outcomes, adds to the complexity of the reform task.

This chapter outlines some potential directions for reform aimed at making service provision more efficient, relevant and responsive to community needs. It then draws some implications for action and review in specific sectors.

5.1 Reform issues

Government, and the not-for-profit and private sectors are all extensively involved in the provision of education, health and community services. However, through its role in funding and providing many services, and as a regulator of service quality, government is the dominant player. In 1994–95, government expenditure on these services was around \$55 billion, or 12 per cent of GDP.

A major Commonwealth function in these areas is funding State governments to provide services, or making personal payments tied to consumption of services. However, the Commonwealth is also a service provider, an important example being higher education. In addition to being service providers, State governments fund private providers and make some payments to users. All levels of government are involved in regulating these sectors.

By developed country standards, Australia’s public expenditures on education, health and community services are not high. For example, public spending in Australia on both education and health is at the middle to low end of the OECD range (EPAC 1993e; Clare and Johnston 1993b).

However, expenditure requirements are continuing to grow at a time when government budgets are under increasing pressure. The National Commission of Audit (1996) estimated that a continuation in current trends would see Commonwealth outlays on health rise from 8.5 per cent of GDP currently, to 12.5 per cent over the next 50 years or so. For fiscal reasons alone, there is thus a need to ensure efficient service provision. More generally, whatever the level of outlays, it is clearly desirable to ensure that funds are targeted effectively.

To date, many of the reforms in these areas have been administrative in nature (box 5.1).

However, as noted above, there has been increasing interest in employing more market-based approaches and competitive mechanisms. Much of the motivation has been to contain costs. But there is also greater recognition of the improvement in quality that such approaches can bring.

Box 5.1 Examples of recent reforms

Health: The introduction of casemix funding in some States is an important change in the way hospitals are funded and has led to: improved timeliness in the provision of data; reduced waiting lists; and higher output from metropolitan hospitals. In some States, there have also been initiatives to develop a more coordinated approach to the delivery of hospital and related services.

Government health departments are also looking increasingly to contracting out as a way of achieving savings and improving the responsiveness of services. For example, the sale of the Hollywood Veterans Hospital in Western Australia has reduced waiting times for elective surgery and increased patients' satisfaction with services received (IC 1996a).

Education: The States have undertaken a range of reforms including: streamlining their education bureaucracies; making curricula more flexible and responsive to changing needs; and devolving more responsibility (including financial) to individual institutions. At the Commonwealth level, major changes have included institutional restructuring and the introduction of the Higher Education Contribution Scheme (HECS).

Community services: COAG is currently developing proposals to draw together health and community services to make them more responsive to clients' needs. A feature of the COAG proposal is the creation of a coordinated care stream for the chronically ill and frail aged who need managed care and, more importantly, access to a wide range of health and community services. At the State level, there have been initiatives to improve the delivery of nursing home, mental health and other services.

Public housing: Key features of the new Commonwealth–State Housing Agreement to be implemented on 1 July 1996 include: clarification of roles and responsibilities across levels of government; funding arrangements which separate commercial and non-commercial activities; flexibility in how individual States address clients' needs; and better performance monitoring of outcomes.

At the State level, administrative reforms to Housing Authorities have led to some significant savings. For example, in Victoria, the Government's subsidy per rental property has declined from \$884 in 1991–92 to \$521 in 1995–96.

Benchmarking: Through COAG, governments are now formally benchmarking their performance in providing services against other jurisdictions.

5.2 Performance gaps

While these reforms are welcome, there is evidence suggesting a need to do much more.

On the supply side, there are significant variations between States and Territories in expenditure on education, health and community services (table 5.1). While these variations partly reflect differences in the quality of services provided, demographic and other external factors, they are also likely to reflect differences in the efficiency of provision.

Table 5.1 **Expenditure per capita, by State and Territory, 1994–95**

<i>Sector</i>	<i>NSW</i>	<i>Vic.</i>	<i>Qld</i>	<i>WA</i>	<i>SA</i>	<i>Tas.</i>	<i>ACT</i>	<i>NT</i>	<i>Aust.</i>
	\$	\$	\$	\$	\$	\$	\$	\$	\$
Education	793	691	776	788	825	852	1 014	1 797	781
Health	727	670	583	698	702	659	729	1 249	685
Welfare	178	204	126	201	218	280	214	271	185

Source: Commonwealth Grants Commission (1996).

Similarly, benchmarking of government service provision has revealed major variations in the cost and effectiveness of service delivery across jurisdictions. For example, the cost of treating in-patients in public hospitals (adjusted for the mix of cases) varies by up to 46 per cent, or \$1000 per patient (SCRCSSP 1995).

Moreover, outcomes for consumers of these services are far from ideal.

- Significant numbers of Australian students commencing secondary school cannot read and write properly (PCA 1993). Moreover, studies show that not all Australian education standards rank highly in international terms. And despite provision of ‘free’ education, socially disadvantaged students are still substantially underrepresented in higher education (Clare and Johnston 1993b).
- In health, long waiting lists in many public hospitals have been well documented. Within some of the major cities there are significant regional imbalances in access to public hospital facilities. And there are concerns that financing systems for doctors’ services do not encourage the best treatment of patients:

Doctors are rewarded more for ordering a test or prescribing a drug, than for lengthy counselling or for ensuring that patients are aware of the network of social supports available to them. People with chronic problems need their treatment provided through the coordination of a range of care-givers including, for example, physiotherapists, pharmacists, and home nursing staff (Macklin 1990, p. 16).

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- The frail aged and people with disabilities often have to deal separately with several government agencies to obtain a package of suitable services. Also, prescriptive regulations can reduce the quality of life for people in institutions. In a submission to the National Commission of Audit, Aged Care Australia (1996) argued that:

Most residential aged care facilities are obliged to operate as sanitised hotels rather than places where people live a normal life (p. 10).

Some of these problems stem from the current distribution of functions across and within levels of government, and from the underlying system of Commonwealth–State financial relations. For example, the provision of financially uncapped medical and pharmaceutical services by the Commonwealth, and capped hospital and other services by the States, leads to cost shifting and potentially inappropriate care for patients. The Victorian Department of Health and Community Services argued that:

MBS and PBS products and services have probably reached the point of diminishing returns yet they will grow without limit. Meanwhile, vital non-medical services, which should be available through Medicare are sourced from the 58 other, disconnected and rigidly capped, programs (DHCS 1995, pp. 19–20).

More generally, across the range of health, education and community services there is duplication of effort due to the failure to effectively clarify the respective functions of the Commonwealth and the States. Further, many argue that the arrangements for funding the States to provide these services have reduced the financial incentives for efficient provision (see chapter 10).

But inefficiencies in these areas also arise because there are few signals and limited information about the benefits and costs of services provided:

- On the supply side, overly bureaucratic program administration, inadequate incentives for cost-effective delivery, and lack of coordination across related programs, help to inflate the cost of providing services.
- On the demand side, the current arrangements give limited scope for consumers to signal their requirements to providers, and limited incentives for providers to respond. More broadly, there are few signals about the value to users of these services relative to other goods and services.

Reforms to deal with these problems would deliver better services to the community and cost savings to government. Using data from the Commonwealth Grants Commission, adjusted to reflect differing State ‘disabilities’, EPAC (Fitzgerald 1993) identified savings of nearly \$3 billion if all States were to match the expenditure level of the second lowest spending State.

5.3 The reform agenda

Participants' views

At the roundtables, business groups spoke of the need to wind back governments' role in these areas to the core functions of providing or funding services that would not otherwise be adequately supplied, and providing a safety net for those who cannot support themselves. More specifically, the Australian Coalition of Service Industries noted the obstacles to rewarding teachers on the basis of performance and the conflict between 'pay for use' education exports to foreign students and 'free' domestic education. It concluded that deregulation of the education system is required. And on health, the Coalition has argued:

... there are some basic incentives structures imposed by policy on the industry which do not lead to the most efficient health care system. There is considerable scope for efficiency improvements from economic reform for what is a 'big ticket' item (ACSI 1992, p. 43).

Some submissions addressed the need to improve the delivery of aged care and better integrate it with health care. For example, Aged Care Australia argued that:

There is too much overlap between the States/Territories and the Commonwealth which hinders the delivery of aged and community care services and so adversely affects their effectiveness and efficiency. Government monitoring processes of aged care services are more detailed than for most commercial enterprises. There is too much red tape.

Aged care and the health of the nation are too important for the present fragmented, often adversarial system to continue. There should be a unified, collaborative, approach ranging across the elements and stakeholders and between the levels of government (Aged Care Australia 1996, p. 7 and 1995, p. 1).

In a similar vein, during the community groups roundtable, there was agreement on the need to reduce compliance costs. One example given was that of a large community service organisation running a 40 bed nursing home which faces costs of \$10 000 per year in processing government forms.

Beyond this stocktake, there have been numerous suggestions for reassessing the objectives and roles for governments in these areas and for making greater use of market friendly mechanisms in service delivery:

- Fitzgerald (1993) argues for reduced government services to middle income earners, claiming that the current 'churning' of money has stretched government finances, skewed the taxation system and corroded private incentives.
- In health, there is support for the use of market mechanisms to: reduce wasteful overuse of services (co-payments); improve the cost effectiveness of service

delivery within hospitals (casemix funding); and services more generally ('purchaser provider split' arrangements and 'managed competition' approaches) (see, for example, Paterson in EPAC 1993e).

- In education, some advocate a shift to providing government support through demand subsidies rather than subsidising suppliers (both government and private), as well as reduced overall support for higher education (see for example, Harrison 1996). And many in the business community see a need for curricula that better prepare students for entry to the workforce.
- Across the gamut of government service provision, the IC (1996a) and others have noted scope for greater contracting out, or indeed privatising, components of service delivery.

However, these views have not gone unchallenged. Community and consumer groups have expressed concern about diminution of service quality under a more market oriented approach. In a submission to the IC inquiry into competitive tendering and contracting, the Brotherhood of St Laurence said that it:

... challenges the notion that widespread contracting-out of human services previously delivered by the public sector is a positive and appropriate development ... (1995, p. 2).

The Brotherhood went on to map out a range of service quality and equity considerations which it said should underpin any contracting out process, including:

- needs-based planning of services;
- assured access for those needing services;
- indicators of effectiveness based on user satisfaction and service outcomes; and
- the use of 'real life' expertise in the tendering process.

Nonetheless, some in the community sector acknowledge parallels between these areas and other parts of the economy. At the community groups roundtable, the argument was put that governments should recognise that community services can be viewed in the same way as other industries, and that reduced government regulation in these areas could improve productivity.

The Commission's assessment

The time has come for a wide ranging assessment of the nature of public involvement in education, health and community services. Government clearly has an important role in these areas. However, the *level* and *form* of public involvement are legitimate subjects for community debate.

Comprehensive assessment of these issues is clearly beyond the scope of this exercise. Appropriate levels of government support are best determined as part of detailed reviews of individual sectors having regard to equity and wider community objectives. However, given constraints on overall government spending, there is a need to supplement sectoral evaluations with a whole of government view on the relative importance of various equity objectives.

Whatever the overall level of government support, there are several broad requirements for ensuring more efficient delivery of services, and a mix of services that better meets users' needs.

These requirements do not assume that pure market solutions are always, or even often, appropriate in these areas. They do, however, presume that there is scope for more market friendly mechanisms to further efficiency and social objectives. Variations of this approach are often known as 'managed' or 'social' markets.

Clarity of roles and objectives: Clear objectives help providers to operate programs that mesh with the priorities of governments and clients. They also make it easier to hold providers accountable for their performance. Effective objective setting requires clear delineation of responsibilities across levels of government and, often, making one level of government responsible for funding. Shared responsibility for funding provides incentives for cost shifting and also diminishes accountability.

Ideally, objectives for service providers should not conflict. This points to the benefits of separating commercial and other roles. The separation of tenancy and property management functions in public housing authorities is an example of this.

Where objectives necessarily conflict, the basis for the trade-offs made should be transparent.

Providing clients with choice: As far as possible, those using education, health and community services should be able to choose the location, level, mix and quality of services that best suits their needs. This in turn means that there are advantages in assisting clients directly (for example, through rebates for services purchased or voucher type arrangements), rather than subsidising providers. Under this approach, the distinction between public and private provision becomes much less important. There is more emphasis on 'what services' rather than on who delivers them.

Promoting appropriate consumption: Government funding of services should focus on meeting equity objectives and addressing market failures. In general, there should be some charge on users of services to encourage appropriate consumption.

To provide information on the relative value to users of different services, charges should generally be linked to the cost of the service provided.

A coordinated approach to customer service: Particularly in the provision of community services, programs should aim to meet the range of needs of target groups. This implies a change in emphasis from delivering a particular program to taking full responsibility for the diverse needs of client groups.

Competition in service delivery: As in other parts of the economy, governments should endeavour to use competition to encourage value for money in service delivery. The scope for competition will be greatest where:

- responsibilities for funding and delivering services are separated;
- funding arrangements give clients the freedom to choose between providers, and give providers the flexibility to respond to those preferences; and
- there is competitive neutrality between public and private providers. This is a particularly important complement to a shift from funding suppliers to funding users.

In addition to direct competition, governments can introduce competitive disciplines through tendering of service delivery and competitive funding arrangements. Such funding should ideally be based on the delivery of outputs, rather than the amount of inputs used. As illustrated by the emerging evidence on casemix funding for hospitals, this approach can give providers better incentives to operate efficiently.

Effective performance monitoring: Reform initiatives to date have been hampered by a dearth of information on outcomes of programs and the costs of providing services to individuals.

Accordingly, the collection and publication of performance indicators is important to help shape future reforms in these areas. It also provides a means for users of services to express views on the quality of services they receive. And it makes providers and governments more accountable for their performance (including providing a means for the Commonwealth to ensure basic objectives are met following any devolution of responsibility for provision of services to the States).

The present gaps and inadequacies in the data mean that considerable caution is required in their interpretation. Improving the information base is clearly integral to more effective benchmarking and monitoring in the future. Nonetheless, pending better information, analysis of existing data may still provide important insights.

τ *Reforms to education, health and community services should be underpinned by the following general principles:*

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- *clarity of roles and objectives;*
 - *providing clients with choice;*
 - *promoting appropriate consumption;*
 - *a coordinated approach to customer service;*
 - *competition in service delivery; and*
 - *effective performance monitoring.*

Some implications for specific sectors

Under the auspices of COAG, there are initiatives in the health and community services area to: clarify roles across all levels of government; separate funding and service provision responsibilities; minimise cost shifting; and better integrate related programs. One of the possible outcomes of this process is that the States will be given even more responsibility for service delivery in these areas, subject to meeting standards agreed with the Commonwealth.

Beyond these changes, there are reform options for particular sectors which would help to give effect to the general principles outlined above. These are canvassed briefly below.

The Commission emphasises that taking some of these options to the implementation phase would require much more work and evaluation. Such detailed work is particularly important given that the human costs of inappropriate or poorly implemented policy changes in these areas can be high.

Education

The current regime for funding and delivering education services does not sit well with the general principles enunciated above. Funding, charging and regulatory arrangements limit students' institutional and course choices; provide few signals to suppliers about students' preferences and restrict their ability to respond to those preferences; and do little to encourage accountability for performance at either the institutional or teacher level. Further, it is an open question whether the current level of government support to students can be justified on either equity or efficiency grounds, particularly in the higher education sector.

Higher education

The Commonwealth funds public universities for the costs of providing education to domestic students, and recoups 23 per cent of these costs through the HECS. Public universities can also directly charge overseas students. Private universities operate on a user pays basis, although they have access to the tax concessions for not-for-profit organisations and to competitive research grants.

In addition to meeting the bulk of domestic tertiary students' costs, the Commonwealth also provides cash payments and means-tested loans to around half of students under the Austudy program.

In the Commission's view, pending a wider review, a number of reforms to the higher education sector could be introduced reasonably quickly:

- Seek to increase flexibility in the academic labour market in both administration and teaching (see, for example, Higher Education Management Review 1995).
- Implement the IC's recommendations to provide greater contestability in the funding of university research (IC 1995d).
- Promote yardstick competition through effective performance monitoring and benchmarking.
- Link HECS charges to the cost of the course provided. This would give students signals about the relative cost of courses, and thereby make costs, as well as future benefits, a consideration in course choice. It would also provide better information to universities on students' valuation of courses in the light of those costs.
- Remove an anomaly between domestic and fee paying foreign students, by allowing tertiary institutions to admit domestic students who do not get a subsidised place on a full fee-paying basis. Institutions would, of course, continue to ensure that fee-paying students had suitable academic qualities.

There may also be a case for increasing overall student contributions to the cost of tertiary education. The wider literacy and numeracy benefits to the community have much less force in relation to higher education than to primary and secondary education. Further, Clare and Johnston (1993b) presents evidence suggesting that the current system of across-the-board subsidies is difficult to justify on equity grounds. Indeed, students from advantaged backgrounds accounted for most of the increase in tertiary student numbers during the 1980s.

However, there are spillover benefits to the community from having people complete tertiary education. Also, universities play an important role in basic research. And, there are widely accepted equity grounds for assisting *disadvantaged* students. A significant public contribution to the costs of higher education is clearly warranted.

What is therefore required is a review of the appropriate level of government support for tertiary education, having regard to community benefits and social objectives. This review should also look at various options for delivering support to students and university research which encourage competition between institutions, including:

- giving universities the power to set fees, and at the same time moving away from funding through block grants, to more use of portable, direct student subsidies. The per capita subsidy could be a fixed dollar amount or a percentage of the course cost. It could also vary according to students' circumstances; and
- up front fees and assistance to disadvantaged students through targeted fee rebates and/or means tested scholarships or loans.

The review should also consider institutional reforms to improve performance, including: the need to retain restrictions on the entry of new institutions in a more competitive funding environment; and the case for allowing public universities to privatise.

τ *In the medium term, the priority is to review: the appropriate level of government support for higher education; options for more efficient delivery of that support; and institutional reforms to improve service delivery.*

τ *Pending such a review, reforms to higher education could include:*

- *pursuing greater flexibility in the academic labour market in both administration and teaching;*
- *implementing the IC's recommendations to provide greater contestability in the funding of university research;*
- *promoting yardstick competition through effective performance monitoring and benchmarking;*
- *linking HECS charges to the cost of the course provided; and*
- *allowing tertiary institutions to admit domestic students who do not qualify for a subsidised place on a full fee-paying basis.*

Primary and secondary education

Primary and secondary education provides the basic building blocks for the subsequent acquisition of skills necessary for Australia to grow and prosper. Thus as in tertiary education, improving the effectiveness and efficiency of these sectors is an important part of future microeconomic reform.

Primary and secondary education in government schools is essentially provided free to students. In addition, government subsidises students enrolled in most fee-paying private schools. These arrangements lead to considerable variation in subsidies to individual students.

Given the current state of play in the sector, there is much that can be achieved through administrative reforms.

First and foremost, the collection of better information on the sector would allow more effective monitoring and benchmarking of performance. At present, there are few indicators which allow meaningful comparisons across jurisdictions of attainments against broad educational and equity objectives. Even monitoring the performance of providers in different systems is in the early phase via the COAG Steering Committee on Government Service Provision. Augmenting and extending monitoring to non-government schools which receive public funding would be an important advance.

At the administrative level, a continuation of the present trend to decentralising responsibility to school boards should, in theory, be beneficial. However, experience to date indicates that if decentralisation is to be successful, school boards must be given adequate capacity to change work and management practices and be properly accountable for their performance. Decentralisation should encompass financial management as well as more routine functions such as maintenance.

Subsequent steps in the reform process would include a review of the scope to improve service delivery by:

- assisting students directly rather than institutions; or
- changing the form of assistance through, for example, more emphasis on per capita subsidies, and less on site allowances and capital grants.

Under either approach, levels of assistance to individual students could and should be varied to reflect equity and access goals.

The review could also examine the merits and means of implementing performance-based pay for teachers. In general, a more flexible school system would facilitate higher pay for better teachers.

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- τ *In the medium term, the priority is to review alternative approaches to funding primary and secondary education which could promote better and more cost-effective service delivery. The review should also examine the merits and means of paying teachers on the basis of their performance.*
- τ *Pending such a review, reforms to primary and secondary education should include:*
- *better information collection to allow more effective performance monitoring and benchmarking of outcomes; and*
 - *further decentralisation of responsibility to school boards, including financial management.*

Health

In recent times, governments have sought to control the health care budget by using their monopoly over purchasing to keep medical and pharmaceutical costs down and capping funding for hospital and ancillary services. More recently, there has again been talk of a co-payment for bulk-billed Medicare services in order to discourage wasteful demand.

While a co-payment may encourage more responsible consumption and produce some cost savings, like the other recent approaches, it does not tackle the big incentives problems in the health care system. To address these requires more fundamental reform directed at increasing choice for consumers and promoting competition in service delivery.

Initiatives to clarify funding and service provision roles across levels of government, and to improve coordination across health and health related community services, are in train or in prospect as part of COAG processes.

Beyond this there is a hierarchy of broad reforms for introducing progressively more market-based incentives. *In briefly describing this hierarchy, the Commission is not advocating any particular approach.* Indeed, the approaches are not mutually exclusive. Rather it is simply seeking to illustrate the directions that should be considered in a more detailed review of the sector. A detailed review is particularly important to ensure adequate recognition of the need for all Australians to have access to quality health care.

- At the first level are initiatives to improve efficiency within common types of care. These include casemix funding of hospitals, contracting out elements of service provision and reforms to improve the operation of the Pharmaceutical Benefits Scheme (for example, reducing delays in the listing of drugs and

increasing the transparency of decision making — see IC 1996f). Ensuring a competitively neutral environment between public and private providers in relation to tax and the like, and reviewing regulations which restrict the entry of private sector competitors, are important components of such reform. As in education, effective performance monitoring and benchmarking is also crucial.

However, by themselves, such changes will not improve the incentives for efficient allocation of resources *across* streams of health care or between health services and the rest of the economy.

- To improve incentives for cost-effective treatment drawing on the various components of the health care system would require, at the very least, adoption of some form of managed competition model. Managed competition, or a ‘fund holder’ arrangement, describes a model in which budget holders are funded to purchase the full range of health services on behalf of a group of consumers. The ‘agents’ could be either government or private organisations, or both. Variations of this model operate through the National Health Service in the United Kingdom and in the United States through Health Maintenance Organisations. Among others, Paterson (1995) and Scotton (1994) have discussed the application of this approach in Australia.

All health and community related services could be funded in this way. Apart from encouraging the most cost-effective form of treatment, this approach would eliminate the current problem of cost shifting between streams of care.

Health costs could be restrained by capping fund holder budgets and by agents exerting competitive pressures on providers of services. The financial incentives for agents to choose the most cost-effective package of care will be greater if consumers can switch between agents. With government funding of budgets, access and equity objectives can be preserved.

- The next level in the reform hierarchy is to introduce incentives for consumers or their agents to weigh up the merits of expenditure on health care relative to other goods and services.

One approach is to signal to consumers the opportunity cost of health care without requiring them to incur out of pocket expenses. A forthcoming paper from the Institute of Applied Economic and Social Research (Harding and Johnson 1996), outlines a scheme in which each individual would be allocated a notional health care allowance based on a risk/experience rated assessment of expected health care costs. Consumers could choose to self-insure, use these funds to purchase private insurance, or remain in a government program similar to the existing Medicare scheme. At the end of the period, any unused funds would be returned in cash to the individual.

Alternatively, a fully privatised system would introduce complete and explicit price signals — see, for example, Porter, Freebairn and Walsh (1987), and Paterson (1993).

Under either approach, special measures would be necessary to protect the frail aged and chronically ill. These could include a ‘COAG coordinated care’ type arrangement (box 5.1), government financing of insurance premiums, and/or subsidies towards the costs of particular services.

To complement or follow such financing reforms, initiatives would be needed to deal with supply restrictions. The options for consideration here include: reviewing anticompetitive regulations limiting entry to the medical profession; reviewing regulation of private hospitals and private insurance funds; greater use of the private sector to build and operate hospitals; relaxing advertising restrictions for health services; and assessing the opportunities to allow paramedics and nurses to perform procedures currently restricted to qualified practitioners. How far to go in these directions will depend on considerations such as the potential for supplier induced demand, the adequacy of information available to consumers and the capacity to ensure high quality care.

- τ *In the medium term, the priority is to review alternative approaches to government funding of health care that could promote better and more efficient service delivery.*
- τ *Pending such a review, reforms to health care should include:*
 - *extending casemix funding of public hospitals;*
 - *applying competitive neutrality principles to the public hospital sector;*
 - *a review of the Pharmaceutical Benefits Scheme; and*
 - *promoting yardstick competition through effective performance monitoring and benchmarking.*
- τ *The requirement under the national competition policy framework for governments to review anticompetitive regulations should extend to regulations governing entry to the medical and health care systems and the advertising of services.*

Community services

Current reform initiatives in community services are consistent with the general principles detailed above (box 5.2). For example, in public housing, the new Commonwealth–State Housing Agreement is underpinned by an output focus for

service delivery and aims to clarify roles and responsibilities across levels of government. A forthcoming EPAC Task Force report on child care is reviewing the need to clarify roles, as well as examining the importance of vesting responsibility for funding with one level of government (the Commonwealth), and shifting assistance from suppliers to consumers.

The current COAG exercise should contribute to more effective and coordinated delivery of aged care services. However, it appears unlikely that it will address the issue of overregulation of service providers. This should be the subject of a separate review.

And, in its report on charitable organisations, the IC proposed a suite of measures to strengthen the contribution made by these organisations in delivering community

Box 5.2 Reform proposals for community services

Public housing: In many respects the new Commonwealth–State Housing Agreement will be a litmus test of the benefits of an output focus in service delivery and sorting out roles and responsibilities across levels of government.

However, there are areas where there are opportunities for further refinements and to extend the application of the general principles. For example, there is scope for: more formal separation of property and tenancy management functions in some jurisdictions; improvements in eligibility and waiting list arrangements; and implementing rent structures which better reflect variations in the quality of housing provided.

Child care: A forthcoming report by the EPAC Child Care Task Force (EPAC 1996c) will examine a range of proposals including: a shift from subsidising suppliers to assisting purchasers; simplifying the suite of assistance schemes; making the Commonwealth solely responsible for assisting general users of child care; and devolving responsibility for regulation (and providing for some special needs) to the States. The Commission sees such proposals as important steps in delivering more efficient and equitable outcomes in this area.

Aged and disability services: As noted earlier, COAG is currently developing proposals to draw together health and health related community services to make them more responsive to clients' needs and to provide for better continuity of care. The COAG reforms are to concentrate on:

- organising services to better meet the needs of clients;
- planning arrangements to allow governments to plan, fund and manage services based on outcomes;
- funding mechanisms which support the provision of more effective services to clients; and
- the development of nationally consistent data to support these directions.

Again, these are important steps forward.

and social services (IC 1995e). These focused on: promoting service quality; improving the partnership with governments; taxation changes; and improving accountability and community involvement. The previous Commonwealth Government endorsed the thrust of the IC's report, but stated that many of the recommendations would require further discussion with the States.

- τ *The Commonwealth should establish an independent review to examine the provision and regulation of aged care services.*
- τ *Through discussions with the States, the Commonwealth should progress the recommendations in the IC's report on charitable organisations.*

Relevant EPAC and IC reports

Economic Planning Advisory Commission

Education Issues, EPAC (1993a)
Education and Training in the 1990s, Clare and Johnston (1993b)
Medium-Term Review: Opportunities for Growth, EPAC (1993b)
Investing in Health Care — A Challenging Future, EPAC (1993e)
Australia's Ageing Society, EPAC (1994b)
Economic Effects of Microeconomic Reform, Filmer and Dao (1994)
Child Care: a Challenging Decade, EPAC (1994a)
Public Expenditure in Australia, EPAC (1994d)
National Strategies Conference Papers 1–3, EPAC (1994e,f,g)
National Strategies Conference Paper 4, EPAC (1995a)
Income Distribution in Australia, EPAC (1995c)

Industry Commission

Exports of Education Services, IC (1991g)
Exports of Health Services, IC (1991k)
Public Housing, IC (1993f)
Impediments to Regional Industry Adjustment, IC (1993g)
Research and Development, IC (1995d)
Charitable Organisations in Australia, IC (1995e)
Competitive Tendering and Contracting by Public Sector Agencies, IC (1996a)

6 TAXATION

Taxation is a key government policy instrument. It is the major source of government revenue. And the way in which it is applied has significant efficiency and equity implications for individuals and organisations throughout the economy. It thus falls squarely within the ambit of microeconomic reform.

Submissions to this study and discussions with a range of business and community organisations highlight important deficiencies in Australia's taxation regime. For example, the Australian Business Chamber said:

Business taxation is the regulatory area of greatest concern to NSW manufacturers, being nominated by 69% of manufacturers surveyed. This response is consistent across all firm size groups (Sub. 29, p. 4).

The Minerals Council of Australia stated:

... fundamental taxation reform is urgently required. For example, a large part of the incidence of Wholesale Sales Tax continues to fall on business inputs. We risk deflecting potential investors who may be considering placing large projects in Australia; we also risk constraining the growth of Australia's internationally operating companies (Sub. 40, p. 9).

The diversity of taxation measures employed by governments, and their complex interaction, complicates assessments of tax structures. In the time available, it was not possible to undertake a comprehensive review. A number of key submissions recognised this in calling for a further separate review. This chapter focuses on identifying the more significant deficiencies and broad reform options for addressing them.¹

6.1 Reforms to date

All three tiers of government in Australia — the Commonwealth, State/Territory and local — levy taxes to meet a broad range of economic and social goals. However, there has been little coordination in taxation policies among governments.

¹ To help in the preparation of this chapter, a background paper reviewing Australia's taxation structure was commissioned from Dr Robert Albon, Senior Lecturer in Economics at the Australian National University. The paper, *An Overview of Australia's Taxation Structure*, is available from the Commission on request.

The current arrangements have evolved in an ad hoc way over many decades, with modifications occurring on a piecemeal basis as circumstances have changed.

It has long been recognised that this haphazard approach has left Australia with a hybrid taxation structure with significant drawbacks. Successive governments have ignored, or responded slowly, to calls for broader tax reform.

- In 1975 the Taxation Review Committee (the Asprey Report) proposed: a broad based consumption tax; a broadening and downgrading of reliance on income tax; an imputation link between personal and corporate taxation; and the introduction of a national integrated system of gift and death duties. None of these recommendations was adopted at that time.
- Following a Draft White Paper on Tax Reform (1985), the Commonwealth initially supported the introduction of a broad based consumption tax. The proposal met with considerable opposition and was subsequently dropped.
- Proposals to coordinate taxation collection between the Commonwealth and the States (see, for example, the Committee of Inquiry into Revenue Raising in Victoria 1983) have not been acted on.

Nonetheless, some significant improvements have been made. For instance, the introduction in the mid-1980s of measures to broaden the income tax base and a system of imputation of company income to final shareholders addressed some anomalies in the Commonwealth tax regime. (Box 6.1 identifies some of the major changes made over the last decade or so.) But the changes leave some fundamental shortcomings in Australia's tax structure.

Box 6.1 Tax reforms

- Introduction of a dividend imputation system, integrating the company and personal taxation system and eliminating the double taxation of corporate income.
- A reduction in the company tax rate.
- Abolition of the 5/3 depreciation rule and the introduction of 'effective life' depreciation (but with some accelerated depreciation rules re-introduced since).
- Flattening of the personal income tax scale and a lowering of marginal tax rates.
- Some rationalisation of the wholesale sales tax.
- Introduction of a tax on capital gains and fringe benefits.
- Abolition of the tax exemption of income from gold mining.
- Establishment of a foreign tax credit system for foreign-sourced income.
- Taxing the income of superannuation funds.
- Introduction of new anti-avoidance and evasion measures (for example, the prescribed payments system and accruals taxation of certain foreign-sourced income).

6.2 Performance gaps

Assessment criteria

Taxation structures are usually evaluated against criteria relating to efficiency, equity and simplicity. In broad terms:

- An *efficient* tax regime minimises distortions to pre-tax patterns of production and consumption (the ‘deadweight loss’).
- An *equitable* tax spreads the burden of the tax ‘fairly’ over all taxpayers. This is generally recognised as requiring that similar treatment be afforded taxpayers in similar economic circumstances (horizontal equity), and that taxpayers who are financially better off pay a greater share of the tax burden (vertical equity).
- A *simple* tax is one which is easily understood and applied. As a consequence, administrative and compliance costs are likely to be low.

In addition, a number of subsidiary criteria are often applied. For instance, taxation systems should be designed to minimise the scope for avoidance and evasion, and there should be a high degree of certainty and stability in the arrangements.

Major shortcomings

Australia’s taxation system has many elements which impair economic efficiency and which ultimately detract from living standards. In addition, there are growing equity concerns about the present structure.

The major weaknesses can be broadly categorised as relating to:

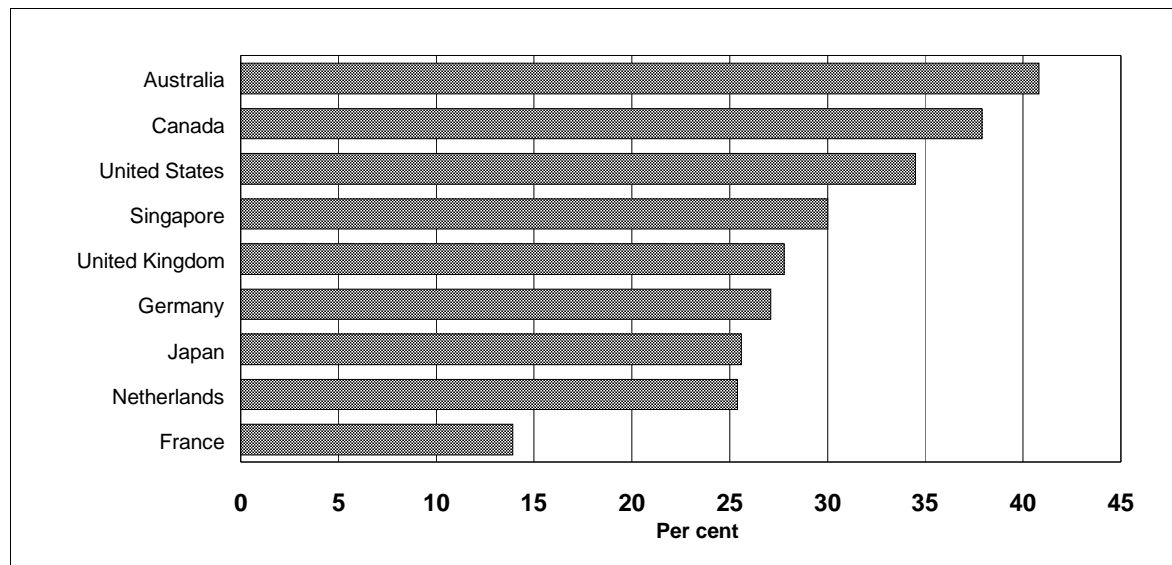
- shortcomings in the structure of personal and corporate income taxes;
- inefficient and inequitable commodity taxes;
- the use of distorting State and Territory taxes; and
- high compliance costs.

Income tax

Income tax paid in 1994–95 by individuals and businesses amounted to \$56 billion and \$18 billion, respectively. Personal income tax alone represented about 40 per cent of tax revenue raised by all levels of government — a far higher proportion than in many other developed nations (figure 6.1).

The broadening of the personal tax base since the mid-1980s has permitted a reduction in the maximum personal income rate. But the rate remains high (up to 47

Figure 6.1 Personal income tax as a percentage of total taxation^a



^a In contrast to Australia, social security contributions in most OECD countries are deducted from wages and income *in addition* to personal income tax.

Sources: OECD (1995b); World Bank (1995).

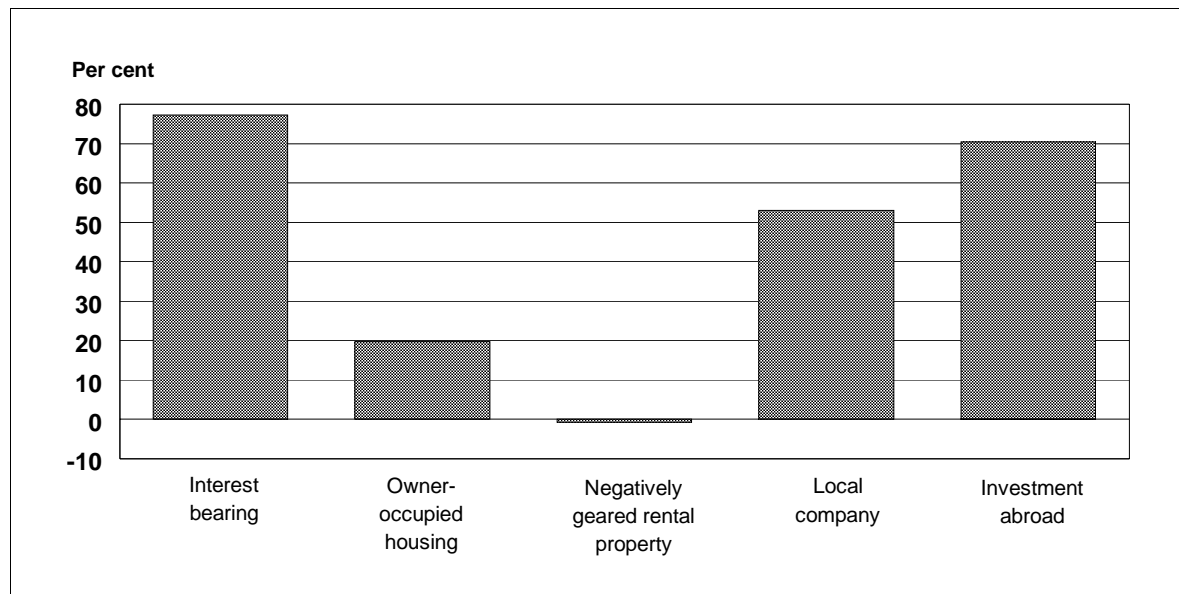
per cent plus the Medicare Levy). This raises the possibility of large efficiency costs, mainly because the higher is the marginal rate faced by a taxpayer, the larger is the incentive for substitution between work and leisure. One study (Findlay and Jones 1982) suggested the marginal deadweight loss from raising revenue by means of personal income tax was at least 23 cents for every dollar raised.²

Inefficiencies also arise within the personal income tax base, in particular from the inconsistent treatment of different forms of savings (figure 6.2). Some savings, such as interest income, are taxed at very high effective tax rates. But some other forms of savings — such as that invested in owner-occupied housing — are effectively subsidised. However, in general, the present arrangements discourage private savings.

Other deficiencies in the personal income tax base include aspects of the fringe benefits tax (for example, its application to some legitimate business expenses and its high compliance cost) and the lack of indexation. The lack of indexation can exacerbate problems in the personal income tax base during periods of inflation. For example, as nominal interest paid on bank savings is typically subject to personal income tax at high marginal rates, even moderate rates of inflation can lead to negative real after-tax returns.

² Freebairn (1995) argued that the marginal deadweight loss could be less than this estimate because of 'stickiness' in the Australian wage fixing system.

Figure 6.2 Effective tax rates for selected major asset classes^{a,b}



^a Assumes a statutory marginal tax rate of 48.25 per cent. ^b Assumes gearing of 10 per cent, 50 per cent and 35 per cent for investment in owner-occupied housing, rental property and local companies, respectively.

Source: Pender and Ross (1994).

Improvements have been made in the corporate income tax base since the mid-1980s. However, some inefficiencies were reintroduced following the One Nation statement, which provided for accelerated depreciation and an investment allowance for the plant and equipment component of large longer term projects. These measures artificially encourage investment in selected projects and distort investment choice.

Other shortcomings with the current corporate tax arrangements include:

- the large gap between the company tax rate (36 per cent) and the maximum personal rate (47 per cent plus the Medicare Levy) which encourages companies to defer distribution of income; and
- the base (for example, depreciation, inventories and interest receipts) not being indexed for inflation.

Commodity taxes

Consumption of commodities is taxed in four major ways. The major Commonwealth taxes are:

- wholesale sales tax;
- excise taxes; and
- customs duties.

At the State level, the main form of commodity taxation is the business franchise fee which applies to tobacco, liquor, petroleum and diesel fuels in most jurisdictions.

Reflecting their narrow base and many exemptions (for example, services are not subject to wholesale sales tax), the rates applying under these taxes vary substantially — from zero to in excess of 200 per cent (on spirits). This large variation suggests that the efficiency losses from these disparate taxes are likely to be far greater than those that would result if commodity taxes were rationalised and a more uniform rate structure adopted. In this context, Albon (1996) estimated that replacing the wholesales sales tax, excise taxes and business franchise fees with a uniform commodity tax to collect an equivalent amount of revenue would result in efficiency gains of at least \$2 billion per year.

A fundamental weakness in the current commodity tax structure is the failure to exempt all inputs into production processes. At present, some intermediate inputs are exempt (for example, diesel fuel used in certain agricultural and mining operations), but commodity taxes continue to apply to a wide range of business inputs.

Taxing business inputs distorts production choices and introduces a bias against production for export. This can result in substantial losses to the economy. The Commission has estimated that, if taxes on petroleum products used as business inputs were replaced by a consumption tax on household purchases of petroleum products, GDP would increase by \$1.1 billion (IC 1994e, p. 269).

As well as being inefficient, the existing structure of commodity taxes is regarded by many as inequitable, because major expenditure items of low income households are highly taxed.

The regressive nature of the present indirect tax regime is illustrated by recent data showing that the poorest 10 per cent of households pay 23 per cent of their gross income on indirect taxes, compared to only 6 per cent for the top 10 per cent of households. Moreover, there has been a substantial increase in the burden of indirect taxes borne by low income families over the last decade (figure 6.3).

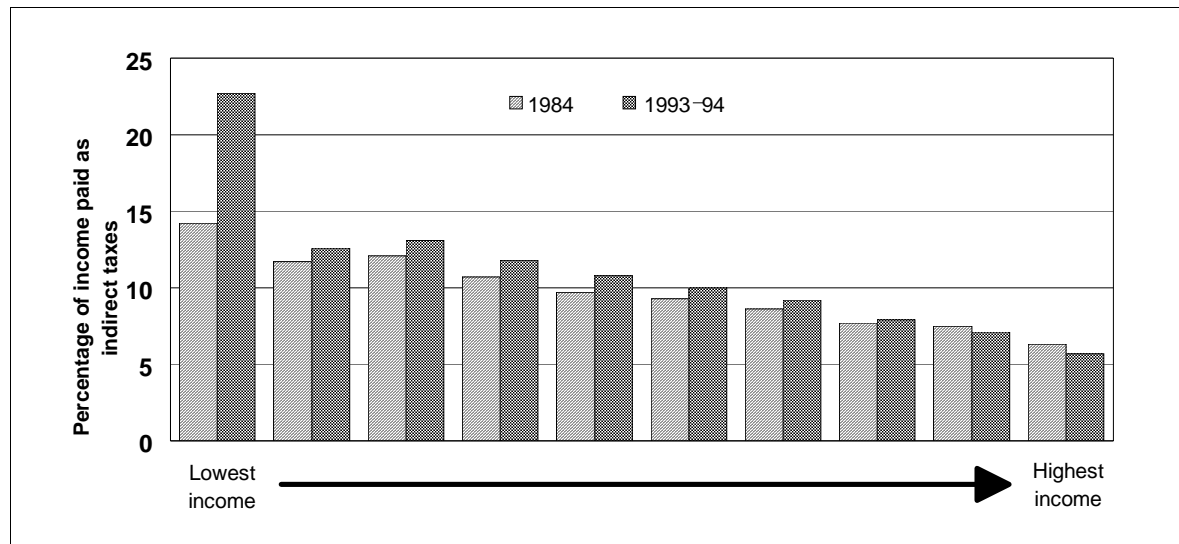
State and Territory taxes

The Australian Constitution limits the capacity of the States and Territories to employ broad based taxes (for example, on consumption expenditure). And the States and Territories ceded their rights to impose income tax to the Commonwealth

during World War II. Hence, the States and Territories have traditionally raised revenue using relatively narrow tax bases and by ‘piggy-backing’ on Commonwealth sales taxes through the use of business franchise fees.

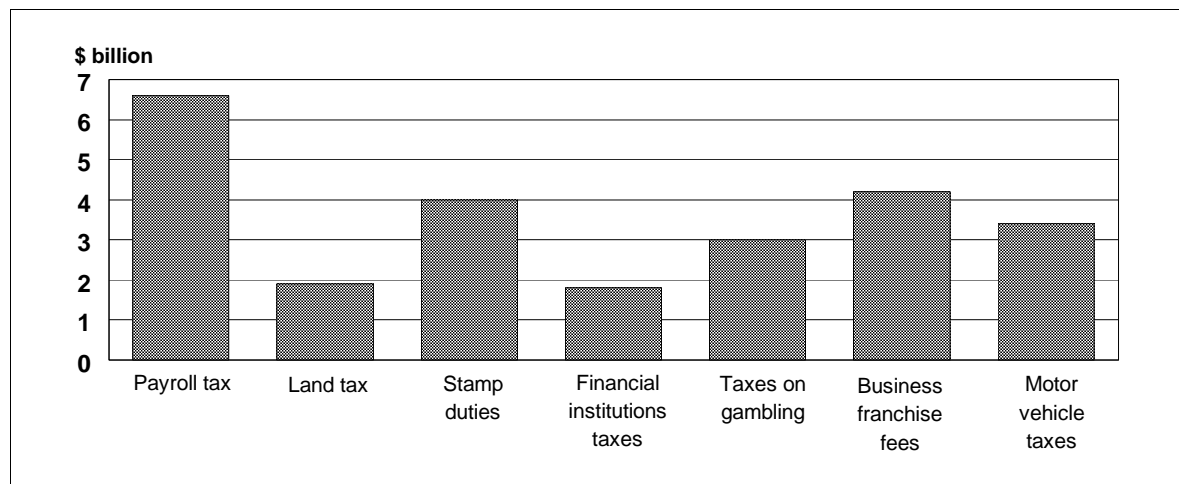
The major taxes employed by the States and Territories are: payroll tax; stamp duties; land tax; financial institutions duties; business franchise fees; and taxes on gambling and motor vehicles (figure 6.4). Annual revenue raised by the States and Territories (including local government) amounts to some \$28 billion — about 25 per cent of revenue raised by all tiers of government in Australia. The proportion has been increasing in recent years.

Figure 6.3 Impact of indirect taxes



Source: ABS, Cat. No. 6537.0.

Figure 6.4 Revenue raised from major State and Territory taxes, 1994–95^a



^a Provisional.

Source: ABS, Cat. No. 5506.0.

Although the taxing powers of States and Territories are limited, they have not fully exploited the broader based taxes available to them, leading to excessive reliance on inefficient, narrowly based taxes. For example:

- Land tax, which has the potential to be broadly based, is usually only applied selectively (for example, owner-occupied housing is generally exempt). As well as eroding the tax base, the exemptions result in the misallocation of land (IC 1993b).
- Payroll taxes typically exempt small businesses and government bodies, as well as certain other employers.
- The revenue raised from stamp duties is far in excess of the cost to government of transactions to which they apply (for example, property conveyancing and motor vehicle and share registration transfers). The significance of some stamp duties (such as those on conveyancing) results in a marked reduction in transactions and, hence, significant efficiency costs.

In aggregate, State and Territory taxes impact severely on some industries. For instance, major State and Territory taxes applying to mining sector activity include: royalties, business franchise fees, payroll tax and, in some jurisdictions, excessive rail freight charges (which are tantamount to a tax).

Compliance costs

Businesses have long expressed the view that Australian tax laws are unduly complex and that the associated administrative procedures are too stringent and inflexible. As a result, compliance costs are widely perceived as excessive. Administrative requirements relating to: international transfer pricing; the reporting of foreign-sourced income; and the fringe benefits tax are commonly cited as areas in which compliance costs are high.

There are few empirical studies of compliance costs in Australia. Those that are available provide mixed results — although one study which compared compliance costs in Australia and the United Kingdom (Pope, Fayle and Chen 1990) suggests that Australian costs are high. However, methodological shortcomings cast some doubts on the findings of these studies.

6.3 The reform agenda

Participants' views

Many of those who met with the Commission contended that Australia's taxation arrangements rank poorly against the standard assessment criteria. Many pointed to

adverse efficiency repercussions. Others considered that aspects of the current arrangements are inequitable and impose unnecessarily high compliance costs on taxpayers (box 6.2).

Business organisations stressed the need to improve efficiency by reducing taxes on industry, particularly on business inputs. To this end, a number of organisations supported the introduction of a broad based consumption tax. For example:

MTIA recommends the introduction of a comprehensive, broad based consumption tax ... a consumption taxation system does not alter relative input prices as does a system that taxes business inputs, and so does not have the distortionary impact on the choice of production methods of the current arrangements (Sub. 27, p. 3).

Box 6.2 Participants' views on deficiencies in Australia's taxation system

Fringe benefits tax

FBT on car parking is a classic example of the Treasury and ATO abandoning basic rules of fairness, efficiency and practicality in the single minded pursuit of revenue. The tax simply doesn't work, on any criteria, and should be reformed (BOMA, Sub. 31, Fringe Benefits Tax attachment, p. i).

State taxes

The taxes available to the States are narrowly based, falling heavily on business inputs. This problem has been exacerbated by the States competitively trading away elements of their existing revenue base in an attempt to persuade business to locate in a particular jurisdiction. The result has been to increase pressure on remaining sources of State revenue (BHP, Sub. 30, p. 19).

Stamp duty

Stamp duty can impose an enormous cost on business and can impede, and in some cases indefinitely defer transactions designed to promote efficiency in business (AMEC, Sub. 21, attachment, p. 24)

Tax law simplification

Despite tax simplification initiatives, tax legislation remains complex and tax compliance costs remain excessive (MTIA, Sub. 27, p. 3).

Compliance costs

The cost of complying with the Australian taxation system is a major obstacle to earning assessable income and investing. In the recent past, new legislation and rulings have had little regard for the compliance burden placed on business. Reducing the costs of compliance must be the first priority of micro economic reform (BOMA, Sub. 31, p. 2).

Similarly, the ACM stated that:

A value added or consumption taxation system coupled with other tax reforms would go a long way to resolving the current deficiencies. Alternatively, if this is not an option, a comprehensive review of the impacts of the current Wholesale Sales Taxation system needs to be undertaken (Sub. 28, p. 8).

The Minerals Council of Australia contended that:

... the high incidence of taxation of business inputs embodied in product prices reduces the competitiveness of Australia's exporting businesses (and import competing business) vis a vis those from other nations operating consumption-based taxation systems which have (VAT-based or other) rebate systems for exports (Sub. 40, p. 10).

The Commission's assessment

The current structure of taxation in Australia is inefficient, impeding productive investment and imposing considerable costs on the community. While some of the necessary changes seem self-evident, the interdependencies and complexities of the taxation system suggest that fundamental reform is required. Indeed, many of the problems with the current arrangements reflect past ad hoc approaches to tax policy development.

The Commission considers that the arguments in favour of some form of broad based consumption tax are compelling. Introducing such a tax would help alleviate serious shortcomings in the existing taxation structure. More specifically, in a revenue neutral environment, a broad based consumption tax would:

- reduce the impost current commodity taxes place on business inputs and, hence, on exports;
- address growing inequities caused by the existing indirect taxation arrangements;
- allow rationalisation of the current suite of indirect taxes;
- permit a reduction in income tax, thereby reducing the distortionary impact of inconsistencies in the income base and mitigating the present bias against savings; and
- help reduce avoidance and evasion.

While a consumption tax would redress some inequities, as well as enhancing national income, it would also have some adverse distributional effects of its own, at least initially. Many of the lowest income households would be likely to gain overall, but other low income groups would be made worse off (Albon 1996). A direct compensation package would be needed to offset such effects.

In almost all OECD countries, a broad based consumption tax is accepted as an efficient and equitable form of taxation. It is unfortunate that this important element of an effective taxation system has become so highly politicised in Australia. Lack of community understanding of what is at stake has compounded the problem. However, there are signs that this may be changing. In addition to the traditional support from business, support for a broad based consumption tax is emerging from community groups, as part of a package of reforms. In these circumstances, the Commission sees the introduction of such a tax as a realistic longer term goal. This will be assisted by further progress in better informing the community.

Among the other problems with Commonwealth taxation arrangements, priority should be accorded to consideration of indexing the personal and corporate income tax bases.

At the State and Territory level, there is a pressing need for reform to current inefficient taxation structures. There are two main tasks:

- the removal of exemptions to the States' and Territories' broader based taxes (land tax and payroll tax); and
- the reduction in the use, or the removal of, the more inefficient State taxes (for example, stamp duties).

There is a question, however, as to the capacity of the States to meet their revenue needs under such reforms in the absence of access to additional, broader based taxes. This places State tax reform within the context of reform in Commonwealth–State financial arrangements (see chapter 10).

Taxation compliance costs remain of great concern to business, despite the establishment of consultative committees and various programs to simplify reporting requirements. Progress in reducing compliance costs appears to be retarded by the lack of agreement about their significance. There needs to be a detailed study to assess the extent of compliance costs in Australia and how they compare with those in other countries.

Finally, as observed at the Commission's business roundtable, it is important to recognise that the costs of the taxation system are directly related to the level of revenue that needs to be raised. This provides a further argument for achieving cost-effectiveness in the activities and programs in which government is involved.

τ *Fundamental changes are required to remove inefficiencies and inequities in Australia's current taxation structure. The introduction of a broad based consumption tax would help overcome some major shortcomings. While the Government has ruled out new taxes in its current term, the Commission sees it as an important longer term goal. Tax reform will be assisted by informed community debate.*

τ *Initiatives that should be undertaken in the short term include:*

- *examining, in the context of Commonwealth–State financial relations, options to improve the efficiency of revenue raising by the States and Territories;*
- *considering indexation of the personal and corporate income tax bases;*
- *reviewing Commonwealth and State government taxation of the mining and other resources industries; and*
- *commissioning an independent study to assess tax compliance costs.*

Relevant BIE, EPAC and IC reports

Bureau of Industry Economics

Does the Australian Taxation System Favour Company Debt?, BIE (1990b)

Tax Losses and Tax Benefit Transfer, BIE (1990c)

Evaluation of the Investment Promotion and Facilitation Program, BIE (1996b)

Economic Planning Advisory Commission

Income Tax and Asset Choice in Australia, EPAC (1993g)

Taxation, Regulation and Private Saving in Australia, Pender and Ross (1994)

Business Taxation in Australia and Asia, Pender and Ross (1995)

Industry Commission

Availability of Capital, IC (1991)

Taxation and Financial Policy Impacts on Urban Settlement, IC (1993b)

Annual Report 1993–94, IC (1994g)

Petroleum Products, IC (1994e)

Compliance Costs of Taxation in Australia, ORR (1996)

7 TRADE AND INDUSTRY ASSISTANCE

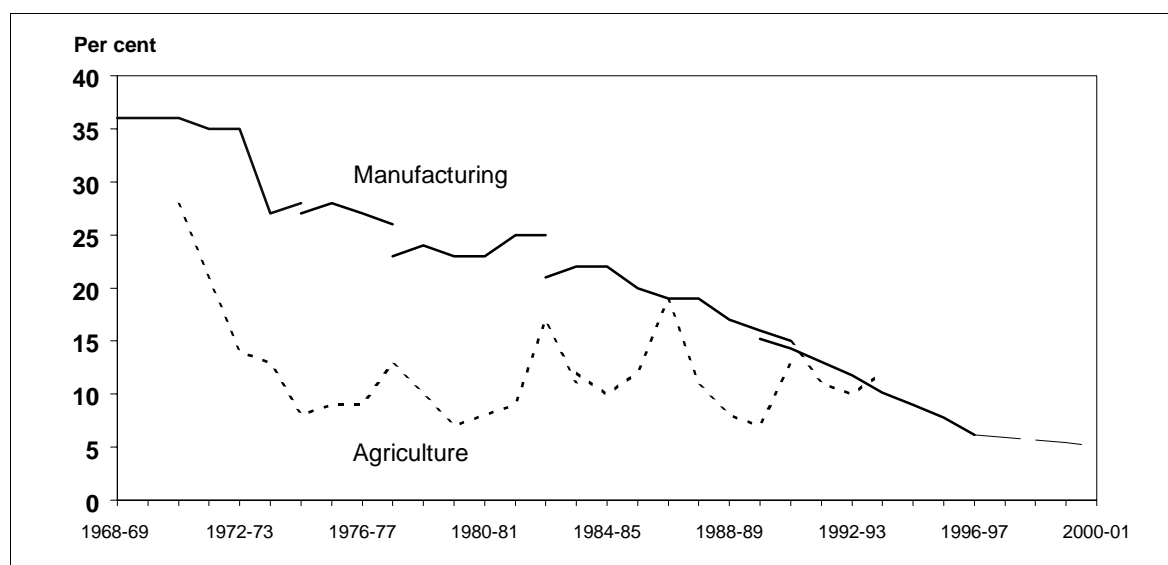
Over the last decade, Australia has reduced its trade barriers significantly. This has increased competitive pressures in the economy, raised the growth prospects of exporters and industry generally and benefited consumers. Australia has also been an active supporter of freer trade in international forums.

The benefits of tariff reductions can be reduced by the emergence of alternative forms of industry assistance. The reform agenda must encompass these as well.

7.1 Reforms to date

Under the program of phased reductions announced in March 1991, most tariffs will have fallen to 5 per cent by July 1996. As a result, assistance to the manufacturing sector has been substantially reduced (figure 7.1 and box 7.1). Reform of agricultural marketing arrangements and other support has also been proceeding (box 7.1).

Figure 7.1 **Effective rates of assistance for agriculture and manufacturing: 1968–69 to 2000–01**



Source: IC estimates.

Box 7.1 Recent trade and assistance reforms

Under Australia's existing tariff reform program, nominal assistance to manufacturing will have fallen from 11 per cent in 1987–88 to 4 per cent in 1996–97 and effective assistance from 19 to 6 per cent.

- Since the removal of import quotas in 1988, the tariff on passenger motor vehicle imports has declined from 57.5 per cent to 25 per cent, and is to fall to 15 per cent by 2000. An additional tariff of \$12 000 per car applies to high volume imports of second hand vehicles.
- Tariff quotas on clothing and footwear were removed in 1993. Tariffs on TCF imports have fallen from a maximum of 55 per cent in 1990 to 37 per cent in 1996, and are to fall to 25 per cent in 2000.
- Concurrent with the tariff reduction program, developing country preferences for all but the least developed of Australia's trading partners are being phased out.

For agriculture, the effective rate of assistance was 11 per cent in 1993–94, much the same as a decade earlier. Nevertheless, reform of agricultural marketing arrangements has been proceeding:

- tariff protection for tobacco leaf and tobacco products was removed in 1995 and local content arrangements protecting growers terminated;
- all States have agreed to deregulate market milk prices beyond the farm gate, with most having begun to do so;
- assistance to the manufacturing milk sector from Commonwealth marketing support arrangements continues to decline and is to end in 2000;
- domestic marketing arrangements for wheat were deregulated in 1989 and the underwriting scheme which guaranteed growers a minimum price was removed;
- deregulation of egg marketing has occurred in New South Wales, South Australia and Victoria and commenced in Queensland; and
- the discriminatory sales tax regime for local fruit and vegetable juices was removed in 1995.

Some production bounties have been terminated and those that remain are phasing down in line with general tariffs.

Under the Government Procurement Agreement of 1991, the Commonwealth, State and Territory governments renewed their commitment not to discriminate between Australian suppliers. However, more recently, some governments have used access to major contracts as a lever to secure industry development commitments.

Australia has also played an active role in the Uruguay Round and has been at the forefront of developments in the Asia Pacific Economic Cooperation (APEC) forum. In the Bogor Declaration of November 1994, APEC members signalled a commitment to free trade and investment in the region by 2020 (with industrialised countries to achieve this goal by 2010).

7.2 Performance gaps

At the end of the general tariff reduction program in July 1996, 95 per cent of manufacturing output still receives some assistance from the tariff. While for most of manufacturing output the rate is no more than 5 per cent, the passenger motor vehicle (PMV) and textile, clothing and footwear (TCF) industries will have tariffs of 15 per cent and up to 25 per cent, respectively, in 2000. By then the 'subsidy equivalent' of tariff assistance will still be some \$4 billion.

Some agricultural activities receive significant assistance through price support schemes and government guarantees. Partly reflecting its countercyclical nature, assistance to agriculture in recent years has been higher than in the late 1970s and early 1980s.

Such assistance imposes considerable costs on business and consumers. For example, the NFF has estimated that tariffs add \$300 million per annum to farm costs (Sub. 37, p. 2). In turn, price support arrangements for market milk were equivalent to a tariff of over 80 per cent in 1993–94, and increased prices by an average 18 cents per litre.

These costs will be further increased by the recent decision to reduce import concessions under the Tariff Concession System (TCS). From July 1996, a range of imports not directly competing with domestic production, which previously entered duty-free under the TCS, will be subject to a duty of 3 per cent. The cost impost will be some \$400 million per year.

In addition, substantial assistance is provided to industry from Commonwealth and State budgets. Taxpayers currently contribute over \$2 billion to industry support programs and \$1.5 billion in tax concessions to firms. State government budgetary support amounts to a further \$2.5 billion (IC 1996l).

Moreover, non-tariff measures are having adverse effects:

- government procurement policies can add to costs, and risk industry fragmentation (IC 1995f);
- antidumping action raises costs to consumers and user industries, with dumping margins often several times higher than prevailing tariffs (IC 1995j, appendix E); and
- restrictions on parallel imports have increased prices for CDs by about a third and computer software by around 20 per cent.

There are also many regulations and restrictions which limit trade in services and foreign investment in Australia.

7.3 The reform agenda

Participants' views

There was little dissent in submissions on the need to push ahead with tariff reform. One exception was the Consumers' Federation of Australia. It urged caution on further reductions on employment grounds:

There are further considerations in tariff reductions particularly where these lead to job losses, increases in taxes and decreases in public revenue. Consumers who are also wage earners can be affected by decreasing employment opportunities. Consumers, as taxpayers, fund unemployment benefits and shortfalls in public revenue (Sub. 22, p. 1).

There was, however, a perception in some quarters that trade reform has outpaced microeconomic reform generally:

... whilst industry has invested to meet the pace of reductions in protection, the promised accompanying reform of the domestic economy has lagged (Australian Electrical and Electronic Manufacturers' Association, Sub. 19, p. 2).

Unfortunately, the benefits accruing to Australian TCF operations have been far outweighed to date by the detrimental effects of the comparatively faster pace of trade reforms ... we are not necessarily questioning the need for trade reform per se. *Rather, the problem for TCF industries lies in the pace and order with which certain other reforms are proceeding, and the relativities between these* (Council of Textile and Fashion Industries of Australia, Sub. 36, p. 2).

MTIA and ICI raised similar concerns. But the NFF cautioned against linking tariff reform to progress elsewhere:

NFF is unequivocally committed to trade liberalisation and Australia's planned tariff reductions ... Although the relationship between microeconomic reform and trade liberalisation is a direct one, Australia should not make one conditional upon the other. Any softening in Australia's trade position will invariably slow down the pace of microeconomic reform (Sub. 37, p. 12).

Others also urged government to finish the job of dismantling industry assistance. The Minerals Council of Australia recommended the phasing out of general tariffs by 1999 and the removal of all tariffs by 2005 (Sub. 40, p. 3). ACCI advocated:

... implementation of our national commitment to the 'free and open trade and investment' agreement under the APEC initiative to deliver zero trade barriers around the Asia Pacific region (Sub. 16, p. 8).

In addition, the Department of Foreign Affairs and Trade noted that:

... where Australia has already taken unilateral policy action to liberalise markets, it is in a much stronger position to advocate similar reforms by our trading partners (Departmental paper 16, p. 1).

IBM cautioned against the use of government procurement for industry development purposes, arguing that it creates an orientation to the government market and fosters a protectionist culture among potential beneficiaries (Sub. 26, p. 2).

There was also widespread concern about the proposed changes to the TCS. The Electricity Supply Association of Australia was concerned that the changes would:

... further increase industry costs as generating plant used by the utilities is almost entirely imported because comparable units are not manufactured in Australia (Sub. 23, p. 6).

And the Association of Mining and Exploration Companies called on the Government to:

Reverse its decision [to reduce] the Tariff Concession System on business inputs and work towards achieving a zero tariff situation (Sub. 21, attachment, p. 2).

The Commission's assessment

Selective industry support imposes costs on consumers and taxpayers, and on more efficient industries as they attempt to adjust to an increasingly competitive international marketplace.

The winding back of Australia's trade barriers has produced considerable benefits. Apart from the direct benefits of better resource allocation and lower costs to business, reductions in assistance and heightened international competition have contributed to a more outward-oriented attitude among domestic firms. In recent times there has been a substantial increase in exports and research and development. Tariff reductions have also been a catalyst for more wide-ranging reforms.

Australia's reductions in protection, from the mid-1980s to the end of the current program in 2000, have been estimated to increase GDP by some \$4 billion (IAC 1988b, IC 1991d). Preliminary estimates by the Commission suggest that unilateral removal of remaining tariffs would add a similar amount. Because tariff reductions also have dynamic benefits and can induce other reforms, the gains could ultimately be much larger. Liberalisation by other countries will add to these gains. But with large benefits on offer from further unilateral reductions, Australia should not wait for reciprocal action by our trading partners.

In the Commission's view it is therefore time to finish the job of dismantling remaining tariff and non-tariff barriers.

Tackling these barriers on a broad front will limit the opportunity for sectional opposition, as has occurred recently in relation to restrictions on imports of CDs. Australia should subsequently also lock these changes into its international commit-

ments, both to prevent future unwinding in response to domestic pressures and to encourage liberalisation by other countries through APEC and the World Trade Organization (WTO).

Tariffs

Phased reductions in general tariffs should continue beyond July 1996. Tariffs for most goods should be removed by July 1998.

This amounts to little more than a continuation of previous tariff phasing. Indeed, to the extent that there is more widespread microeconomic reform, the impact on industry would be less than in the past.

In terms of resource allocation effects, the announced changes to the TCS are a step in the wrong direction. Much of the revenue raised will be a tax on imported business inputs for which there are no domestically produced alternatives. Taxing business inputs is costly to the economy. It would also be preferable to avoid the double adjustment costs on industry from reinstating duties at the same time as reducing tariffs more generally (IC 1991c). The TCS will become redundant with the elimination of general tariffs.

Implementation of the Commission's tariff proposal would reduce tariff revenue (by over \$1 billion in 1998–99). But tariffs are a bad 'tax' — they encourage inefficient domestic production and consumption, as well as taxing business inputs. As argued in chapter 6, there is a need to reduce the use of such inefficient taxes.

The reduction in tariff revenue would be partly offset by proposals for further winding back budgetary support for industry and savings in customs administration costs. And proposals elsewhere in this report to improve the efficiency of government administration and service delivery could also be used to benefit the budget.

Protection for the TCF and PMV industries imposes significant costs on both consumers and other industries. Together, the TCF and PMV industries account for around half the remaining assistance to the manufacturing sector. Commission reviews of these industries are scheduled for 1996. The reviews will take place against the background of the progressive elimination of tariffs for other industries and Australia's commitment to free trade in the Asia Pacific region by 2010.

τ General tariff reductions should continue beyond July 1996. There should be a further reduction to 3 per cent in July 1997 — the rate to apply to a range of goods previously entering duty free under the Tariff Concession System — with tariffs for most goods being removed in July 1998.

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- τ *Foreshadowed Productivity Commission reviews of post-2000 assistance arrangements for the textile, clothing and footwear and passenger motor vehicle industries should proceed in 1996.*

Agricultural support

Further reform of statutory marketing arrangements to end compulsory acquisition, production controls and discriminatory pricing arrangements will improve resource use and benefit consumers to the tune of hundreds of millions of dollars (IC 1991e). It should also facilitate better linkages with overseas markets.

In 1993–94 the cost to consumers of supporting agricultural producers via domestic pricing arrangements was more than \$500 million. Of this, 80 per cent was to support dairy producers. In addition, government guarantees on borrowings by the Australian Wheat Board and Wool International amounted to \$100 million.

- τ *Consistent with the Competition Principles Agreement, statutory marketing arrangements should be terminated unless an independent and transparent review finds that, despite their anticompetitive effects, the arrangements satisfy a public benefit test — that is, they raise national income.*
- τ *Reforms to market milk arrangements should be extended to all States and to the farm gate level by July 1999. Phasing out of support for manufacturing milk by 2000 should continue. The tariff-quota on cheese imports should be removed, and the within-quota tariff phased out no later than general tariffs (IC 1991i).*
- τ *The tariff on sugar and the regulatory arrangements for the sugar and rice industries should be terminated as previously recommended (IC 1992b, IAC 1987).*
- τ *The wheat export monopoly should be subject to independent review and retained only in markets where it clearly results in price premiums (IAC 1988a). Where it is retained, there should be scope for suppliers other than the Australian Wheat Board to provide the monopoly service.*
- τ *Western Australia and Tasmania should deregulate their egg industries and Queensland should continue with reform.*
- τ *Government guarantees on borrowings by the Australian Wheat Board and Wool International should terminate as scheduled.*

τ *Tariffs on agricultural commodities should be phased out no later than general tariffs.*

Budgetary and export measures

The IC broadly supported the need for government support for research and development in its recent inquiry. But it recommended changes to the arrangements in order to achieve greater effectiveness and consistency (box 7.2).

Other budgetary support for industry includes many programs where the benefits accrue directly to business, without other benefits to the community which may justify such support (box 7.3). Consistent with further tariff reform, budgetary support for industry should be wound back.

Box 7.2 Government support for R&D

It has long been recognised that not enough R&D will be performed unless governments intervene. This is because individuals aiming to create new knowledge are not always able to capture enough of the benefits to justify the effort. Governments can provide support by creating property rights, creating and strengthening markets and/or assisting financially.

The main message from the IC's inquiry into R&D was that changes in the ways in which governments organise public sector research and support private R&D can enhance the returns from Australia's R&D effort (IC 1995d).

- **Public sector:** Increasing the contestability of funding among research providers can make the research effort more cost-effective and oriented to community priorities. The IC saw merit in wider community influence on CSIRO's priorities and a greater role for government in monitoring its performance.
- **Business:** The effectiveness of assistance arrangements can be improved by reducing inconsistencies in the way different firms and industries are treated. The IC recommended replacing selective grants with more widespread support for (typically smaller) companies unable to use the 150 per cent R&D tax concession.
- **Rural sector:** Changes were recommended to more closely align support for rural research with that for other industries and to enhance the role of the R&D Corporations and Councils.

There are several areas where action identified by the inquiry is still required.

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 review (Hughes 1989).

Box 7.3 **Budgetary and export support**

Production bounties cost around \$130 million in 1995–96. These have been used instead of tariffs to assist particular industries.

The IC has proposed changes to support for the pharmaceutical industry. It found that the Factor f program (\$130 million) is administratively inefficient and is not transparent (IC 1996f).

Past studies have questioned the merits of other budgetary schemes.

- The IAC advocated a review of the need for longer term funding of the Australian Tourist Commission (ATC) (IAC 1989, p. 19). Current support for the ATC is \$80 million.
- A study undertaken for the Centre for Independent Studies called for the removal of assistance to the film industry (\$90 million). It concluded that ‘most of the arguments used in support of government intervention ... cannot be supported on economic or equity grounds’ (Jones 1991, p. 49).
- The IC recommended that the National Procurement Development Program (now part of the Industry Innovation Program) be terminated (IC 1995d, p. 635).

The Rural Adjustment Scheme (\$200 million) and Income Equalisation Deposits (\$10 million) are to be reviewed in 1996–97.

Budgetary (and other) assistance provided to industry by lower levels of government is being addressed in a current IC inquiry (IC 1996l).

Substantial assistance is provided to exporters. The major schemes are the Export Market Development Grants Scheme (\$240 million), the International Trade Enhancement Scheme (\$15 million), the PMV export facilitation scheme (\$325 million) and the TCF import credits scheme (\$140 million). EFIC is to be reviewed in 1998–99.

The Development Import Finance Facility (DIFF) (\$120 million) assists Australian exporters of capital goods and services by allowing aid funds to be combined with loans provided through EFIC. To be eligible for DIFF support, the equipment or service being supplied must be wholly or mainly of Australian origin. The scheme can provide very high assistance to exporters.

The duty drawback (\$85 million) and Tariff Export Concession Order (TEXCO) (\$45 million) schemes are listed for review in 1996–97. These schemes will become redundant with the removal of tariffs.

τ *Budgetary support for industry should be retained only where a clear rationale for government support is established and the measures enhance national income. Provision should be made for subsequent review.*

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- τ *Remaining production bounties should be terminated no later than general tariffs in July 1998.*
 - τ *Recommendations outstanding from the IC's research and development inquiry should be implemented.*
 - τ *Reform of support for the pharmaceutical industry should proceed as recommended by the IC.*
 - τ *The Export Market Development Grants Scheme and the International Trade Enhancement Scheme should be terminated. The range of other export programs in place should be rationalised.*
 - τ *The Government should proceed with its plans to terminate the Development Import Finance Facility.*
 - τ *The export facilitation scheme for passenger motor vehicles and the import credits scheme for textiles, clothing and footwear should be assessed as part of the scheduled reviews of these industries.*

Non-tariff measures

The progress made in reducing tariffs must not be undermined by the expansion of non-tariff measures (NTMs). The list of NTMs is long — including certain technical, health and safety, and packaging and labelling standards; export controls; government procurement policies; antidumping arrangements; and restrictions on parallel imports. Many of these measures have been introduced for other reasons, such as consumer protection or the prevention of disease. But it is important that such objectives are pursued in ways which do not unduly restrict international competition.

Australia's quarantine system is currently being reviewed. Judging quarantine policies and programs against community-wide interest should be the paramount consideration.

Steps to deal with several NTMs should be taken immediately (see below). Others should be subject to a general review against efficiency criteria and reformed as necessary.

Ending controls on the export of coal, bauxite and alumina, natural gas and mineral sands (IC 1991b), and on logs and woodchips (IC 1993d), has been recommended previously. Such controls restrict export market development opportunities, increase uncertainty and add to costs.

Packaging and labelling regulations have also been subject to recent critical review and an agenda for reform proposed (IC 1996d).

Parallel imports

Previous inquiries have established a clear case for removing restrictions on parallel imports of books, sound recordings and software (IC 1995f; PSA 1989, 1990, 1992, 1995b). Similar restrictions apply to intellectual property for a range of products, and to trade marks and patents in addition to copyright. The effects of these arrangements should be considered as part of a broader review of NTMs.

Government procurement

A re-emerging trend is for governments to use access to major contracts as a lever to secure industry development commitments. Such practices add to costs. They also carry the risk of industry fragmentation (IC 1995f). This was demonstrated by the experience of the heavy engineering industries in the 1980s. Proposals to source a fixed proportion of Commonwealth contracts from small and medium-sized Australian businesses can only add to the problems.

Antidumping system

Australia's antidumping system protects a narrow range of domestic producers against competition from imports at prices below those in the country of origin. Current legislation does not include a mechanism for assessing the costs imposed on consumers and user industries by antidumping action (IC 1996d).

A review of antidumping legislation has been scheduled for 1997–98 (Costello 1996). This is part of the Commonwealth's legislative review commitments under the Competition Principles Agreement. The competition policy principles agreed to by COAG discourage predatory activity which would limit competition, but recognise the benefits from price competition generally. Australia's antidumping arrangements limit import competition even where there is no predatory intent. Competition laws in Australia and New Zealand have applied to relevant anti-competitive conduct in trans-Tasman trade since 1990.

- τ ***Commonwealth controls on the export of minerals (apart from uranium) and on logs and woodchips should be removed.***
- τ ***Packaging and labelling regulations should be reformed as recently proposed by the IC.***

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- τ *Restrictions on parallel imports of books, sound recordings and software should be terminated. The Australian Government should oppose the inclusion of such restrictions in international agreements.*
 - τ *Industry development undertakings should not be included in government purchasing contracts.*
 - τ *Commonwealth, State and Territory governments should recommit to a national approach to the use of government purchasing for industry development, as part of the impending review of the Government Procurement Agreement.*
 - τ *The scheduled reviews of recent purchasing reforms, and the Fixed Term Arrangement and Partnerships for Development programs, should be replaced by a comprehensive review of government procurement arrangements. The review should also consider whether Australia should sign the WTO Government Procurement Agreement.*
 - τ *The scheduled independent review of the antidumping system should examine the scope for basing assessments on economy-wide costs and benefits, as well as competition policy alternatives to the current arrangements.*
 - τ *Other non-tariff measures should be subject to a general review against efficiency criteria, and reformed as necessary.*

Foreign investment

Relaxation of Australia's foreign investment regime has accompanied the liberalisation of tariff barriers. Most sectors of the Australian economy are open to foreign investment, though the notification and screening processes of the Foreign Investment Review Board (FIRB) apply above certain limits.

Given the proposals for further trade reform, a review of current limits on foreign investment in areas where restrictions remain would be timely. A review of foreign investment policy is scheduled in 1996–97.

- τ *Current limits on foreign investment in areas such as banking, aviation, shipping, real estate, telecommunications, and the media should be reviewed.*
- τ *The scheduled review of foreign investment policy in 1996–97 should examine the role and operation of the Foreign Investment Review Board. The review should aim to make transparent all relevant laws and administrative procedures, including the reasoning behind FIRB recommendations.*

Relevant EPAC, IAC and IC reports

Economic Planning Advisory Commission

Tariff Reform and Economic Growth, EPAC (1996a)

Industries Assistance Commission

The Rice Industry, IAC (1987)

The Wheat Industry, IAC (1988a)

Travel and Tourism, IAC (1989)

Industry Commission

Mining and Minerals Processing in Australia, IC (1991b)

The Commercial Tariff Concession and By-law Systems, IC (1991c)

Changes to Manufacturing Industry Assistance, March 1991, IC (1991d)

Statutory Marketing Arrangements for Primary Products, IC (1991e)

Australian Dairy Industry, IC (1991i)

The Australian Sugar Industry, IC (1992b)

Horticulture, IC (1993a)

Adding Further Value to Australia's Forest Products, IC (1993d)

Defence Procurement, IC (1994f)

Assistance to Agricultural and Manufacturing Industries, IC (1995b)

Research and Development, IC (1995d)

Computer Hardware, Software and Related Service Industries, IC (1995f)

Annual Report 1994–95, IC (1995j)

Packaging and Labelling, IC (1996d)

The Pharmaceutical Industry, IC (1996f)

State, Territory and Local Government Assistance to Industry, IC (1996l)

8 RESOURCE ACCESS AND THE ENVIRONMENT

Earlier this century, industry experienced few difficulties securing access to raw materials located on publicly owned land. And there were relatively few government controls designed to protect the environment from commercial activities. Those environmental regulations that did exist were often ineffective and poorly enforced. Many of Australia's current environmental problems can be traced back to those early times.

Today the situation is very different. In the face of growing public concern to protect the environment, and increasing appreciation of cultural and heritage values, governments are under pressure to deny industry access to natural resources located in 'sensitive' areas and ensure that commercial activities do not cause unnecessary environmental damage.

Governments clearly have a responsibility to ensure that appropriate trade-offs can be made between conservation and development goals. This is not an easy task. However, in a number of areas, responses by governments have not adequately addressed this issue. A wide variety of regulations and administrative procedures are employed by Commonwealth, State, Territory and local governments. Some have been at least partially successful in meeting their objectives, but this has sometimes been at considerable cost. The costs have been manifest in a variety of forms, but there are two broad areas in which their impact has been particularly significant:

- Conflicts between different tiers of government, 'arbitrary' government decisions in response to political pressures and frequent policy changes, have contributed to uncertainty about access to natural resources, raising perceptions of sovereign risk and deterring new investment.
- Governments have employed prescriptive regulations to reduce harmful environmental effects associated with existing industry activities. These can limit flexibility and impose unnecessary costs on industry.

For illustrative purposes, these concerns are discussed below in relation to, first, access to natural resources and, second, environmental protection, although some problems are common to both. The discussion touches on some of Australia's major natural resource and environmental issues. However, this is not to deny the need for

further government action in other areas (for example, in relation to preserving biodiversity and the treatment of hazardous wastes).

8.1 Access to natural resources

Performance gaps

The performance of government in determining access to natural resources has been criticised on a variety of grounds. Property rights have been poorly defined;³ administrative processes for resolving conflict over, or valuing competing uses of, land have been inadequate; and administration and charging practices for natural resources have often been inefficient.

All tiers of government have attempted to redress these inadequacies. For example, some States and Territories have sought to rationalise regulations relating to the granting of exploration and mining licences to reduce ‘red tape’ costs. Reforms leading to more efficient management of and cost-recovery for commercial fisheries have been implemented. And intergovernmental approaches have attempted to address problems arising from the traditional regulation of forest and water access (box 8.1) and from overlapping environmental impact assessment processes — for example, through the 1991 Intergovernmental Agreement on the Environment (IGAE). More recently, the Commonwealth Government has proposed amendments to the Native Title Act to improve its cost-effectiveness (box 8.2).

Nonetheless, government interventions continue to be inadequate. Notable examples include:

- Aboriginal property rights remain unclear, including in the Northern Territory where legislation has been longstanding;
- policies or processes to reserve areas for conservation purposes (for example, world heritage listings, national park declarations and the Commonwealth’s coastal zone policy) have not always provided for adequate consideration of all the costs and benefits, including the scope for multiple resource use;
- in spite of recent renegotiations between the Commonwealth and States and Territories over fisheries management, jurisdictional problems remain;
- the management of recreational fishing continues to be inefficient;

³ For a property right to promote the efficient use of natural resources, it must be well-defined and legally enforceable. It is well-defined if it is allocated to someone, embodies an entitlement to exclusive use (and benefits) of the resource, and is freely transferable.

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- access to forest resources remains uncertain, largely because progress in implementing the National Forest Policy Statement has been slow; and
 - water for irrigation continues to be underpriced.

Such shortcomings can prevent natural resources from being used where they are valued the most and give rise to serious environmental problems. For example, uncertainties about the status of Aboriginal property rights adds to the risk

Box 8.1 Access to forests

Largely because of increasing community concerns to protect the environment and to conserve Australia's natural endowments, governments have designated additional conservation reserves or heritage areas in which logging is no longer permitted. And State and Territory governments have been less willing to provide long term assurances about future wood supplies because of the possibility of Commonwealth Government intervention. Forest-based industries contend that these changes have created considerable uncertainty and deterred new investment.

Uncertainty attributable to government also affects the export of woodchips and logs. For example, the Commonwealth controls the volume of woodchip exports through licences which are reviewed annually. The short licensing period, coupled with ongoing debate about future export levels, curtails companies' capacity to enter into long term supply agreements with overseas customers and, thus, contributes to uncertainty.

The National Forest Policy Statement (NFPS), agreed to in 1992 by mainland governments, and subsequently Tasmania, recognises the need to reduce uncertainty and provide resource security. It sets out a broad policy framework for sustainable management and use of Australia's forests. Its centrepiece is a commitment by governments to comprehensive regional assessments. A principal aim of regional assessments is to reach a single agreement on the respective obligations of the Commonwealth, State and Territory governments for forests in a particular region (for example, assessments of national estate and world heritage values and obligations under international treaties covering endangered species and biological diversity). This process will increase the capacity of States and Territories to determine future wood supplies and to enter into long term supply agreements with forest-based producers.

In a subsequent report into Australia's forest-based industries, the IC (1993d) endorsed many of the NFPS proposals, but pointed to the need to accelerate implementation. Other recommendations to improve resource security included: corporatising government agencies responsible for the management of Crown land used for wood production; and abolishing all Commonwealth Government controls on the export of logs and woodchips.

Progress in implementing the NFPS and the IC's recommendations has been slow. If uncertainty is to be reduced, implementation must be accelerated.

perceptions of mining and exploration companies and can distort their investment decisions. On the Native Title Act, BHP said:

The present procedures have ... created considerable uncertainty for all parties affected by Native Title claims. In the resource sector, decisions on the search for new resources are becoming distorted as companies seek to locate projects where they know native title does not, or is unlikely to, exist (Sub. 30, p. 18).

Box 8.2 Native title and mining

The *Native Title Act 1993* (NTA) recognises native title as an interest in land that survived the declaration of sovereignty over Australia by the British Crown. The Act was intended to meet several objectives: to reduce uncertainties arising from the Mabo (No. 2) decision; to give statutory recognition to, and protection of, native title; and to address complex social objectives (for example, Aboriginal reconciliation and self-determination).

In spite of the Act, major uncertainties remain in relation to native title (for example, whether it exists or is extinguished, where it exists, who has it and its content) and the status of pastoral leases (for example, whether pastoral leases extinguish native title or whether they coexist). A large area of Australia is potentially affected by these uncertainties.

Mining sector interests contend that processes in the NTA are exacerbating uncertainties about native title and affecting investment decisions.

In a recent report, the IC (1996h) concluded that: it is inevitable that the uncertainties will affect mining investment decisions by raising perceptions of risk and costs; it is very difficult to judge the size of the effects and the extent to which they are greater than necessary, particularly against a 'post-Mabo' benchmark; and the longer it takes for uncertainties about native title (and pastoral leases) to be resolved, the more costly it is likely to be.

The IC suggested reforms to reduce uncertainties about native title and reduce transaction costs and delays associated with NTA processes. Key suggestions were that: the Commonwealth give priority to the resolution of the status of pastoral leases and, if necessary, expedite early test cases to the High Court; a more thorough test for granting the right to negotiate be introduced; and the States and Territories accelerate the establishment of their own right to negotiate process under the NTA, or at least integrate their own processes with the right to negotiate process (known as parallel processing).

The problems identified by the IC were recognised in a recent Commonwealth Government discussion paper which proposes amendments to the NTA to improve its 'workability' (DPMC 1996). While several of the proposals are broadly in line with the IC's proposals, others go further. Examples of the latter are proposals to: exclude mineral exploration, renewals of pre-1994 mining titles and alterations to pastoral leases from the right to negotiate; and to enhance the role of native title representative bodies.

The Australian Conservation Foundation noted the relationship between underpricing of natural resources, in particular forests and water, and environmental degradation and resource depletion, observing:

The rate of this environmental degradation and resource depletion is, by any assessment, ecologically unsustainable (Sub. 3, attachment 1, p. 1).

Reform agenda

Participants' views

Industry representatives stressed the need to provide greater certainty to users of natural resources and balance the benefits and costs of competing claims on natural resources. For instance, AMEC said in relation to native title:

The provision of an efficient system which provides certainty and fair, predictable outcomes for both Aboriginals and developers within commercial time frames, is viewed by AMEC as essential to the growth and continued economic competitiveness of the minerals industry — an industry which is required to market its products in the global market place (Sub. 21, attachment, p. 8).

On the need for forest resource security, the National Association of Forest Industries commented:

The first [Regional Forest Assessment] which will lead to Commonwealth–State agreement on both the reserve system and resource security should be completed by the end of 1996 but, at the current rate of progress, it is likely to take several years before all the major forestry regions are covered. The industry believes that it is essential that this process be speeded up principally by the Commonwealth accrediting State processes and removing duplication (Sub. 4, p. 1).

In relation to reserving areas for conservation purposes, the Minerals Council of Australia favoured a multiple land use approach. It stated:

Proposals for the declaration of new reserves should include an analysis of the resource base and land uses, including a cost-benefit analysis of alternative approaches to conserving biodiversity. The feasibility of multiple land use should be a key component of any evaluation (Sub. 40, attachment, p. 32).

Environmental representatives argued that there is a need to extend microeconomic reform to natural resources. The Australian Conservation Foundation said that reforms embodied in intergovernmental agreements on water and forests should be progressed. It also said that, in relation to State-based resource management authorities, there is a need for: pricing reform; greater financial accountability; independent pricing and environmental regulation; and clarification of the roles of resource managers, operators and regulators (Sub. 3, p. 2).

In some quarters, there are also concerns about a lack of progress in implementing the principles enunciated in the National Strategy on Ecologically Sustainable Development, which was adopted in 1992 by the Commonwealth, State, Territory, and local governments (box 8.3).

Box 8.3 Ecologically sustainable development

In 1989, the Commonwealth Government proposed to develop a National Strategy for Ecologically Sustainable Development (NSES D). Ecologically Sustainable Development (ESD) working groups comprising representatives from industry, conservation groups, unions and governments and other interest groups were established to produce reports on key sectors of the economy (for example, manufacturing, mining and tourism), as well as an intersectoral report covering issues such as climate change and biodiversity. The recommendations from these reports (approximately 500) formed the basis of the NSES D which was endorsed by COAG in 1992. (A National Greenhouse Response Strategy was developed in parallel to the NSES D and also adopted by COAG.)

The NSES D incorporates five key principles of ESD. These are: integrating economic and environmental goals in policies and activities; ensuring that environmental assets are properly valued; providing for equity within and between generations; dealing cautiously with risk and irreversibility; and recognising the global dimension.

Each level of government has implemented the NSES D, but to varying degrees. At the Commonwealth level, for example, implementation has involved the development of a number of specific ESD-consistent policies — such as on forests, waste management, biodiversity — and the incorporation of ESD principles in government decision-making processes. Current Commonwealth priorities include: finalising a national rangelands strategy; examining the greater use of economic instruments in environmental policy; establishing state of the environment reporting; and developing intergovernmental cooperation and coordinated policies for management of the coastal zone.

Implementation of the NSES D (and the National Greenhouse Response Strategy) is monitored by an intergovernmental committee which reports to Heads of Government.

The Commission's assessment

There has been limited progress in implementing reforms to clarify access to natural resources. Much more can be done.

Minerals

Changes to native title processes are required as a matter of priority. Implementation of some of the Commonwealth Government's proposed amendments to the NTA — particularly a more thorough test for gaining a right to negotiate and parallel processing — would help reduce unnecessary uncertainty, costs and delays in

gaining access to minerals. However, the Government needs to monitor judicial progress on resolving the status of pastoral leases and, if necessary, expedite test cases to the High Court that will address those factors relevant to Western Australia.

High priority should also be accorded to the use of cost–benefit processes to ensure that competing land uses, including multiple land uses, are adequately assessed (for example, declarations of national parks and world heritage listings) (IC 1991b). These reforms will help ensure that land is allocated to uses with the highest value to the community.

Commonwealth Government controls still apply to some of Australia’s major mineral exports (for example, alumina, bauxite and coal). In the Commission’s view, there is little evidence to justify them (IC 1991b). The controls should be abolished, except in relation to the Nuclear Non-Proliferation Treaty and Australia’s bilateral safeguards agreements (see chapter 7).

Forests

The implementation of the National Forest Policy Statement should be accelerated to help reduce uncertainties about access to forest resources. Although this will require the cooperation of all governments, the Commonwealth Government should continue to accept responsibility for advancing this agenda.

Administrative reform of forest management agencies is also a priority. This should involve the corporatisation of agencies responsible for the management of crown land used for wood production. Corporatised agencies should be required to fully recover costs and to identify, cost and separately fund any community service obligations or non-commercial functions.

Changes to Commonwealth Government export controls on logs and woodchips are also required. While consideration is currently being given to increasing quotas, the Commission does not consider that there are valid grounds for retaining export controls, especially once regional assessments are in place (IC 1993d). Concerns about the environment, which form the basis for the export controls, could be addressed in better ways, such as directly regulating *all* logging activity in designated areas. If it is deemed necessary to maintain some controls, licence conditions should be relaxed. As a minimum, the licence period should be extended well beyond the current 12 month limit.

Water

The Commonwealth Government has offered financial incentives to the States and Territories to implement the COAG water agreement. It is important that it continues to encourage full implementation of the reforms. As discussed in chapter 4, a particular priority is accelerating further pricing reforms for irrigation water.

Fisheries

Although a number of Offshore Constitutional Settlements agreements have been struck to rationalise jurisdictional responsibility for fisheries management, some difficult multiple jurisdiction problems remain unresolved. This has meant that, for example, different charging and enforcement arrangements could apply to the same fishery. Accordingly, there is scope for ‘jurisdiction shopping’ by fishermen. To address these problems, there is a need to develop options for clarifying responsibilities. National performance monitoring, as part of the Offshore Constitutional Settlements agreements, could improve fisheries management performance in each jurisdiction.

Recreational fishing reforms are also required. Compared with commercial fisheries management, the management of recreational fisheries is generally inefficient, with charges for access being levied in only a few jurisdictions. And there are concerns about the sustainability of some recreational fisheries. A national recreational fishing licensing system and improved management of recreational fisheries could help overcome these problems.

Other matters that need to be reviewed include:

- the level of assistance provided to marine aquaculture which currently benefits from the provision of free sites and publicly funded R&D; and
- Commonwealth management of fisheries and aquatic resources management, which is currently fragmented among seven main agencies.

τ *To improve government involvement relating to resource access:*

- *The Commonwealth Government should: amend the Native Title Act to introduce a more thorough test for gaining the right to negotiate; monitor judicial progress in resolving the status of pastoral leases and, if necessary, expedite test cases to the High Court. State and Territory governments should, as a minimum, integrate their approval processes with the right to negotiate process.*

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- *The implementation of the National Forest Policy Statement should be accelerated, with the Commonwealth continuing to be responsible for advancing the agenda.*
 - *Consideration should be given to corporatising government agencies responsible for the management of natural resources used for commercial purposes, such as State forest agencies.*
 - *Commonwealth export controls on coal, bauxite and alumina, natural gas and mineral sands, and on logs and woodchips should be abolished. If controls on logs and woodchips are retained, the term of export licences should be extended beyond the current 12 months limit.*
 - *Governments should ensure effective implementation of the COAG water agreement.*
 - *The Commonwealth, State and Territory governments should clarify outstanding jurisdictional problems over fisheries under the Offshore Constitutional Settlements arrangements.*
 - *The Commonwealth, State and Territory governments should consider introducing a national recreational fishing licensing system and improving the management of recreational fisheries.*

8.2 Environmental protection

Performance gaps

Considerable progress in addressing Australia's environmental problems has been made over the last decade or so. For example, all governments have taken action to reduce harmful emissions to the atmosphere and improve water quality, such as in coastal waters in the Sydney region. Nonetheless, significant environmental problems remain. For example:

- up to five million hectares of land in New South Wales have a moderate to high probability of becoming saline in the near future in the absence of broad scale changes in land management (Bradd and Gates 1995);
- soil acidification is estimated to effect around 17 million hectares of improved pasture and cropping soils in south-eastern and western Australia (Morris, Wilks and Wonder 1988);
- inland waters in southern Australia are in 'poor shape', suffer from high salt levels because of excessive irrigation, and are subject to bouts of toxic blue-green algae (SEAC 1996);

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- damage has occurred to several coastal marine ecosystems through discharges of high levels of nutrients and sediments (for example, Lake Illawarra in New South Wales, the Peel–Harvey estuary in Western Australia and Port Phillip Bay in Victoria) (DEST 1995);
 - in the past 200 years, about 130 species of native flora and fauna have become extinct and a further 235 species are considered endangered (ANCA 1995); and
 - large cities, notably Sydney, are experiencing problems associated with photochemical smog, stormwater and wastewater (SEAC 1996).

The effectiveness of government initiatives to address such environmental problems has been reduced by a number of factors including:

- poor coordination between governments;
- a lack of information about the nature and extent of environmental problems; and
- inappropriate policy responses, particularly over use of inefficient regulations.

Reform agenda

Participants' views

Some participants acknowledged improved performance by governments. But there is a widely held perception that progress has been far too slow. For example, the Minerals Council of Australia said that several of the processes flowing from the IGAE should be expedited. In particular, the Council noted that:

- a systematic, well defined approach to the issue of accreditation of environmental regulation (“full faith credit” provisions) is still to be implemented between the Commonwealth and the States
- mutual accreditation of Commonwealth and State environmental impact assessment ... processes should be speedily finalised on a general rather than a project specific basis, including the signing and implementation of the National Agreement on EIA (Sub. 24 to the IC’s firms locating offshore inquiry, p. 26).

The Council also noted that the IGAE is dated in its application to greenhouse gas response measures.

Some participants claimed that environmental goals are undermined because government agencies continue to underprice natural resources. The Australian Conservation Foundation commented that:

The presence of subsidies (in the form of low prices and charges) contributes to the overexploitation of native forests for timber production ... These large subsidies serve as a major disincentive to the establishment of commercial hardwood plantations in particular, as potential investors recognise that they are unable to compete with cheap, subsidised timber sourced from public native forests (Sub. 3, attachment 1, p. 3).

The Commission's assessment

Policy coordination

Responsibility for environmental protection is a matter for all three tiers of government. The IGAE is intended to facilitate consultation and greater coordination of environmental regulation and processes between different levels of government. And States and Territories have generally aimed to achieve a greater degree of centralisation of their environmental regulation.

However, progress on the implementation of the IGAE has been slow and there are still substantial differences in the institutional and regulatory frameworks employed between jurisdictions. Although jurisdictional variation should not of itself be a problem — indeed, some differences may be desirable because of variations in environmental characteristics between regions — it has given rise to complex regulatory structures, and to overlaps and duplication of some regulatory functions. For example, some firms are regulated under several different State Acts and required to hold a variety of licences administered by different environmental bodies. This has increased compliance costs and created a degree of uncertainty, particularly for proponents of major projects.

Implementation of the IGAE should be accelerated. In addition, the recommendations contained in chapter 9 on regulatory review procedures, particularly on overlapping environmental processes, should be adopted.

Information problems

Obtaining comprehensive and relevant information is an important prerequisite for evaluating policy options to address environmental problems. More specifically, there needs to be thorough assessments of the benefits and costs of environmental protection measures, especially those involving regulation, to ensure that the outcomes are consistent with the public interest and with environmental objectives. For example, waste management is perceived to conserve resources. But the IC (1996d) has found that some recycling programs make a *negative* contribution to environmental goals when account is taken of the resources used in transporting,

sorting and cleaning. Similarly, some contend that materials such as plastics and metals should be substituted for wood to 'save' forest resources. But the Resource Assessment Commission (1991, pp. 8–9) found that the environmental costs associated with production of these substitutes often exceed those associated with wood production.

The level of information that is available on environmental problems varies enormously. Some problems have been extensively researched. However, SEAC (1996, p. 14) noted data inadequacies in a number of areas, including aspects of urban air quality and water systems. In these circumstances, a 'staged response' to an environmental problem may be warranted to reduce the risk of decisions proving to be inappropriate in the light of later information. Australia's response to concerns about greenhouse gas emissions should adopt this approach (box 8.4).

Land management is another major area in which further information is clearly required. There has been considerable debate about the appropriate indicators to assess the quality of land, the efficacy of the various available policy measures, and funding responsibilities and priorities. A comprehensive inquiry is required to examine these issues and provide the information necessary to ensure efficient policy outcomes.

Policy instruments

Governments have traditionally relied on prescriptive regulations stipulating specific actions that must be taken to achieve environmental standards (for example, requirements that firms install specified pollution control equipment). A major disadvantage of this approach is its inflexibility — firms do not necessarily have the capacity to choose the lowest cost option to meet environmental requirements. Unless regularly modified, prescriptive regulations can also lock firms into outmoded technologies.

The costs of meeting environmental objectives can frequently be reduced by employing outcome-oriented regulation and economic instruments that provide firms the flexibility to modify their production and/or consumption so that the requirement is met in a least-cost fashion. Economic instruments that can be used to pursue environmental objectives typically involve a financial transfer between polluters and the community. They include tradeable permits, environmental taxes and charges, user charges and performance bonds. To date, governments in Australia have used economic instruments sparingly. There is scope for them to be used more extensively.

For many environmental problems, the introduction of user charges can be a relatively straight forward and efficient solution. They help overcome environmental problems that have arisen because government services have been provided free of charge, or substantially underpriced. For example:

Box 8.4 Addressing global environmental problems in the presence of uncertainty: greenhouse gas emissions

There is international concern that greenhouse gas (GHG) emissions may have significant adverse effects on the global climate. The timing, nature and consequences of these effects are uncertain, and may remain so for many years. However, because the potential consequences could be large, deferring decisions until comprehensive information is available is not a sensible option.

The GHG strategy endorsed by governments in Australia addresses this concern. As an initial step it encompasses 'no regrets' abatement action — actions which reduce GHG emissions, but which are expected to have net economic benefits (or at least no net cost) to the economy. Examples include reforming inefficient energy pricing practices and addressing any information deficiencies about, say, conserving energy.

Some groups in the community advocate more stringent measures — such as the unilateral imposition of targets for reductions in emission levels, enforced by government regulation. If adopted, this approach could impose substantial costs on the Australian economy with no significant benefit. There are two reasons for this:

- Because the potential problems caused by GHG emissions are global in nature, the benefits to Australia from unilateral action (in terms of a reduction in global emissions) would be negligible relative to costs associated with the adjustments required from industry, households and individuals to meet stringent emission targets.
- The costs of measures going beyond 'no regrets' actions could, in the light of later information about the nature of the problems posed by GHG emissions, prove to be excessive (IC 1991j).

According to recent empirical work, if Australia were to impose a carbon tax from 1996 to reduce emissions to 1990 levels by 2000 and then stabilise emissions thereafter, real per capita GNE and real GDP would reduce in 2010 by 0.3 per cent and 0.1 per cent, respectively (ABARE and DFAT 1995).

In these circumstances, the most appropriate policy response is to take precautionary action in the form of 'no regrets' or voluntary measures, and defer more prescriptive actions until better information is available. If at that stage such action is warranted, Australia should not act unilaterally — its response should be part of a broader global response. The preference for a multilateral — rather than a unilateral — approach to GHG emissions needs to be contrasted with tariff reform, where a unilateral approach yields significant net gains to Australia (discussed in chapter 7).

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- underpricing of water has encouraged irrigators on major Australian waterways (such as the Murray and Darling Rivers) to invest in crops and irrigation technologies which use high volumes of water and contributed significantly to high river salinity levels;⁴ and
 - the lack of specific ‘tip charges’ in many municipalities has reduced the incentive for businesses and consumers to reduce waste and exacerbated problems associated with disposing of waste at landfills.

The cost savings from employing user charges and other output-oriented measures are potentially large. Studies outlined in Tietenberg (1990) on the cost of air pollution control in the United States suggest cost penalties in excess of 200 per cent are commonly associated with the use of prescriptive mechanisms. Some economic instruments are employed to address environmental objectives in Australia — such as a tradeable permit scheme to control river salinity in the Murray–Darling and fees applied to discharges to tidal water in South Australia. However, little empirical information is available about the benefits from these measures.

Governments in Australia are reducing their use of prescriptive regulation. However, all such regulation should be reviewed to assess the scope for using outcome-oriented measures. While this will not always be feasible (for example, in dealing with diffuse source pollution), there is scope to shift the balance away from the use of prescriptive regulation. Governments should also assess the feasibility of meeting environmental objectives by using economic instruments to modify production and consumption technologies.

These approaches will help in the efficient achievement of governments’ environmental goals. However, the challenges involved in meeting these goals are daunting, and will require more extensive action by governments. To this end, the Commonwealth Government has announced an ambitious program to help rectify many of Australia’s environmental problems. The availability of funding for this program is contingent on the partial sale of Telstra. The funds available for this program should be allocated to projects yielding the highest net pay-offs. It will be important to have transparent systems in place to ensure that this occurs.

τ To improve the efficiency of environmental protection measures:

- ***Where feasible, governments should replace prescriptive environmental regulation with outcome-oriented regulation or use economic instruments.***

⁴ To the extent that underpricing has increased demand for water, it has also encouraged excessive government expenditure in supporting infrastructure.

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- *Implementation of the Intergovernmental Agreement on the Environment should be accelerated.*
 - *Governments should seek to obtain more comprehensive information about options to address environmental problems. Where such information is incomplete, as in relation to greenhouse gas issues, a 'staged' response is likely to be most appropriate.*
 - *The Commonwealth Government should commission an independent public inquiry on land management.*
 - *Grants from environmental restoration funds should be allocated on the basis of the highest net pay-offs to the community. Decision-making processes should be as transparent as possible.*

Relevant BIE, EPAC and IC reports

Bureau of Industry Economics

Waste Management and Landfill Pricing — A Scoping Study, BIE (1993b)

Economic Impact of Reducing Greenhouse Gas Emissions in Australia: a Survey of Recent Studies, BIE (1994d)

Energy Labelling and Standards: Implications for Economic Efficiency and Greenhouse Gas Emissions: A Case Study of Motors and Drives, BIE (1994e)

Plastics Recycling: Economic Issues and Implications, BIE (1994g)

Greenhouse Gas Abatement and Burden Sharing: An Analysis of Efficiency and Equity Issues for Australia, BIE (1995c)

Implications of a Ban on Trade in Non-Ferrous Metals for Recycling, BIE (1995e)

Implications of a Ban on Exports of Used Lead Acid Batteries, BIE (1995j)

Energy Efficiency and Greenhouse Gas Abatement — The Role of Cooperative Agreements in Australia, BIE (1996c)

Economic Planning Advisory Commission

Issues in the Pricing and Management of Natural Resources, EPAC (1991)

Managing Australia's Natural Resources, EPAC (1992a)

Industry Commission

Recycling, IC (1991a)

Mining and Minerals Processing in Australia, IC (1991b)

Costs and Benefits of Reducing Greenhouse Gas Emissions, IC (1991j)

Cost Recovery for Managing Fisheries, IC (1992a)

Raw Material Pricing for Domestic Use, IC (1992c)

Water Resources and Waste Water Disposal, IC (1992e)

Adding Further Value to Australia's Forest Products, IC (1993d)

Environmental Waste Management Equipment, Systems and Service, IC (1993e)

A Guide to Regulation Impact Statements, ORR (1995d)

Regulation and its Review, IC (1995i)

Packaging and Labelling, IC (1996d)

Implications for Australia of Firms Locating Offshore, IC (1996h)

Land Degradation and the Australian Agricultural Industry, IC (1996k)

9 REGULATORY REFORM

Irrespective of their institutions or legal frameworks, many countries are experiencing common problems with their regulatory systems. These include:

- inflexible regulations which often focus on fixing existing problems and are not adaptable to new situations;
- rapid growth in regulation, much of which is not subject to consistent and objective assessment prior to implementation; and
- the challenge of balancing a sense of being ‘overregulated’ (or inappropriately regulated) with the support of many citizens for regulations which achieve certain economic and social outcomes.

Australia also faces these problems. They cannot be ignored. Effective regulation is fundamental to good government.

There is wide acceptance of the need to move further from fragmented State-based regulations to a regime more amenable to a national market in goods and services. There is also growing concern from the small business sector that it is disproportionately burdened by regulation, inhibiting its growth (and the jobs that go with it).

But regulatory reform is not just a domestic issue. The rapid development of global markets in many goods and services means that the domestic regulatory environment is becoming increasingly more important for the international competitiveness of Australian firms.

Partly because the effects of regulation are so pervasive, the potential gains from further regulatory reform — in higher productivity and increased economic opportunity — are substantial.

This chapter is not primarily concerned with regulations of particular sectors (some of which are dealt with in earlier chapters) but on the scope for improving government *processes* in order to achieve a more effective, yet less intrusive, regulatory regime. This is of fundamental importance to microeconomic reform.

9.1 Reforms to date

There have been significant reforms by individual governments as well as at the national level, and in the international arena.

National reforms

An important national reform has been the scheme for mutual recognition of goods and occupations that commenced in March 1993. It ensures that most goods produced or imported into one State or Territory under the laws of that jurisdiction can be sold freely throughout the country. In addition, members of registered occupations can now enter an equivalent occupation in other jurisdictions. Mutual recognition brings substantial benefits through freer movement of goods and skilled workers across interstate borders. It has provided a strong incentive for each jurisdiction to move towards national standards in areas such as product standards and safety regulations.

But perhaps the most important recent reform initiative at the national level is the four-year program of legislative review for the Commonwealth, State and Territory governments. Under the Competition Principles Agreement (see chapter 3), governments must review all legislation which restricts competition. These review programs offer an unprecedented opportunity for broadly based reform of Australia's regulatory framework.

Commonwealth reforms

The Commonwealth has decided to examine, at the same time, legislation which affects business, even if there is no restriction on competition. The Government has announced details of almost 100 reviews to be undertaken over the next four years (Costello 1996). This will be the most comprehensive and systematic review of regulation ever undertaken by the Commonwealth.

Apart from such broadly based review programs, the regulatory problems in particular sectors may become so substantial that pressure builds up for a special review. Some of the inquiries and reviews done by the IC, the BIE and EPAC have been of this nature. The latest major sector-specific review is into the financial system (box 9.1).

Box 9.1 **Review of financial sector regulation**

Regulatory reform of the financial sector has been a gradual process, not a one-off event.

Until the early 1980s, Australia's financial system was heavily regulated, with quantity controls over bank lending, controls on the exchange rate and foreign currency flows, and interest rate controls to limit the cost of finance to particular sectors of the economy.

These controls were progressively undermined during the 1970s by the emergence of more open international capital markets, by the relatively strong growth of the less regulated non-bank financial institutions, and by evidence that interest rate controls often disadvantaged those they were designed to assist (IC 1991).

Reviews by the Campbell Committee in 1981 and the Martin Committee in 1983 both recommended a substantial program of deregulation. Subsequent changes included floating of the Australian dollar, lifting of interest rate ceilings, and allowing foreign banks to operate in Australia.

More recent developments in financial sector regulation include proposals to allow non-bank financial institutions to issue cheques directly to consumers, and separate reviews of the regulation of financial advisers and derivatives. In addition, following the corporate failures in the late 1980s, new regulatory regimes have been implemented aimed at enhancing corporate accountability and disclosure. A number of these involve self-regulation, based on codes of conduct.

Yet there has been growing debate about whether the overall regulatory regime is appropriate in the 1990s. Accordingly, on 30 May 1996 the Government announced a wide-ranging inquiry into the regulation of the financial sector. A report is to go to the Treasurer by 31 March 1997.

A better framework of regulation offers the prospect of a more efficient and effective financial system, with less duplication, greater certainty and lower compliance costs for firms. A reduction in duplication and its associated costs would also reduce barriers to entry for new firms and products. In the longer term, this would result in improved competitiveness, growth, employment and consumer choice. In addition, there would be less opportunity for new products and/or firms — such as those operating on the Internet — to fall outside the regulatory framework. This would enhance the stability of the financial system and ensure that consumers receive adequate protection.

State and Territory reforms

Regulation review and reform have been features of State government for some years, particularly so in New South Wales, Victoria and Queensland. Early State approaches to regulation review were driven by the pursuit of good government and efficient administration, but recently the focus has shifted to microeconomic reform and improving competitiveness between the States. There have been sector-specific

reviews of existing legislation, such as of the motor trades industry in South Australia and of the legal profession in Victoria, as well as broad-ranging reviews of all legislation such as that undertaken in Queensland since 1991. Most States impose structured vetting processes on new legislation and have in place Acts to better control the growth of subordinate legislation. They are moving away from prescriptive regulation to performance or results oriented regulation, and they have achieved some reductions in compliance costs, especially for small businesses.

International developments

Regulatory reforms described above are domestic. There are also important developments in the international arena.

- COAG and the New Zealand Government have reached agreement based on Australia's mutual recognition arrangements. This means that (when legislation is passed) most goods that meet one of the country's regulations and standards can legally be sold in the other. In addition, persons registered to practise an occupation in either country may do so in the other, without further testing or examination.
- The reform of standards is an important part of the APEC agenda. Despite the diversity of the APEC countries, action is in train to better align standards in the region with international benchmarks.
- Negotiations for mutual recognition of conformance assessment between Australia and the European Union commenced in 1994; they are nearing completion and are expected to lead to the first agreement the European Union has signed with a non-member country.
- The Commonwealth Government recently announced reforms to the treaty-making process. Whenever it is considering committing to a treaty, a National Interest Analysis will be prepared and tabled in Parliament. This will set out the reasons for Australia becoming a party to the treaty, the obligations, and costs and effects, and is to involve public consultation. New arrangements for formal consultations with the States and Territories were announced at the June 1996 COAG meeting.

9.2 Performance gaps

Despite such developments, there are well-founded perceptions that reform of regulation has been inadequate. Such perceptions were evident in submissions made to the Commission during this stocktake.

Business interests argued for a push to wind back regulation. For example, commenting on regulation in its industry (box 9.2), Australian Petroleum said:

Regulation has not worked: bureaucratic processes can not replicate efficient markets and usually end up creating problems much greater than the perceived market failures they attempted to fix. It is high time for government to give deregulation a go. Deregulation may not be perfect but it will be very much better than regulation (Sub. 10, p. A1).

Overlapping and inconsistent regulations, and regulations that are too prescriptive, are also major concerns for business. For example, the Australian Business Chamber stated:

When nominating which approaches to regulation reform would be most beneficial, the manufacturers surveyed gave highest priority to national uniformity/consistency and industry standards/codes of practice (Sub. 29, citing its Survey of 506 Manufacturers, p. 1).

The legal profession (box 9.3) illustrates that Australia is yet some way from national uniformity in the provision of some key services.

Box 9.2 Regulation of petroleum product prices

Governments have regulated the industry in response to concerns that:

- competition is not sufficient to safeguard the public interest;
- there is an imbalance in contractual power in the industry, leading to 'unfair' trading;
- there be a fair return for retailers;
- retailers do not face 'excessive' competition from other petrol retailers; and
- there be low and stable prices for consumers.

The ACCC sets daily maximum wholesale prices for petrol and diesel sold by the oil majors. These prices are based on estimates of the cost of importing refined products into Australia. The ACCC also determines maximum freight charges on wholesale sales by the oil majors to resellers throughout Australia. In addition, most States and Territories have legislation covering petrol prices.

Several other Commonwealth Acts regulate the industry. These include:

- the *Petroleum Retail Marketing Sites Act 1980* which limits the number of retail sites owned and operated by the oil majors, and
- the *Petroleum Retail Marketing Franchise Act 1980* which regulates the relationship between franchisors and franchisees in the industry. The Act provides, among other things, nine-year assignable tenure for franchisees.

These two Acts are listed for review in 1997–98. The ACCC is currently reviewing its petroleum products declaration, and is to report to the Minister by 31 July 1996. The ACCC will recommend whether the supply of petrol and distillate products should be subject to prices oversight and, if so, its appropriate form.

Box 9.3 Regulation of the legal profession

Legal services are an important input into many businesses, and the legal system underpins the efficient functioning of a market-based economy.

The legal profession is regulated by State and Territory legislation, and by professional codes of conduct administered by industry associations.

The TPC examined the implications for competition and for the public interest of regulation of the legal system. It found the legal profession was highly regulated, and that regulation increased the costs to consumers, restricted business practices by lawyers, and reduced the choice of legal services available to consumers.

The recommendations of the TPC included that:

- all States and Territories adopt measures that automatically recognise the practising certificates of lawyers from other jurisdictions; and
- all levels of government establish a more nationally integrated and competitive market for legal services, including reducing the differences in regulations between jurisdictions.

Others referred to continuing bottlenecks in achieving regulatory reform. For example, NatRoad said that, five years after the process of seeking uniform road transport laws began, State and Territory governments have still not agreed on what those uniform laws should be.

There were also concerns about the failure of domestic regulators to account for the implications of regulations for Australia's international trade. For example, the MTIA said:

Australia's excessive business regulation significantly hinders competitiveness, particularly where Australia must compete globally with countries with far less stringent regimes in areas such as industrial relations policy and environmental restraints (Sub. 27, p. 8).

And the Australian Electrical and Electronic Manufacturers' Association noted the importance of aligning Australian and international standards:

Adopting international standards is essential as they open up export opportunities for Australian industry (through manufacturing to international standards) and promote innovation (Sub. 19, p. 3).

Other performance gaps in the Commonwealth's regulation reform efforts can be identified. For example:

- the Commonwealth is well behind some of the States where systematic reviews and staged repeal programs have resulted already in some tangible improvements;

-
- while there are processes in place to ensure that regulatory proposals are assessed carefully, they are not being used fully;
 - the business sector perceives that compliance costs of regulation are unreasonably high; and
 - there remains scope for improving the ways in which many regulations are administered.

9.3 The Commission's assessment

The review and reform of regulation is a complex process. It involves striking a balance between competing interests. It calls for some fundamental shifts in the community's perceptions as to how much (or how little) governments can achieve through regulation, and at what cost. It is likely that these difficulties can be adequately addressed only with a package of measures having many different layers or facets.

Political commitment

Experience overseas and in Australia shows that regulators and special interest groups are often opposed to sweeping and effective regulation reform and will undermine it unless there is strong political commitment and support.

Insufficient political commitment has been the major weakness in Commonwealth regulatory policy over recent decades. As a result, regulators have often ignored or circumvented regulation review processes. But good regulation demands good processes. That may require Ministers to demonstrate that regulatory options have been properly assessed. For important matters given Cabinet consideration, it may be necessary for a senior Cabinet Minister to have that role.

In the long term, the maintenance of a strong political commitment depends on wide community support. In this regard, the regulation impact statement approach (box 9.6) involves consideration and balancing of the interests of all groups in the community and does not favour particular groups, such as business, at the expense of other groups, such as consumers.

Wide community support also requires that the gains from regulatory reform be better known and understood so that the momentum for reform is maintained.

- Under the Competition Principles Agreement, Australian governments must report annually and publicly on progress made in the review and reform of regulation which restricts competition. Governments could use this as an

opportunity to sell the message that regulatory reform is for the long term benefit of the nation.

- Further, in developing their reports, individual review bodies should give particular attention to the costs and benefits of regulatory arrangements and their impact on various groups within the community.
- τ *The Commonwealth Government should reinforce its commitment to regulation reform by designating a senior Cabinet Minister, preferably the Treasurer, specifically responsible.*
- τ *Regulators and governments should make more effort to publicise the gains from reforms.*

Intergovernmental issues

Overlapping regulations between levels of government and differences in regulations between them have figured prominently as issues in microeconomic reform. Such overlap and inconsistency have imposed unnecessary costs on firms and industries, created uncertainty for investors, restricted the operation of national markets and increased the burden on taxpayers.

There could be some scope for the Commonwealth to vacate areas where there is considerable regulatory overlap with the States and Territories (for example, child care and education) which would be free to harmonise regulations through Ministerial Councils or national standard setting bodies.

Mutual recognition has considerable potential to eliminate much of the inconsistency between State and Territory regulation. This is so because no jurisdiction has the incentive to implement regulation which is more demanding than any other jurisdiction. But its benefits to date have been limited because:

- its application to goods is restricted to the *sale* of goods, and not necessarily the use of goods; further, manufacture in several different jurisdictions by a single firm remains subject to the (possibly different) regulations of each jurisdiction; and
 - there has not been sufficient effort to familiarise either regulators or the regulated with the concept, so that many in business remain under the impression that they must abide by the regulations of each jurisdiction where they make sales.
- τ *The impact of mutual recognition should be monitored more closely. COAG should agree on ways to make its applicability more widely known and should explore the scope to extend its coverage to areas such as services.*

Review and reform of specific regulations

Government initiatives to review and reform specific regulations or specific regulated sectors are often the result of accumulating pressure from interest groups. Examples of current specific reviews are the Small Business Deregulation Task Force, the Tax Simplification Program and the Financial System Inquiry (box 9.1). Intellectual property regulation is an example of where pressures for review have been increasing (box 9.4); another is the broadcasting and media sector (box 9.5).

Box 9.4 Intellectual property regulation

Intellectual property regulation involves trading off exclusive rights over protected property (thereby restricting competition) against incentives to produce and exploit such material. Because it influences the flow of information and technology, it is crucial to the development of some of Australia's emerging industries. Different regulators and different acts regulate intellectual property in Australia. For example, the *Copyright Act 1968* provides protection for certain works and artistic performances; it is under review by the Copyright Law Review Committee.

A number of other intellectual property issues have recently been reviewed. For example, the IC's report into vehicle repairs and insurance (1995c) recommended that manufacturers of motor vehicle spare parts not receive design protection for certain smash parts such as fenders. Similar recommendations were made by the BIE (1995g). In addition, the IC's report on the pharmaceutical industry (1996f) argues that manufacturers of generic drugs should be allowed to prepare their products for sale in the last two years of a drug's patent life (but not sell until the patent has expired). Several reports have recommended removal of parallel importation provisions.

However, the current framework of regulation based on specific forms of intellectual property has been left behind by the rapid change and convergence of technologies. Previous and ongoing reviews of specific legislation, such as those covering copyright, designs, patents and trademarks, have not examined the overall framework for intellectual property protection. In addition, changes to intellectual property regulation have occurred without careful economic analysis. As a consequence, producer interests dominate over the interests of users.

Intellectual property regulations, including patents, copyright, trademarks and design regulations, are scheduled for review in 1998–99. The review should examine any unjustified protection of producers, as well as issues of duplication, inconsistency, and complexity in current legislation, and the feasibility of regulating new forms of intellectual property. In addition, it should compare Australia's regulations with those overseas and our international obligations. This could result in substantially improved intellectual property regulations and revision of Australia's negotiating objectives in international forums.

Box 9.5 Regulation of broadcasting and the media

The goals of regulation in this sector include:

- promoting the availability of a diverse range of television and radio services to Australian audiences;
- promoting diversity in ownership of the main broadcasting services;
- ensuring Australian control over the most influential services;
- promoting a competitive and efficient broadcasting industry;
- encouraging broadcasting services to contribute to the development of an Australian identity and to cultural diversity;
- encouraging broadcasters to cover events accurately and fairly;
- encouraging broadcasters to respect community standards and provide means for complaints to be addressed; and
- ensuring children are not exposed to harmful material.

In addition to the Australian Broadcasting Authority (ABA), regulatory bodies include the Australian Copyright Council, the National Transmission Agency, the Office of Film and Literature Classification, the Australian Telecommunications Authority, the Telecommunications Industry Ombudsman, and the ACCC. In the case of the ACCC, it has reported to the ABA on satellite and non-satellite licences, and has also examined a number of competition issues in the areas of program bundling, program purchasing, subscriber management systems and the involvement of telecommunication carriers in broadcasting.

Some recent reforms include:

- a role for self-regulation — commercial television and commercial and community radio have developed codes of practice. Codes also are being developed by subscription television and narrowcasting services;
- relaxation of some ownership regulations — for example, there are no limits on foreign control of commercial radio stations (outside the guidelines of the Foreign Investment Review Board); and
- the prohibition on pay television has been removed.

However, some regulation of the media and broadcasting remains overly prescriptive and reduces competition. The Commonwealth Government has foreshadowed a public review of the cross-media ownership rules to determine the most effective means of promoting plurality, diversity and competition. There is also to be a review of broadcasting legislation in 1997–98. There would be merit in this review examining the entire range of regulations imposed on the sector — local content in advertising, for example, remains one of the more stringent border protections for an Australian industry.

There is a risk that reviews of such wide ranging issues, often by review bodies or persons with specialist backgrounds and perspectives, give inadequate recognition to the overall costs and benefits to the Australian community. The risks can be reduced if all reviews are guided by a common set of principles aimed at sound regulatory practice and a ‘fair go’ for all. In addition, there is wide acceptance that governments and regulators be required to provide documented justification for proposals. Such principles and requirements are embodied in the regulation impact statement (RIS) approach (box 9.6).

The RIS framework ensures that an important threshold question is asked — is regulation really necessary? Where it is so, the framework helps in the search for the most efficient and effective option.

The RIS approach should be seen as simply formalising processes that are needed for good policy making. Its wider use by the Commonwealth is likely to contribute to good government by improving the quality of all regulations. Like all policy tools, it must be used wisely. While it is sound practice to apply the RIS process to all significant proposals, the level of detail and the commitment of resources will depend on the magnitude of their potential impact.

Box 9.6 Key characteristics of regulation impact statements

A regulation impact statement should include:

- a clear statement of the objectives of the regulation based on the nature and magnitude of the problem;
- alternative approaches for dealing with the problem — they include self-regulation, market-based instruments such as taxes, subsidies and tradeable permits, and reliance on the legal system;
- assessment of the expected benefits and costs to the community of each alternative approach to regulation;
- analysis of the impact of the regulatory proposal on business, consumers, government and the community as a whole — ideally, the RIS process should lead to selection of the regulatory option that maximises the community’s net benefit;
- public consultation, thus enhancing transparency and confidence in regulation review and reform; and
- the establishment of future review mechanisms for new or amended regulations.

τ *The terms of reference for all future reviews of regulation should include the key elements of a regulation impact statement — assessment of alternatives, analysis of impacts, and public consultation. The level of detail of this analysis will need to vary with the significance of the regulation’s likely impact.*

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- τ *The scheduled review of intellectual property regulations should examine any unjustified protection of producers, as well as issues of duplication, inconsistency, and complexity in current legislation, and the feasibility of regulating new forms of intellectual property. In addition, it should compare Australia's regulations with those overseas and our international obligations.*

Systematic review and reform of existing regulations

In addition to reviews of the specific and targeted nature discussed above, there is an important need for systematic reviews of the whole legislative arena. In the Commonwealth's case, there appear to be as many as 1200 Acts on the statute books and little effort has been made to rationalise them.

While systematic reviews such as under the Competition Principles Agreement will focus on economically important competition issues, they will address only a relatively small segment of Commonwealth legislation. In order to reduce compliance costs, there is a good case for major 'housekeeping' on the bulk of Commonwealth legislation.

As a first step, the Commonwealth could follow the example of several of the States by passing a single Act repealing the clutter of inoperative laws. It could also consider the scope for consolidating closely related legislation and for reviewing, in order to simplify, other legislation with high compliance costs. Such tasks could be included as options for the 'regulation repair' package which the Government has foreshadowed.

Quality controls on new and amended regulations

Efforts to make the stock of existing legislation more efficient and effective will be thwarted if there are not appropriate quality controls on new regulations. These are often referred to as 'gatekeeper' mechanisms. They are procedures for ensuring that the responsible Minister and the relevant officials assess different options, consult those affected, and document the likely impacts of their regulatory proposals. The preparation of a regulation impact statement is one systematic way of doing so, but certainly not the only way. It can form an important part of the essential information needed for government to reach soundly based decisions.

Partly because there are no sanctions on those who ignore 'due process' when making regulations, the existing quality control mechanisms are often ignored. The Government's new Legislative Instruments Bill (June 1996) addresses these problems for subordinate legislation with formal process requirements including:

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- mandatory consultation;
 - documentation of the need for regulation, its costs and benefits, and alternatives to regulation; and
 - five-year sunset clauses.

The Government has also directed that consideration be given to other more effective ‘gatekeeper’ arrangements. The Office of Regulation Review, drawing on its experience in working together with those developing new regulations, will be taking that opportunity to put forward some specific suggestions.

Making regulators more accountable

Surveys of business consistently reveal that the way in which officials interpret and enforce the regulation can be as much a problem as the regulations themselves. For example, there are common complaints that regulators show little inclination to modify their approaches in order to reduce the compliance costs on business. There is wide agreement that regulators must become more ‘customer-oriented’ and be more accountable for their behaviour.

Achievement of such an objective will require a wide range of initiatives and a substantial ‘cultural change’ among regulators. That requires, in turn, for appropriate political commitment (see above) to be reflected in the guidelines and instructions given to regulatory officials.

- τ *Each government needs to set clearer boundaries between its regulators, in order to reduce duplication and the confusion currently facing those being regulated.*
- τ *All assessments of regulations should include estimates of the likely compliance costs.*
- τ *Regulatory agencies should be obliged to provide clients with written details of likely processing/response times, and how any appeal process can be triggered.*

Regulation and the legal system

General liability laws can be an alternative or complement to regulation. They can provide discipline on producers to supply safe goods and services and on consumers to exercise appropriate care when using those goods and services. In so doing, they can sometimes obviate the need for more prescriptive regulations. More generally, effective contract laws and property right systems are vital to many market transactions.

Although it underpins the effective operation of markets, the efficiency of the legal system has not featured prominently in the microeconomic reform debate. This is despite some evidence that the system does not encourage efficient outcomes. For example, some argue that recent changes to the interpretation of legal liability flowing from negligence have increased costs and time spent on litigation, while reducing the incentives for buyers and sellers to take proper care. There are also questions about the impact of punitive damages and contingency fee arrangements on incentives, and the relationship of common law to the range of complementary legislation governing market transactions.

Review of the efficiency of the basic legal framework could also address the cost-effective provision of legal services (box 9.3), as well as the importance of promoting competition in the supply of legal services and the provision of justice more generally.

A review from a legal perspective alone, however, may miss the significance of these important economic issues; an economic perspective is also required. The IC's analysis of product liability laws (IC 1990b) is one precedent for such a review.

Relevant BIE, EPAC and IC reports

Bureau of Industry Economics

The Economics of Intellectual Property Rights for Designs, BIE (1995g)

Business Licences: International Benchmarking, BIE (1996d)

Business Licences and Regulation Reform, BIE (1996e)

Economic Planning Advisory Commission

World Standards and APEC Trade, EPAC (1993f)

Continuing Reform of Product Standards Essential, EPAC (1996b)

Industry Commission

Product Liability, IC (1990b)

Availability of Capital, IC (1991)

What Future For Price Surveillance?, IC (1994c)

Petroleum Products, IC (1994e)

Vehicle and Recreational Marine Craft Repair and Insurance Industries, IC (1995c)

Regulation and its Review: 1994–95, IC (1995i)

Competition and Retail Banking, ORR (1995b)

An Economic Analysis of Copyright Reform, ORR (1995c)

A Guide to Regulation Impact Statements, ORR (1995d)

The Pharmaceutical Industry, IC (1996f)

Extending Patent Life: Is it in Australia's Economic Interests?, IC (1996g)

Merger Regulation, IC (1996i)

10 GOVERNMENT PERFORMANCE

Governments play *the* pivotal role in microeconomic reform. They set the legal, institutional and policy environments in which firms and individuals operate. They therefore shape the incentives that the private sector faces to improve its performance.

Governments also have a role in microeconomic reform in improving their performance. The public sector (excluding the armed services) accounts for just over a quarter of the value of production and employment in the economy. Its sheer size means that even small improvements in productivity can have a substantial impact.

Governments also affect the productivity performance of the rest of the economy in other ways. For example:

- advantages conferred on government agencies can reduce the opportunities for more efficient private sector suppliers;
- demands made on the community's resources by governments affect prices, wages and interest rates and can crowd out efficient activities indirectly; and
- taxes and charges to fund government services, as well as compliance requirements, add to the costs of doing business and can impair firms' competitiveness.

Many of these issues have been discussed in previous chapters. For example, competition policy, better labour market regulation and clarification of property rights over resources are necessary to ensure an efficient and productive economy.

The federal system of government also has an impact on economic activity. The decisions of different governments affect the flow of goods, services, capital, and people across borders and thereby determine the scope of national markets. These decisions also affect the extent of competition within Australia and the competitiveness of firms internationally.

To lift their performance, governments around the world are having to confront two major issues:

- Do they still need to be involved in some activities? Can these be better provided by others?

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- Are there better ways of providing the services demanded of governments?

Also, the federal system of government in Australia gives rise to a further question:

- What changes need to be made to federal arrangements to improve the collective performance of Australian governments?

Systems of political governance can also affect economic activity. However, such broader constitutional matters are not canvassed in this chapter.

10.1 The performance of different levels of government

The activities of governments

The Australian system of government divides responsibilities between Commonwealth; State and Territory; and local government. Commonwealth outlays comprise the largest part of total government outlays (figure 10.1). Transfer payments, including those to State, Territory and local governments, account for some 70 per cent of Commonwealth outlays (figure 10.2). State government outlays contribute over 40 per cent of total outlays, but transfer payments form only a small part of State outlays.

The main areas of Commonwealth expenditure are social security and welfare, health, defence and general public services (figure 10.3). State expenditures are mainly on education, health and transport and communications.

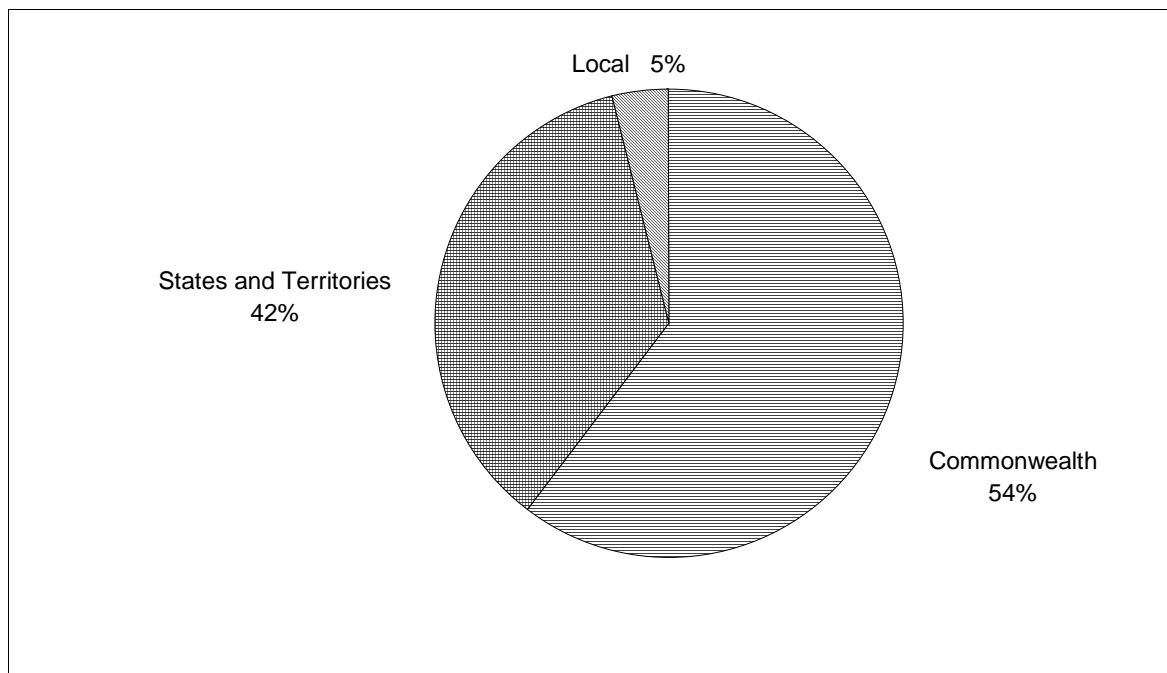
Local government is responsible for about 5 per cent of outlays, the main areas of expenditure being transport, housing and general public services including recreational facilities.

Broadly speaking, governments operate at two levels:

- a general government sector administering programs and services covered by the budget; and
- GBEs delivering a range of commercial services.

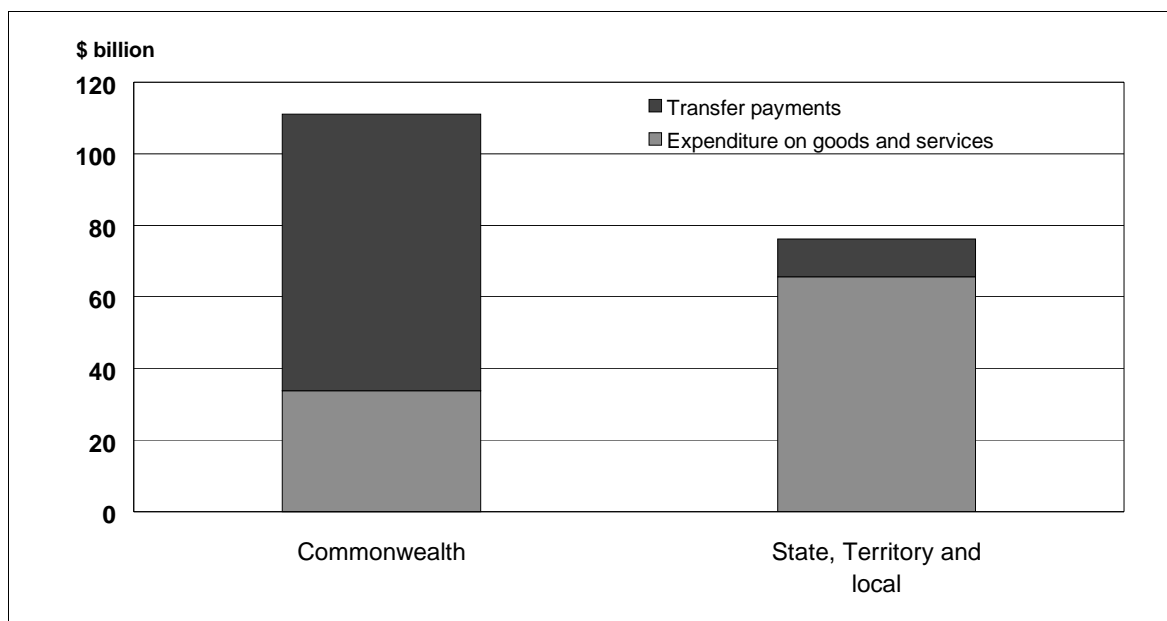
The general government sector is the larger part, accounting for about 60 per cent of public production and 80 per cent of public employment. As well as conventional public administration, it includes business units and activities which elicit revenue through charges of various kinds.

Figure 10.1 Total outlays by level of government, 1994–95



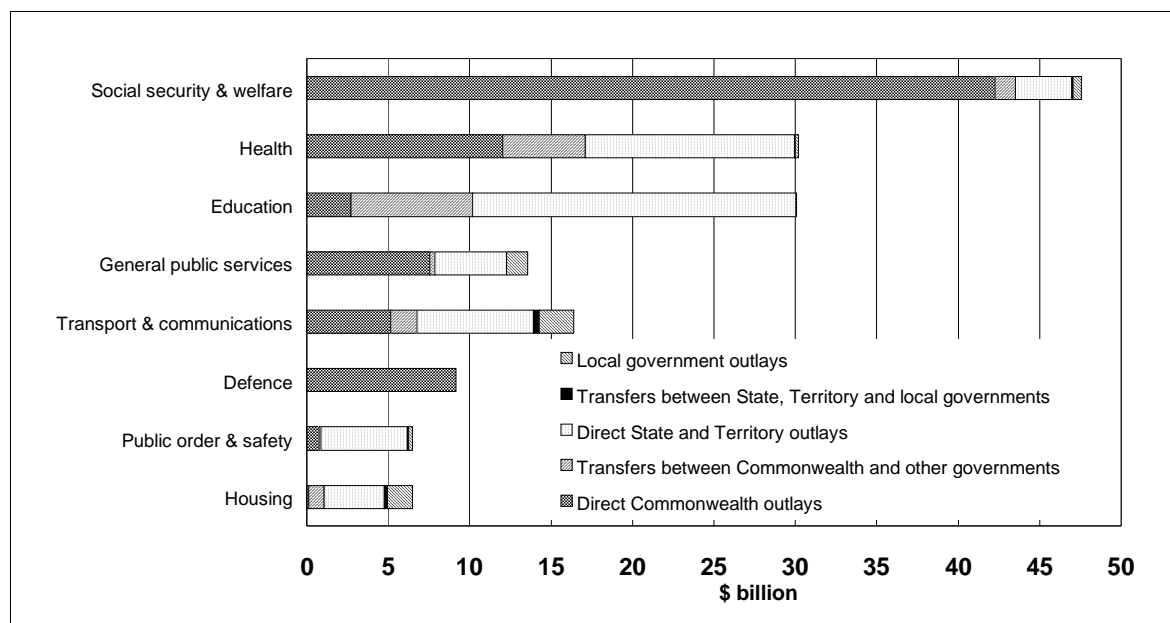
Source: ABS, Cat. No. 5512.0.

Figure 10.2 Transfers and outlays on goods and services by government, 1994–95



Source: ABS, Cat. No. 5206.0.

Figure 10.3 Commonwealth, State, Territory and local government outlays and transfers, by major functions, 1994–95



Source: ABS, Cat. No. 5572.0.

Performance gaps

The performance of the government sector can be assessed in relation to its major components.

GBEs provide most of Australia's infrastructure services (see chapter 4). GBEs are also involved in non-infrastructure areas such as banking, produce marketing, housing, abattoirs and gambling.

The aggregate performance of GBEs has been improving in recent years (SCNPM 1995; EPAC 1995e). Total factor productivity has increased sharply and users of some services have benefited from falls in prices and improvements in the quality of services. Profitability and dividend payments to governments have increased and debt levels have been reduced. However, there are significant variations in performance between industries and between individual GBEs, partly reflecting differences in the pace and nature of reform.

In most areas, Australia's infrastructure performance still lags considerably behind the world's best (chapter 4). Application of the national competition policy, administrative reforms and labour market reforms to government enterprises could provide significant benefits to the Australian community.

Governments also maintain business units within departments of state which operate on commercial principles. The Joint Committee of Public Accounts (1995) concluded that there is considerable scope to improve the efficiency and effectiveness of Commonwealth government business units.

There are also significant performance gaps in general government service provision and administration (see chapter 5). The Steering Committee for the Review of Commonwealth–State Service Provision (1995) reported on the performance of a range of government services across Australia accounting for nearly 10 per cent of Australia's GDP. It found wide variations in the cost and effectiveness of service delivery in most areas across jurisdictions.

In some areas, the lack of nationally comparable data limits observations about the efficiency and effectiveness of government services. Examples include public hospitals, school learning outcomes, policing, corrective services and government support services.

Local governments generally enjoy monopoly control over basic services and their businesses are rarely exposed to competitive pressures. Little data are available to gauge their performance.

However, there is a widespread perception of considerable room for improvement. For example, a former chief executive officer of a major local government authority has stated that many local governments are inefficient and a drain on the public purse; cover very small populations resulting in high overheads; focus on increasing rates rather than reducing labour and other costs; and are very slow in adopting quality customer service practices and modern financial management techniques (Proust 1994).

There is considerable variation in the level of cost recovery for water and sewerage services by local authorities and regional water boards and charges often fall short of covering operating costs and depreciation (IC 1992e). Poorly structured charges for solid waste disposal at public landfills and low levels of cost recovery have adverse efficiency and equity implications for the wider community (IC 1993e). The wide variation in the use of competitive tendering and contracting (CTC) by individual councils noted by the IC (1996a) also suggests scope for many councils to extend their use of CTC.

Reform agenda

Commercial activities

Reforms to GBEs supplying infrastructure services were outlined in chapter 4. Broadly, these involve reforms such as: increasing competition; ownership changes for activities that are more appropriately run by the private sector; a range of management reforms to ensure prices reflect costs of providing services; and full economic analysis of major investment projects.

All these principles have wider application to government business units within departments of state and other government organisations supplying services on a commercial basis.

- The national competition policy framework requires application of competitive neutrality principles, including full cost attribution and corporatisation, to these businesses where appropriate.
 - In considering which of their business units should be corporatised, governments should also consider whether they should be retained in government ownership.
 - There is a strong case to extend independent prices oversight to major business units and other government bodies providing monopoly services to the public. For example, at the Commonwealth level, there seems little reason why charges imposed by the Australian Quarantine and Inspection Service should be excluded from independent prices oversight.
 - Performance monitoring of GBEs should be extended to include major business units and other government commercial bodies.
- τ *Governments should review whether the activities of their business units should continue to be carried out in the public sector and, if so, whether those units would operate more efficiently as separate business corporations.*
- τ *Governments should extend independent prices oversight by national or State-based authorities to major business units and other government bodies providing monopoly services to the public.*
- τ *National performance monitoring of GBEs should be extended to major government business units and other government commercial bodies.*

Other general government

The general principles for reform in government service provision set out in chapter 5 in relation to education, health and community services have wider application in the general government sector and public administration. They cover:

- clarity of roles and objectives;
- providing clients with choice;
- promoting appropriate consumption;
- a coordinated approach to customer service;
- competition in service delivery; and
- effective performance monitoring.

These principles are designed to improve the effectiveness and efficiency of service delivery. However, they abstract from the broader — but nonetheless important — question of the appropriate level of service and support that governments should provide. Periodic reviews of government programs should evaluate the need for continuing government involvement as well as performance.

Key approaches

There is a basic core of reforms that should be extended throughout the public sector to give effect to the above principles. These are:

Financial management reforms: Many governments have implemented financial management reforms for their administration and service provision (for example, see Department of Premier and Cabinet, Victoria, Departmental paper 2; Treasury, Western Australia, Departmental paper 4; Department of Finance, Departmental paper 15). Public administration reform should continue to focus on improving management, clarifying objectives in terms of outcomes and improved financial management through greater budget control, accountability and improved appraisal and evaluation.

Commercialisation of functions: Commercialisation of public sector functions, involving charging for goods and services provided, ranges from minor cost recovery to full user charging. The extension of user charging has much to offer in many instances. It provides incentives to manage costs and improve the quality of services to customers. Charging for services also encourages more responsible consumption as users must pay for what they consume. It also assists suppliers to assess consumer preferences. Commercialisation of public sector operations is most

appropriate where the beneficiaries of services can be readily identified, charging is feasible and users are able to modify their consumption.

Purchaser/provider arrangements: Increasingly, governments are recognising that while they might have a responsibility to *fund* services, they are not always best placed to *provide* the service. By funding others to provide the service (through a competitive process), delivery to clients can be improved and savings can be made to the benefit of taxpayers and/or other programs. Even within government, there are advantages in clarifying and separating the roles of purchasers and providers, with the purchasers able to buy services from alternative suppliers.

Competitive tendering and contracting: Purchaser/provider splits provide the basis for CTC. CTC offers an important opportunity to get better value for money in the government sector. CTC is not new, but there is still much scope to extend its use (IC 1994f, 1996a). If properly applied, it can lead to significant improvements in accountability, quality and cost effectiveness, while providing benefits to clients, taxpayers and the broader community. For example, studies reveal savings ranging from 10 to 30 per cent and economy-wide gains, under a range of scenarios, are estimated to be between \$1.3 and \$7.3 billion (IC 1996a).

The IC report on CTC developed some important principles for governments in assessing the scope for CTC. Key lessons for its future use by governments are outlined in box 10.1. Governments should implement the IC recommendations on CTC.

Monitoring of outcomes: Monitoring outcomes is a driver of future reform. Program evaluation has been a feature of improvements in public sector management for some time. However, the systematic and transparent performance monitoring of public administration through the Steering Committee for the Review of Commonwealth–State Service Provision is only a recent development.

Box 10.1 Application of competitive tendering and contracting

Key lessons for the future application of CTC include:

- structure CTC in a way which ensures effective competition so that the best providers are chosen;
- use CTC to force agencies to review what they are doing and assess whether their current activities are effective in meeting policy objectives;
- focus CTC on service outcomes rather than processes; and
- support CTC through a cultural change in the public sector and a new mix of skills.

There is a need to improve the coverage and quality of outcomes data in a number of service areas (SCRCSSP 1995). Moreover, the focus of attention has been mainly on State and Territory responsibilities, rather than on Commonwealth or local government responsibilities.

Information on the effectiveness and efficiency of Commonwealth services should be included in the Review of Commonwealth–State Service Provision. Monitoring should proceed as planned for areas such as aged care, child care, and some federal courts. Consideration should also be given to extending systems of performance monitoring to areas of private provision substantially funded by governments such as private education and private housing rental.

- τ *Governments should apply the following reforms as broadly as possible in the public sector:*
 - *financial management reforms;*
 - *commercialisation of functions;*
 - *purchaser/provider arrangements;*
 - *competitive tendering and contracting; and,*
 - *monitoring of outcomes.*
- τ *Governments should implement the recommendations of the IC's report on competitive tendering and contracting.*
- τ *The Review of Commonwealth–State Service Provision should continue to develop efficiency and effectiveness indicators to provide comprehensive coverage of service provision areas. Governments should improve the coverage and quality of outcomes data across service areas.*
- τ *The Review of Commonwealth–State Service Provision should proceed as planned to include information on the effectiveness and efficiency of Commonwealth services such as aged care, child care and some federal courts. Consideration should be given to extending national performance monitoring to private service areas receiving substantial government funding.*

Specific areas for reform

As discussed in chapter 5, the Commission sees education and health as high priority areas for further reform in the general government sector. In addition, the reform effort needs to be extended into other areas and to include local government.

Local government services consist of a mix of commercially based activities, welfare support services and local public goods. Service provision would be enhanced by greater resort to competitive tendering and contracting for service delivery; amalgamation of local government areas (or cooperation between them) to reduce costs; improved financial management and information systems; pricing policies which reflect costs of provision; greater focus on customer service; and more effective performance monitoring. Recent structural, operational and labour market reforms to local government in Victoria indicate what is possible (Department of Premier and Cabinet, Victoria, Departmental paper 2).

Some governments have taken steps to establish performance monitoring systems for local government (for example, see The Cabinet Office, New South Wales, Departmental paper 1 and Department of the Premier and Cabinet, Queensland, Departmental paper 3). The Local Government Ministers' Conference has agreed to the development of national indicators of efficiency, effectiveness and accessibility of local government services. However, implementation has been stalled for some time and there are disagreements between governments over the nature of the indicators and funding for collating and reporting the information.

To speed up progress, the introduction of national performance monitoring for local government services should be treated as a priority by COAG. It would complement the monitoring of GBE performance and service provision. Performance measures should include both financial and non-financial indicators, the latter including quantitative and qualitative indicators.

A longer term agenda for reform should include review of defence services, law and order provision and the justice system. There are particular difficulties for governments in ensuring efficient and effective supply of these national and local public goods. There is much scope for both undersupply and oversupply and they are not easily subject to competitive forces. Therefore, reform will need to rely on administrative changes, such as better financial management and contracting out procedures, to improve efficiency and the quality of service delivery.

A review of defence expenditure is necessary to obtain greater efficiencies, particularly in administration. As the Minister for Defence has stated, there is a need to ensure defence expenditure is more cost effective (*The Australian*, 21 June 1996).

There remains scope for improvement in defence procurement (IC 1994f). The implementation of the Commercial Support Program for the contracting out of defence activities offers the scope for major cost savings. It has been proceeding far

too slowly, with too many support activities being treated as core defence activities. The Commonwealth Government should take up the recommendations of the IC report on defence procurement (IC 1994f) to speed up the implementation of the Commercial Support Program. Formal or informal local content requirements for major defence projects are likely to add to costs and should be avoided unless there are commensurate benefits in the attainment of defence objectives.

- τ *The introduction of national performance monitoring for local government services in common should be treated as a priority by COAG. Performance measures should include both financial and non-financial indicators, the latter including quantitative and qualitative indicators.*
- τ *Local government service provision should be reviewed through a public inquiry to assess the scope for increased competitive tendering and contracting for service delivery; amalgamation of, and greater cooperation between, local government areas to reduce costs; improved financial management and information systems; pricing policies which reflect the costs of service provision; improved focus on customer service; and more effective performance monitoring.*

10.2 Intergovernmental responsibilities

Australia's federal structure of government and related institutions have a pervasive impact on our economic performance.

While the federal system is a source of important benefits, various institutions for intergovernmental cooperation have long been seen as necessary to prevent it producing inefficient outcomes. In recent years, cooperation on reform issues involving both the Commonwealth and the States has been primarily managed through Ministerial Councils and COAG.

Significant progress has been achieved through these intergovernmental forums in furthering the scope of national markets and addressing interjurisdictional impediments on businesses. Particular achievements noted in previous chapters include: the national competition policy framework; mutual recognition; integration of national infrastructure in electricity, gas, water and rail; reform of GBEs; the creation of several national regulatory bodies; and rationalisation of the structure and operation of Ministerial Councils. In many cases, the negotiations and agreements have covered complex issues.

Performance gaps

However, as also demonstrated in previous chapters, significant problems remain, including:

- overlapping Commonwealth and State regulations in areas such as industrial relations and environmental impact assessments;
- lack of harmonisation of State regulations in areas such as transport which increases costs and inhibits internal trade in goods and services;
- duplication, cost-shifting and lack of integration and accountability in service provision by the Commonwealth and the States in areas such as health, education and community services;
- continuing impediments to national markets — in infrastructure services in particular;
- resort to inefficient taxes by State and Territory governments; and
- competition between State governments to attract activity from each other through selective industry assistance.

These features of our current federal arrangements have induced firms and individuals to behave in less productive ways and raised costs for Australian businesses and households.

The lack of progress in rationalising roles and responsibilities between levels of government is one of the most significant failures. Areas such as health, community services, education and training and child care have been on the agendas of intergovernmental forums through the 1990s. But, there has not been any major realignment of roles or delineation of responsibilities apart from that agreed for public housing. The National Commission of Audit (1996) has made a number of recommendations to address this general problem.

As discussed in chapter 6, the problems of State taxation also remain unaddressed.

Even the more successful areas of reform have been subject to delays and setbacks. For example:

- The formation of national infrastructure networks has been delayed by interstate rivalries, concerns about effects on State finances and demands for compensation from the Commonwealth.
- There are concerns about the future participation of the Queensland Government in the national electricity grid following its decision to abandon the construction of Eastlink.

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- Some State governments have been reluctant to agree to full separation of electricity generation, transmission and distribution assets, which is necessary for the creation of a competitive market in electricity.
 - The ownership and control of tracks and other infrastructure by State governments continues to frustrate the development of a national rail freight network.

And, as noted previously, pressures are emanating from some areas for the exemption of pharmacies, newsagencies and statutory marketing authorities from the application of the national competition policy.

Reform agenda

Cooperative and competitive federalism

Cooperation and competition between governments are fundamental to progress in microeconomic reform. Where national approaches are needed (for example, infrastructure and some regulation), progress can be sought through cooperation and mutual recognition. However, where diversity is preferable (for example, local environmental regulation, planning, and community services), a ‘competitive’ approach can yield beneficial outcomes.

A federal system has the advantage of vertically assigning responsibilities between governments, based on national and local functions, while allowing horizontal comparisons and competition of subnational government performance in a variety of areas. Government decisions can be made more responsive to local needs and successful innovations may be copied by other jurisdictions. Indeed, there is an important role for competition between governments in developing ‘best practice’ models. In this sense, a federal system provides for experimentation and continuous improvement.

Many of the microeconomic reforms proposed in previous chapters are national in scope. Successful implementation will depend on cooperation between governments. Reform in training, workers’ compensation and occupational health and safety (chapter 2), the implementation of national competition reforms (chapter 3), greater integration of physical infrastructure between regions (chapter 4), maintaining a national approach to government procurement (chapter 7) and improving regulatory regimes (chapters 8 and 9) all demand concerted, cooperative, efforts by governments in the national interest.

Intergovernmental processes and procedures need to facilitate such cooperative effort. COAG is the key forum for debate and decision on major strategic issues,

with Ministerial Councils also playing a part in resolving problems of efficiency and effectiveness in particular policy areas.

Significant progress in reforms requiring joint government agreement has typically been preceded by extensive public inquiry and reporting. This creates a climate for reform by identifying problems, assessing the potential gains from reform and developing policy options for consideration by governments. It is notable that the areas in which COAG has been least successful (such as clarifying roles and responsibilities of governments and resolving issues in Commonwealth–State financial relations) have not been subject to such processes.

- This suggests that a priority for achieving progress in federal reform is better integration of public inquiry and intergovernmental processes. This would contribute to better problem definition and setting of policy directions, while providing more extensive public input into these deliberations. Such reviews have been proposed in chapter 5 for education, health and aged care services.
- Greater transparency of intergovernmental procedures will also help build government and public commitment to change. More systematic use of public inquiry processes to help set policy directions would help in this regard. In addition, there is a need for improved public reporting of intergovernmental decisions and processes. An annual report on the activities of COAG and Ministerial Councils would be a desirable step in this direction.

Cooperative reform and improving the processes of intergovernmental forums should be complemented by a framework for intergovernmental competition.

There has been some significant progress towards a constructive framework for competitive federalism with the establishment of performance monitoring systems for GBEs and government service provision. They should be extended to cover service provision by Commonwealth and local governments. A number of service areas must improve the coverage and quality of outcomes data (see above).

A better framework for cooperative and competitive federalism needs to be extended to two of the main problems in Commonwealth–State relations — the roles and responsibilities of different levels of government in service provision, and financial relations.

- τ *Governments should better integrate independent public inquiry programs and the agendas of intergovernmental forums.*
- τ *Governments should increase transparency of intergovernmental procedures through improved public reporting of decisions and processes and an annual report on the activities of COAG and Ministerial Councils.*

Roles and responsibilities

Governments need to clarify their roles and responsibilities in areas of shared interest. Comprehensive outcomes indicators have a crucial role to play in this process.

A framework for clarifying roles and responsibilities could be structured around nationally agreed objectives in service provision; clear assignment of responsibility for delivery of the service to one level of government where possible; and monitoring of outcomes achieved by different governments. For example, the Commonwealth Government may retain responsibility for income support measures where appropriate, but would otherwise withdraw from oversight and enforcement of standards and processes in service delivery.

This framework may not be universally appropriate but it would provide a basic guide to be adjusted according to the circumstances of particular areas of government reform. The Intergovernmental Agreement on the Environment and the agreement for realigning responsibilities in public housing provide practical models of this approach.

The issue of roles and responsibilities has been considered in greater detail by the National Commission of Audit (1996).

Commonwealth–State financial relations

There is also pressure for more fundamental change in intergovernmental relations. Some of the more successful ‘experiments’ in intergovernmental reform (public housing and the competition policy framework) have demonstrated how financial relations between governments can impede progress. Further progress may involve some fundamental changes to Commonwealth–State financial relations. For example:

- sorting out roles and responsibilities in service provision (chapter 5) could substantially alter the relative expenditure responsibilities of governments and create pressures for change in the funding arrangements between governments; and
- taxation reform (chapter 6) raises issues about the allocation of tax powers between governments.

In comparison with other federal systems, Australia has a large disparity between the revenue raising capacities and expenditure responsibilities of different levels of government — the so called ‘vertical fiscal imbalance’. The Commonwealth raises a little over 70 per cent of total government revenue, but only accounts for 54 per cent

of own-purpose outlays. In contrast, State governments only raise about 25 per cent of revenue, but account for over 40 per cent of own-purpose expenditures (table 10.1). This disparity in revenue-raising and expenditure responsibilities necessitates an extensive system of intergovernmental grants and has involved increasing use of specific purpose payments.

Table 10.1 Revenues and outlays by level of government, 1994–95

	<i>Percentage of own-source revenue</i>		<i>Percentage of own-purpose outlays</i>
	<i>Taxation revenue</i>	<i>Total revenue</i>	
Commonwealth	76	72	54
State and Territory	20	24	42
Local	4	4	5
Total	100	100	100

Source: ABS, Cat. No. 5512.0.

According to many, pronounced vertical fiscal imbalance and the associated system of intergovernmental grants are a significant source of inefficiency and a factor inhibiting reform. A range of problems are often attributed to vertical fiscal imbalance including overspending by governments, confusion between roles and responsibilities and inefficiencies in State taxation. For example, the BCA stated:

... the existing Vertical Fiscal Imbalance between the Commonwealth and the States is partly responsible for the recent reliance on higher dividends from GBEs. The taxes available to the States are narrowly based, and fall heavily on business inputs. Potential gains from the competition policy agenda are also being eroded as States seek to shore up their revenue base (Sub. 38, p. 3).

While it is difficult to establish a distinct causal link in some cases, the current fiscal structure does have some important consequences. Among them are:

- The extent of vertical fiscal imbalance encourages the States to resort to inefficient taxes (chapter 6). While the costs of State taxation could be reduced by removing exemptions and concessions in more broadly based taxes (payroll tax and land tax), these taxes have limitations as a source of revenue growth. As noted previously, it would be desirable to reduce or eliminate taxes on business inputs.
- The high degree of Commonwealth control over taxation revenue enables it to extend its influence to State areas of responsibility, especially through tied grants. Among other things, this has contributed to confusion and duplication in roles and responsibilities. Reducing reliance on tied grants would not resolve the more general problem of the blurring of political accountability for expenditure decisions within the States.

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- The incentives for the States to undertake nationally beneficial reforms are reduced where they perceive that such reforms will erode revenue sources. The South Australian Department of Premier and Cabinet observed that vertical fiscal imbalance ‘reduces the capacity for State governments to promote microeconomic reforms because tax gains from such reform are not necessarily passed back to the States’ (Departmental paper 5). This problem has been variously addressed by ‘compensation’ payments from the Commonwealth and allowing States to collect tax-equivalent payments from their GBEs. But it remains an issue, as illustrated by the BCA’s concerns about excessive dividend payments to governments from GBEs.

The need for change in the structure of Commonwealth–State financial relations can be oversold. Some of the adverse consequences attributed to vertical fiscal imbalance can, in principle, be ameliorated by cooperative government actions within the existing framework and every effort should be made in this direction. In particular, the heavy reliance on tied grants should be reduced. The broad-banding of specific purpose payments and/or their absorption into financial assistance grants would enhance efficiency within the grants framework. National objectives could be pursued through national agreements about objectives and national monitoring of outcomes. State and Territory governments could also give joint consideration to harmonising their tax bases.

However, there is still a compelling case to negotiate a fundamental change in federal financial relations to reduce accountability problems, address inefficiencies in State taxation and minimise disincentives for governments to undertake needed reforms. In the absence of other changes, moves to further devolve responsibilities to the States will widen the extent of fiscal imbalance and accentuate the associated problems.

A package of reforms to Commonwealth–State financial arrangements could include:

- a transfer of revenue raising responsibility from the Commonwealth to State governments; and
- restructuring the existing tax bases of the States to fill in gaps and reduce their use of the more distorting taxes.

The choice of particular mechanisms will require careful consideration of a number of complex issues. This should be the subject of a joint review by the Commonwealth and the States.

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- τ *The Commonwealth Government should reduce the significance of tied grants by broad-banding specific purpose payments and/or absorbing them into financial assistance grants.*
- τ *Governments should agree to establish a joint review to develop options for reducing the extent of vertical fiscal imbalance including:*
- *a transfer of revenue raising responsibility from the Commonwealth to State governments; and*
 - *restructuring the existing tax bases of the States to fill in gaps and reduce the more distorting taxes.*

Relevant EPAC and IC reports

Economic Planning Advisory Commission

Profitability and Productivity of Government Business Enterprises, EPAC (1992b) and updates in Clare and Johnston (1993a) and EPAC (1995e)

Medium-Term Review: Opportunities for Growth, EPAC (1993b)

Economic Effects of Microeconomic Reform, Filmer and Dao (1994)

Public Expenditure in Australia, EPAC (1994d)

Industry Commission

Availability of Capital, IC (1991)

Water Resources and Waste Water Disposal, IC (1992e)

Taxation and Financial Policy Impacts on Urban Settlement, IC (1993b)

Environmental Waste Management Equipment, Systems and Services, IC (1993e)

Public Housing, IC (1993f)

Impediments to Regional Industry Adjustment, IC (1993g)

Defence Procurement, IC (1994f)

Annual Report 1993–94, IC (1994g)

Competitive Tendering and Contracting By Public Sector Agencies, IC (1996a)

APPENDIX A: ABOUT THE STOCKTAKE

Pending the formation of the Productivity Commission, the Commonwealth Treasurer asked the IC to undertake a stocktake of progress on microeconomic reform and to advise on specific areas for further reform. The Treasurer announced the stocktake in late March and called for a report by end June 1996.

The request did not come as a formal public inquiry. However, the Government's requirements were set out in a media release (attachment A1) and letter to the IC (attachment A2).

The stocktake has been conducted as a joint exercise of the three agencies forming the Productivity Commission: the BIE, EPAC and the IC. It has drawn heavily on the staff and reports of each of these agencies.

Within the limited time frame for the project, the Commission has had the benefit of input from a wide range of interests.

- Submissions were invited from around 80 business and community groups. Forty-five submissions were received (attachment A3).
- All Commonwealth government departments and State and Territory governments were requested to provide information on reform developments within their areas of responsibility. (Respondents are listed in attachment A4.)
- Discussions were held with a number of individuals and agencies with particular interest in and relevance to this exercise (attachment A5).
- In the absence of public hearings, three 'roundtable' discussions were held, covering business, community groups and experts in the area of microeconomic reform (attachment A6).

In addition, a background paper on taxation was commissioned from Dr Robert Albon, Senior Lecturer in Economics at the Australian National University. The paper, *An Overview of Australia's Taxation Structure*, is available from the Commission on request.

In keeping with the Government's intentions to avoid duplication, the stocktake has taken account of the National Commission of Audit, the recently announced review of the financial system and the concurrent Productivity Commission study on labour market benchmarking.

Attachment A1: Contents of the Treasurer's press release

Industry Commission to produce a stocktake of microeconomic reform and advise on future reform agenda

The Prime Minister indicated in announcing the composition of the Ministry that a new Productivity Commission, combining the functions of the Industry Commission, the Economic Planning Advisory Commission and the Bureau of Industry Economics, would be established in the Treasury portfolio.

In line with that announcement I have asked Mr Bill Scales, Chairperson of the Industry Commission, to undertake the amalgamation of the agencies on an administrative basis pending the passage of the necessary legislation.

Also, pending the creation of the new Commission, I have asked the Industry Commission to carry out a stocktake of progress on micro-economic reform and to provide advice on specific areas for reform.

This will not be a formal inquiry but the Commission will consult with interested parties to facilitate consideration of the full range of views.

In line with the Government's focus on improving Australia's competitive performance, the Commission will place emphasis on specific areas which impact on our international competitiveness.

It will also advise on the implementation of any specific initiatives it suggests as well as on any measures needed to ease the transitional costs of adjustment to possible reform initiatives.

The Commission has been asked to produce a report within three months. The Government intends to publicly release the report.

Canberra ACT 2600

28 March 1996

Attachment A2: Contents of the Treasurer's letter

30 April 1996

Mr W I Scales AO
Chairman
Industry Commission
Locked Bag 2
Collins Street East
MELBOURNE VIC 3000

Dear Mr Scales

In my press release of 28 March 1996 I announced that, pending the creation of the Productivity Commission, the Industry Commission is to undertake a stocktake of progress on microeconomic reform and to provide advice on specific areas for reform.

As this is not a formal public inquiry and given the guidance provided by the Press Release and various Policy Statements, I do not propose to provide a formal terms of reference.

However, I would emphasise that the Government intends the exercise to be wide ranging. It is to cover all sectors of the economy, including government services and infrastructure, the operation of markets for labour and capital, and the scope for change in the nature and extent of government intervention. Within this broad scope, the Commission should place particular emphasis on areas which impact on the productivity and international competitiveness of Australian industries.

I would also emphasise that the Government intends this exercise to be forward looking. It is to recommend specific reforms and indicate the areas where further action is most needed, including potential areas of reform requiring further information and review. The exercise is to highlight performance gaps and benefits from further reform and also implementation and adjustment aspects of any specific initiatives.

The Commission should be mindful of related review exercises. In particular it is to take account of and minimise duplication with the National Commission of Audit, the foreshadowed review of the financial system, and the Commission's separate study into benchmarking microeconomic reform initiatives, which has the particular aim of identifying restrictive work practices and other arrangements which unnecessarily add to the costs of doing business.

As foreshadowed in the press release, the stocktake is not to be a formal public inquiry, but the Commission is to consult with interested parties to facilitate consideration of the full range of views. The Commission is to report by 30 June 1996.

Yours sincerely

PETER COSTELLO

Attachment A3: Submissions received

<i>Participant</i>	<i>Submission number</i>
Aged Care Australia	17
Aircraft Owners and Pilots Association of Australia	1
Association of Mining and Exploration Companies (Inc)	21
Australian Automobile Association	12
Australian Business Chamber	29
Australian Catholic Social Welfare Commission	18, 43
Australian Chamber of Shipping Ltd	2
Australian Chamber of Commerce and Industry	16
Australian Chamber of Manufactures	28
Australian Conservation Foundation	3
Australian Electrical and Electronic Manufacturers' Association Ltd	19
The Australian Gas Association	24
Australian Petroleum Pty Ltd	10
Australian Shipowners Association	7
Australian Tax Research Foundation	8
Australian Youth Policy & Action Coalition Inc	13
BHP	30
Brotherhood of St Laurence	20
Building Owners and Managers Association	31
Business Council of Australia	38
The Chamber of Mines and Energy of Western Australia	32
Churches of Christ Care	6
Civil Contractors Federation	39
Consumers' Federation of Australia Inc	22
Council of Textile and Fashion Industries of Australia Ltd	36
Eastern Suburbs Community Groups	25

(Continued on next page)

Attachment A3 (continued)

<i>Participant</i>	<i>Submission number</i>
Electricity Supply Association of Australia Ltd	23
IBM Australia Ltd	26
ICI Australia	34
Institute of Applied Economic and Social Research	42
Liner Shipping Services Ltd	15
Minerals Council of Australia	40
Metal Trades Industry Association	27
National Association of Forest Industries Ltd	4
National Farmers' Federation	37
NatRoad Ltd	9
NRMA	44
Plastics and Chemicals Industries Association	33
Professor John Quiggin, James Cook University	45
Public Interest Advocacy Centre	14
Pulp & Paper Manufacturers Federation of Australia	11
Road Transport Forum	35
Professor Judith Sloan, National Institute of Labour Studies	5
Taxation Institute of Australia	41

Attachment A4: Contributions from Commonwealth, State and Territory government departments

	<i>Departmental paper number</i>
State/Territory departments	
The Cabinet Office – New South Wales	1
Department of Premier and Cabinet – Victoria	2
Department of the Premier and Cabinet – Queensland	3
Treasury – Western Australia	4
Department of the Premier and Cabinet – South Australia	5
Department of Premier and Cabinet – Tasmania	6
Chief Minister’s Department – Australian Capital Territory	7
Commonwealth departments	
Attorney-General’s Department	8
Australian Competition and Consumer Commission	9
Department of Administrative Services	10
Department of Communications and the Arts	11
Department of Defence	12
Department of Employment, Education, Training and Youth Affairs	13
Department of the Environment, Sport and Territories	14
Department of Finance	15
Department of Foreign Affairs and Trade	16
Department of Immigration and Multicultural Affairs	17
Department of Industrial Relations	18
Department of Industry, Science and Tourism	19
Department of Primary Industries and Energy	20
Department of Social Security	21
Department of Transport and Regional Development	22
Department of the Treasury	23
Department of Veterans’ Affairs	24

Attachment A5: Informal discussions

Business Council of Australia (Australian Competitiveness Panel)

COAG Secretariat

Commonwealth Department of the Treasury

Council of Small Business Organisations of Australia

Department of Premier and Cabinet – Victoria

Department of the Prime Minister and Cabinet

Evatt Foundation

Dr Mark Harrison, Department of Economics, Australian National University

Institute of Applied Economic and Social Research

Minerals Council of Australia (Economics, Technology and Trade Committee)

MTIA (National Business Strategy Group)

National Competition Council Secretariat

Reserve Bank of Australia

Treasury – New South Wales

Attachment A6: Roundtable meetings

Roundtable of experts

7 May 1996 (12.30 pm – 4.00 pm)

Professor Peter Dawkins Director, Institute of Applied Economic and Social Research	
Dr Vince FitzGerald Executive Director, Allen Consulting Group	Apology
Mr Denis Hussey Managing Director, ACIL Economics and Policy	
Mr Roger Kerr Executive Director, New Zealand Business Roundtable	Apology
Mr Mike Nahan Executive Director, Institute of Public Affairs	
Professor John Nevile School of Economics, University of NSW	
Dr Michael Porter Executive Director, Tasman Institute	Apology
Professor John Quiggin Department of Economics, James Cook University	Apology
Dr Ed Shann Director, Access Economics	
Professor Peter Sheehan Director, Centre for Strategic Economic Studies	Apology
Professor Judith Sloan Director, National Institute of Labour Studies	
Dr Andrew Stoeckel Executive Director, Centre for International Economics	
Professor Cliff Walsh Executive Director, South Australian Centre for Economic Studies	

(Continued on next page)

Attachment A6 (*continued*)

Business roundtable

10 May 1996 (12.30 pm – 4.00 pm)

Mr Fergus Ryan
Australian Managing Director, Arthur Andersen
(represented by Mr Phil Anderson, Partner)

Mr Ian Spicer
Chief Executive Officer, Australian Chamber of Commerce and Industry
(represented by Mr Brent Davis, Director)

Mr Allan Handberg
National Chief Executive, Australian Chamber of Manufactures
(represented by Ms Penny Taylor, Manager ACT Region)

Ms Judith King Apology
Executive Director, Australian Coalition of Service Industries

Mr Allan Horsley
Managing Director, Australian Telecommunications Users' Group
(represented by Brigadier Neil Horn, Director)

Dr Robin Stewardson
Chief Economist, BHP Ltd
(represented by Mr Mike Waller, Director of Public Policy)

Mr Bob Lim
Director Policy Analysis and Research, Business Council of Australia
(represented by Mr Claude Piccinin, Assistant Director)

Mr Rob Bastian
Chief Executive Officer, Council of Small Business Organisations of Australia

Mr Bill Shields
Executive Director and Chief Economist, Macquarie Bank

Mr Tony Cole Apology
National Practice Leader, W M Mercer Pty Ltd

Mr Leigh Purnell
Director, Metal Trades Industry Association

Mr David Buckingham
Executive Director, Minerals Council of Australia
(represented by Mr Ron Knapp, Deputy Director)

Dr Robert Bain
Executive Director, National Association of Forest Industries

Dr Wendy Craik
Executive Director, National Farmers' Federation
(represented by Mr Todd Ritchie, Director Economic Policy)

(Continued on next page)

Attachment A6 (*continued*)

Community roundtable

17 May 1996 (10.00 am – 4.00 pm)

Mr Toby O'Connor

National Director, Australian Catholic Social Welfare Commission

Professor David Yencken

President, Australian Conservation Foundation

(represented by Mr Tim Fisher, Natural Resource Campaign Co-ordinator)

Ms Louise Sylvan

Chief Executive Officer, Australian Consumers' Association

(represented by Mr Peter Kell, Senior Policy Officer)

Mr Robert FitzGerald

President, Australian Council of Social Services

Apology

Ms Jennie George

President, Australian Council of Trade Unions

(represented by Mr Peter Moylan, Industrial Officer)

Dr David Widdup

Director, Australian Federation of Consumer Organisations

Ms Alison McClelland

Deputy Director, Brotherhood of St Laurence

Professor Mark Lyons

Centre for Australian Community Organisations and Management

Mr Michael Costa

Assistant Secretary, Labor Council of NSW

Sister Margaret McGovern

formerly Chief Executive Officer, Mercy Family Centre

Apology

Ms Liza Carver

Senior Solicitor, Public Interest Advocacy Centre

Apology

Professor Peter Saunders

Director, Social Policy Research Centre

Apology

APPENDIX B: TRANSPORT AND OTHER INFRASTRUCTURE

This appendix commences with a brief overview of the significance of transport and other infrastructure in Australia. It subsequently provides a stocktake of microeconomic reform in rail (section B.2), roads (B.3), ports and the waterfront (B.4), shipping (B.5), aviation (B.6), electricity (B.7), gas (B.8) and postal services (B.9).

B.1 The significance of the infrastructure industries

Transport and other infrastructure are a major part of Australia's economy, representing 12 per cent of GDP (table B.1). Communication services is the largest infrastructure industry, accounting for 3.3 per cent of GDP and 1.8 per cent of employment.

Table B.1 **Output and employment in the transport and other infrastructure industries, 1994–95**

	<i>Gross product</i>		<i>Employment</i>	
	<i>Level</i>	<i>Share of economy</i>	<i>Level</i>	<i>Share of economy</i>
	\$m ^a	%	'000	%
Total transport and other infrastructure	50 427	12.2	616.4	7.6
Communication services	13 467	3.3	148.2	1.8
Road transport ^b	10 180	2.5	178.6	2.2
Electricity	8 947	2.2	50.8	0.6
Air transport	5 470	1.3	43.4	0.5
Water supply, sewerage & drainage	3 651	0.9	28.5	0.4
Water transport	2 834	0.7	9.3	0.1
Rail	2 151	0.5	53.5	0.7
Gas	851	0.2	7.6	0.1
Total economy	412 593	100.0	8 093.1	100.0

^a In constant 1989–90 prices. ^b Road transport gross product figures are ABS unpublished working estimates.

Sources: ABS, Cat. No. 5206.0; BTCE (1995a); unpublished working estimates supplied by the ABS.

Road transport is the largest of the transport industries, accounting for 2.5 per cent of GDP and 2.2 per cent of employment. While the output of rail is much smaller, it is relatively labour intensive. Thus, it is the second largest employer in the transport sector.

Over the past decade, strong growth in the communication services industries (telecommunications and post) has driven the 4.5 per cent average annual growth in the transport and infrastructure industries. The transport industries have grown at an average 3.6 per cent a year, with aviation exhibiting the strongest growth.

B.2 Rail

Rail plays a major role in moving coal, iron ore and grain to ports, and in carrying commuters, mainly in urban areas. Rail accounts for 0.5 per cent of GDP and employs over 50 000 persons.

Recent rail reforms

Australian public railways have been developed as independent State networks with substantial differences in technical standards, labour and managerial practices. Previous studies have identified major shortcomings in pricing, service quality, productivity and the financial performance of public rail authorities. The IC (1991h) estimated that government railways drained public sector savings by \$4 billion annually.

Rail reform commenced with administrative changes focusing on better management, improving work practices, reducing staff levels and replacing and upgrading obsolete equipment. Commercialisation involved establishing rail operations as GBEs. It included explicit funding of CSOs and the establishment of separate business units. In more recent times, the scope of rail reform has broadened.

Rail authority reforms

Partly as a result of differences in internal management priorities and government policy initiatives, the pace and nature of reforms has varied between systems. For example:

- The operations of Australian National (AN) are being rationalised as key functions (for example, interstate freight) are transferred to the National Rail Corporation (NR). AN is now concentrating on long distance passenger services and freight operations in South Australia and Tasmania.

-
- The Public Transport Corporation of Victoria (PTCV) has been separated into five businesses (V/Line Passenger, V/Line Freight, Met Trains, Met Tram and Met Bus). It has reduced its rolling stock and its labour force (by 49 per cent) and also its call on government funds (by 41 per cent or \$250 million).
 - Queensland Rail (QR) was corporatised in July 1995 and now faces competition in its non-coal activities. QR is phasing in commercial pricing for coal and minerals.
 - In New South Wales, the Rail Access Corporation (previously RailNet) is to manage third party access to the State's rail network. Separate business groups within the State Rail Authority of New South Wales (SRA) will operate intrastate freight operations (Freight Rail), metropolitan/regional passenger services (CityRail) and long distance passenger services (Countrylink), while the Railway Services Group will manage the non-core assets of individual business units. Some activities have been contracted out.
 - In Western Australia, the *Right Track* program will lead to Westrail focusing on core activities (bulk freight and passengers), with non-core functions being contracted out. Westrail's work force will be cut by over 40 per cent and competitive neutrality reforms will be introduced (involving, for example, a tax equivalent regime and separate funding of passengers (CSOs)).

For a more detailed summary of current reforms see SCNPM (1996).

Interstate freight

Cooperation between the States and the Commonwealth has led to the creation of NR, which has responsibility for interstate rail freight. NR's acquisition of rolling stock was delayed by disagreements between NR and other rail systems over the quality and appropriateness of wagons and locomotives offered for transfer. However, in February, NR announced a \$275 million investment program for new locomotives and wagons.

To improve the efficiency of its rail freight business, NR was granted additional Commonwealth funds to standardise the rail gauge from Melbourne to Adelaide and from Acacia Ridge to the Port of Brisbane. The standard gauge now links all mainland capitals. The Melbourne–Sydney and Sydney–Brisbane rail lines were also upgraded, as were terminals in Melbourne and Sydney. A recent BTCE (1994) report found that a further \$3.2 billion could be invested in rail over the coming 20 years with benefits exceeding costs — although for many of the projects, greater benefits would accrue if the investment was in road rather than rail infrastructure.

Access arrangements

Reforms have been introduced to open up the track networks to third parties. In 1995, the Commonwealth and AN's Track Access Unit established the only access pricing regime for an interstate rail network. Since July 1995, Specialised Container Transport has operated a weekly service from Melbourne to Adelaide. TNT expects to commence interstate services in mid-1996.

Private operators currently have to negotiate access with the rail authorities responsible for each section of the interstate network. However, the Commonwealth is currently looking at establishing, in partnership with the states, a national rail infrastructure authority to provide greater efficiency in the management of access to the interstate network.

Current rail performance

The performance of rail in Australia today reflects the very poor performance of rail at the start of the reform period, as well as the variability in the pace and nature of the reforms between systems.

In general, rail freight charges have fallen by around 19 per cent since 1989–90. Over the same period, passenger charges have risen. Labour productivity has increased by 50 per cent. This has supported 10 per cent increases in the level of cost recovery and return on assets (SCNPM 1995).

As a result of these performance improvements, the BIE has estimated that Australian rail freight systems have closed 42 per cent of the identified gap against world best practice. However, cost recovery levels remain low (in 1993–94 the industry recovered only 73 per cent of its costs), and the Australian systems need to reduce their 1993–94 operating costs by a further 24 per cent (about \$500 million) to match world best practice (BIE 1995i).

For rail freight, the greatest improvements have taken place in the PTCV, Westrail and AN. QR and the SRA have further to go to achieve world best practice. At the current pace of reform, Australia, on average, could meet best practice by the year 2000. The PTCV may already have achieved the necessary gains, but QR is not expected to reach world best practice within 15 years (BIE 1995i). The recent BIE (1995i) study also found that Australian coal rail freight rates are 50 per cent above observed world best practice, while grain rates are broadly comparable.

Reflecting its relatively poor performance, a number of participants were particularly critical of rail in Queensland. For example, BHP indicated that it costs

three times as much to transport coal in Queensland than it does to transport iron ore on its own rail systems in Western Australia. BHP estimated that:

... improved competition could give rise to cost savings to BHP Minerals in the order of \$300 million per year in Queensland alone (Sub. 30, p. 12).

The performance of the Commonwealth's rail corporations has also come under scrutiny. Despite halving its operating deficit (around \$150 million a year) and some recent freight rate reductions, NR's difficulties in acquiring suitable rolling stock have had a negative impact on its reliability. For example, the Plastics and Chemicals Industries Association indicated that:

... difficulties have been encountered in booking rail wagons and transit times have increased due to greater demands on limited rolling stock (Sub. 33, p. 3).

AN's deteriorating financial performance (a \$9.6 million profit in 1993–94, a loss of \$48.5 million in 1994–95 and expected higher losses in 1995–96) has prompted a review of its activities. The review is assessing the most practical future for those operations which have not been transferred to NR. The review will also examine AN's commercial prospects and possible contracting-out and business disposal strategies.

Rail reform options

Past reforms have delivered significant improvements in the operation of Australia's rail systems. However, the need for further reform of rail is clear cut. The IC (1995a) recently estimated that the gains from further reform of rail could increase GDP by \$1.2 billion.

While some participants stressed the importance of achieving best practice, others emphasised particular aspects of the rail reform agenda. For example, Liner Shipping Services and BHP highlighted the importance of introducing a rail access regime which is consistent across the States. The Chamber of Mines and Energy of Western Australia pointed to the need for more commercial pricing and management practices, as well as allowing third party access to the rail track. The Australian Chamber of Shipping emphasised the need to improve customer service, in particular at the point of interface between transport modes.

A cooperative approach between the Commonwealth and State governments and their rail authorities will be required to progress rail reform. Rail authorities must be subject to the reforms set out in the Competition Principles Agreement. There is also a need to introduce performance enhancing initiatives by paying particular attention to cost savings in corporate overheads, rolling stock maintenance, signalling and

control. Attention also needs to be paid to coal freight rates, which remain at unjustifiably high levels and adversely impact on a major export industry.

The operations of public rail authorities should mimic a commercial operation. In competing with road transport, rail should not be advantaged by regulations which tie certain commodities to rail, or by exemptions from requirements to earn a rate of return and to pay all commercial dividends, taxes and interest payments (or their equivalents). At the same time, the managers of rail corporations should be free to establish commercial capital structures and to introduce flexible employment and purchasing arrangements — including the contracting-out of non-core functions.

Consistent with road transport, the operation of the rail track bed should be separated from the operation of rolling stock. Access to the track bed should be determined on commercial grounds, subject to non-discriminatory safety and engineering requirements. As far as possible, users of the track bed should not be able to distinguish between the various owners of the track. This could be achieved by a single owner of the interstate and intrastate track. Alternatively, multiple ownership of the track bed could be retained, but with a single access arrangement, or with a set of consistent access arrangements. Abuse of monopoly powers by the track bed owner could be constrained by appropriate prices oversight and asset valuation arrangements.

In such an environment, commercial realities would determine when public rail corporations introduce new services or cease uneconomic services. The cost of providing CSOs could be minimised by putting them up for competitive tender so they could be provided by either a public or a private operator.

The reform of AN and NR should be progressed immediately.

B.3 Roads

The value of Australia's road network is estimated at between \$42 billion and \$100 billion. This is larger than the assets of either the combined electricity and gas industries or the rail industry. Similarly, road transport contributes more to GDP (2.5 per cent) than any other transport industry.

Road transport is the most important transport mode for both passenger and freight movements. It accounts for 70 per cent of the freight transport task and nearly 60 per cent of the transport work force. Road freight is also an important business input, typically accounting for between 3 and 5 per cent of industry costs.

Revenue from road-related taxes and charges (\$13 billion) is well in excess of annual road expenditure (\$6 billion). The balance between revenue collection and expenditure has changed substantially over the past decade, with Commonwealth fuel excise taxes trebling. The Commonwealth's share of aggregate road revenue has also risen — from 47 per cent in 1984–85 to over 60 per cent in 1994–95. Yet the burden for road expenditure has increasingly fallen on State and local governments.

Recent road issues

Recent developments in the roads sector can be categorised into: road laws and regulations; funding and allocation; and road construction and maintenance. Road transport issues also encompass the operation and regulation of buses, taxis and many other public transport issues. While important, these issues were not identified as priority areas for reform by participants and are not examined in this report. Urban transport issues were examined by the IC in an earlier report (IC 1994b).

Road laws and regulations

Under an intergovernmental agreement on road transport, the Commonwealth, State and Territory governments agreed to develop and implement a national system of uniform regulations and heavy vehicle charges. Uniformity is being pursued in order to improve the efficiency, safety and competitiveness of the road transport industry. To progress these reforms, the National Road Transport Commission (NRTC) was established in 1991 to identify and recommend the necessary legislative changes. These reforms are then submitted to the Ministerial Council on Road Transport (MCRT) for approval.

The NRTC has proposed a range of road reforms including: uniform national registration charges for heavy vehicles; a national licensing system for heavy vehicle drivers; mass and loading regulations; and regulation of truck driving hours. Governments have agreed on uniform charges for heavy vehicles. However, progress in implementing the other reforms has been slow.

A number of participants indicated that these delays reflected a serious gap in the reform of road transport. For instance, DTRD acknowledged that there have been:

... occasions of lack of active commitment and reluctance by some jurisdictions to progress some issues (Departmental paper 22, p. 5).

Funding

Since January 1994 the Commonwealth's direct road funding responsibilities have been confined to the 18 500 km National Highway System, although it continues to indirectly fund both State and local governments through 'identified road grants'. These grants complement the funds raised by State and local governments for road expenditure through taxation and land rates.

As noted above, the gap between road revenue and expenditure has widened considerably. A number of participants, including the Australian Automobile Association, argued that recent declines in road expenditure represent an underinvestment in roads which should be reversed. While it is unclear whether there is a current underinvestment, the argument poses a number of basic questions about road investment. First, is the level of road funding appropriate? Second, is the allocation of road funds between competing projects efficient?

The process of determining road funding priorities and its allocation has been problematic for many years, with funding decisions often determined by political as much as by economic considerations. Reform in this area would entail redirecting road expenditure toward those investments exhibiting the highest benefit–cost ratios, such as urban roads. This has already begun at the Commonwealth level and is also being implemented at the State level.

The Commonwealth has also been active in promoting reform in the road supply industry. In 1994 the Commonwealth introduced a three-year rolling funding program designed to promote the cost-effective delivery of the roads program. This program allocates funds for new construction on a needs basis, with benefit–cost ratios determining priorities. The Commonwealth has also negotiated performance agreements with all States and Territories (with the exception of Western Australia). These agreements should enable the various State road authorities to be benchmarked against each other.

While these programs appear to go some way to addressing road funding concerns, a paper prepared for the BCA argued that:

The greatest microeconomic reforms in the road transport sector will come from a re-allocation of existing road expenditures to projects which provide greater economic returns (Cox 1994).

The BCA study found that:

Microeconomic reform benefits of 2.5 per cent of GDP could be realised through a better distribution of investment funds and a 10 per cent efficiency increase in the use of construction and maintenance expenditures (Cox 1994).

These potential benefits are far in excess of benefits from other transport or infrastructure reforms. This reflects the size of the road transport industry, as well as the absence of an effective pricing instrument.

In the majority of market transactions, user charges/prices are the mechanism which: allocate the existing infrastructure among current users and indicate when and where new investment should take place. In the case of roads, fuel excises can generate the necessary revenue to cover road expenditure, but they are one step removed from decisions relating to road usage and investment.

However, for the majority of Australia's roads, the absence of a direct pricing mechanism does not contribute to inefficiencies. Indeed, introduction of road user charges could impose efficiency costs for uncongested roads which have many public good characteristics (that is, to a large extent they are not competitive in consumption and it is difficult/costly to exclude individuals from using them).

The same cannot be said for congested roads in large urban areas. Congestion creates delays which introduces a competitive element into road usage. Technological developments have made it easier to electronically monitor individual road usage patterns and to impose direct road charges. Direct charges would discourage road users from travelling on heavily congested roads and encourage travel outside peak periods. By acting as a rationing device, road user charges would reduce and disperse the demand for road infrastructure, thereby delaying investments in new roads. Road user charges also provide a direct means of indicating when and where new road investments should take place.

A recent BTCE (1996a) study indicated that the potential benefits (for example, reduced travel times and fuel consumption) from road congestion charges are highest in Melbourne and Sydney and lower in the smaller cities of Adelaide, Canberra and Perth. Modelling work undertaken for the study indicated that:

In Melbourne ... congestion is concentrated on a relatively small central area near the CBD, where the economically efficient charge would be in the order of \$1.26 per kilometre travelled. Only nine kilometres from the centre the charges are less than a tenth of this value. These concentrated charges encourage drivers to divert their routes around the central area. Thus average speeds over the whole city can be increased by 35 per cent at a cost of reducing road travel by a relatively modest 16 per cent (BTCE 1996a, p. 74).

In the absence of direct charging, normal investment analysis cannot be undertaken as there are no known revenue streams linked to the new investment. Rather, more complex cost-benefit analyses have to be undertaken. They need to take into account a number of externalities associated with road travel. These studies are complex exercises and may not be justifiable for minor projects. However, given the

size of the potential benefits from rectifying the current misallocation of road investment funds, there is clearly much to be gained from the widespread application of cost–benefit analyses to road investment.

Road construction and maintenance

Reform of road construction and maintenance has typically involved:

- setting clear corporate goals and objectives for State road authorities to allow performance monitoring; and
- an increased focus on contracting out.

In addition to corporatisation, some State governments, in particular Victoria and New South Wales, have been active in promoting private sector involvement in financing and operating roads and tollways. For example, in Sydney, the M2, M4 and M5 motorways are operated privately, while Transurban will build and operate the City Link project in Melbourne. These projects are valued at \$3 billion. However, EPAC (1995d) has cast doubts on the benefits from privately owned roads and indicated that contracting out road construction and maintenance will generally be preferable to private financing.

Current road performance

Benchmarking the performance of road construction and maintenance has proceeded relatively slowly due to definitional disagreements and a paucity of consistent data. However, the various State road authorities are gradually accepting the need for benchmarking.

A BIE (1992b) study compared the performance of Australia's road freight transport industry with those in the United States, Canada and the United Kingdom, and found that:

- the cost of Australia's short-haul trucking operations were equivalent to those in the United States and Canada, but well above costs in the United Kingdom; and
- the cost of Australia's long-haul trucking operations were equivalent to those in Canada, below costs in the United Kingdom, but well above costs in the United States.

After excluding taxes and charges from the calculation of costs, Australia was ranked second in terms of short-haul trucking and first for long-haul trucking.

Road reform options

There has been steady reform of road construction and maintenance in recent years. The current trend to increase the level of contracting out should be continued, subject to the requirements detailed in the IC's recent report on competitive tendering and contracting (IC 1996a). Further work is required to satisfactorily benchmark Australia's road authorities against each other and against their international counterparts. This should help in improving performance and identifying future reform priorities.

Better targeting of the existing road budget is also important, and should be a major priority for State governments and their road authorities. The allocation of road funds would be improved by adopting the principles proposed by the EPAC Private Infrastructure Task Force.

Given the significance of the road network, its efficient use should also be a priority. Efficient pricing is a prerequisite to efficient use. In principle, users should pay the full economic cost of road use, including the effects on third parties and the environment. The traditional proposal, and the one preferred by the IC in its urban transport inquiry, is for users to be charged the incremental costs associated with their usage of roads, as well as an 'access fee' to cover the fixed costs of providing roads (IC 1994b).

A form of congestion pricing is needed in busy urban areas. This could involve an incremental approach based on electronic road pricing, commencing in Sydney and Melbourne with tolls (preferably electronic) on certain new or upgraded urban arterial roads, bridges and tunnels. Wherever practicable, tolls should be extended to existing arterial roads and differentiated by time of travel to create controlled access to congested areas. However, tolls and related charges should not be used to raise additional revenue from motorists in total, but rather to shift the burden towards those who impose the greatest costs.

Irrespective of the revenue-raising devices used, the quantum of revenue raised from road users should be sufficient to cover road construction and maintenance costs and a rate of return on the existing road asset base. Road-related taxes should be designed to minimise distortions in consumption, so that goods for which demand is relatively responsive to changes in prices should be taxed least whilst goods for which demand is relatively unresponsive to changes in demand should be taxed most. Taxation of petroleum fuels or other road-related inputs should follow the standard taxation principles of minimising taxes on intermediate inputs and minimising administration costs.

B.4 Ports and the waterfront

The waterfront's direct contribution to economic activity is relatively small at around 0.25 per cent of total employment (approximately 20 000 persons) and 0.3 per cent of GDP (\$1.2 billion).

However, the waterfront's importance to Australia lies not in its direct contribution to economic activity, but in its role as a facilitator for international trade. For instance, in value terms, around three-quarters of Australia's imports and exports pass over the waterfront (including the majority of Australia's commodity exports).

Waterfront reforms have comprised two distinct elements: reform of government owned port authorities; and labour market reforms.

Port authority reform

Recent port reforms

Port authority reforms have focused on administrative and structural arrangements. The reform initiatives vary between States and between port authorities within each State. Nonetheless, port authority reform has generally involved the shedding of non-core services and activities and a move towards a landlord function. This is in line with the recommendations made by the IC (1993c).

In New South Wales, for instance, the move to a landlord function has been accompanied by the corporatisation of the ports of Newcastle, Port Kembla and Sydney. The key objectives of this process include increasing competitiveness, as well as improving services to port customers. In Victoria, the ports of Geelong and Portland have been privatised, the Port of Melbourne corporatised, and the Victorian Channel Authority has been established.

While other States have corporatised port authorities, the divesture of non-core assets has not automatically followed. For instance, in Western Australia, the management of the corporatised port authorities is responsible for maintaining those non-core activities which they can provide on a commercial basis.

Current port performance

Since the beginning of the reform process, port authorities have generally improved their financial performance, cut real charges and reduced costs. The SCNPM (1995) found that since 1989–90: average real prices for port authority services have fallen

by 14 per cent; and real revenue per employee has increased. In 1993–94, authorities paid around \$65 million in dividends.

However, concerns have been expressed that the benefits of port authority reforms are accruing to government treasuries rather than port users (NTPT 1994). The Australian Chamber of Shipping (ACOS) argued that requiring ports to return fixed dividends to State treasuries was akin to taxation (Sub. 2, p. 8). In addition, ACOS (Sub. 2, p. 11) argued that, despite recent declines, overservicing still continues in some areas as ‘more tugs are employed for berthing and unberthing than are really necessary’.

Port reform options

While the performance of Australia’s ports has improved in recent years, further reforms consistent with competition policy objectives would intensify the commercial incentives in Australia’s ports. Further reform has been estimated to raise GDP by around \$90 million per annum (IC 1995a).

There are difficulties in striving for commercial reforms in industries where competitive pressures are muted. In general, ports do not compete for the great majority of the goods which pass through them. As a result, port owners and managers possess considerable discretion when valuing assets and pricing port services. Furthermore, market and legal barriers can limit the extent to which competitive forces place a discipline on port practices and costs. For example, partly because of the volume of traffic which passes through Australian ports, the market structure for many port services, such as towage and stevedoring, is either monopolistic or duopolistic. In many ports, there will have to be a large increase in the volume of trade for these circumstances to change, at least in respect of pilotage and towing. In addition to these market constraints, entry by new service providers within a port is often controlled by licence arrangements.

The ACCC (1995, p. xiv) identified a possible solution to poor performance in harbour towage when it noted the potential role for:

... competitive performance-based tendering and the use of non-exclusive licences issued by state and territory governments or their instrumentalities to facilitate competition in the supply of harbour towage.

The ACCC argued that, given the natural monopoly characteristics of towage services in some ports, pro-competitive reforms are unlikely to be a panacea for weak competition in harbour towage. In the interim, the ACCC’s recommendation that price surveillance be replaced by price monitoring is likely to raise the

transparency of towage costs and introduce an element of yardstick competition into harbour towage.

Entry barriers should not be exploited by State governments and their port authorities to capture monopoly profits. As far as possible, entry barriers to port service providers should be minimised. Where licences are required, they should be non-exclusive and based on competency requirements (for example, for towing, piloting and mooring). Any licence fees should reflect the costs of the facilities provided by the port authority and used by the licensee. Oversight arrangements and performance targets should be included in the tender documents and licence conditions, to ensure that the successful service providers do not, in turn, abuse the market power they possess. These reforms should be integrated with broader reform to corporatise ports and to apply competition policy reforms.

Waterfront reform

Waterfront reform

Problems with inefficiencies and unreliability on Australia's waterfront were identified over three decades ago by the National Stevedoring Industry Conference and again in 1986 by the Webber task force on shore-based shipping. These issues were further explored by the Inter-State Commission's 1989 inquiry which led to the establishment of the Waterfront Industry Reform Authority (WIRA). The WIRA reform process adopted a consensus approach involving industry, unions and government and, upon completion in 1992, had cost just under \$440 million (\$413 million of which was outlaid on early retirement and redundancy packages).

In addressing the major achievements of the reform process, WIRA (1992, p. 5) stated:

- Enterprise employment has replaced industry based employment arrangements;
- The parties have achieved a reliable, efficient and competitive stevedoring industry;
- [There had been] reform of work practices through enterprise agreements, the introduction of the new skills level based on a career path Stevedoring Industry Award, and the introduction of comprehensive training plans ... ; and
- The work force has been reduced by 57 per cent while handling similar quantities of cargo as in the peak period of 1989.

Reform of the waterfront has continued slowly since the end of the WIRA process in 1992. In some areas, there is evidence of backsliding.

Current waterfront performance

The initial improvements in stevedoring productivity benefited port users through lower charges and faster turnaround times. For instance, a recent BTCE (1995b) review indicated it benefited Australians by \$203 million in 1993. In addition, the PSA (1995a) claimed that, over the seven years to 1993, the real price of container stevedoring services fell by 42 per cent. While the bulk of this reduction occurred in 1991 and 1992, not all of the price falls were due to the impact of the WIRA reforms — lower volumes also placed downward pressure on stevedoring charges.

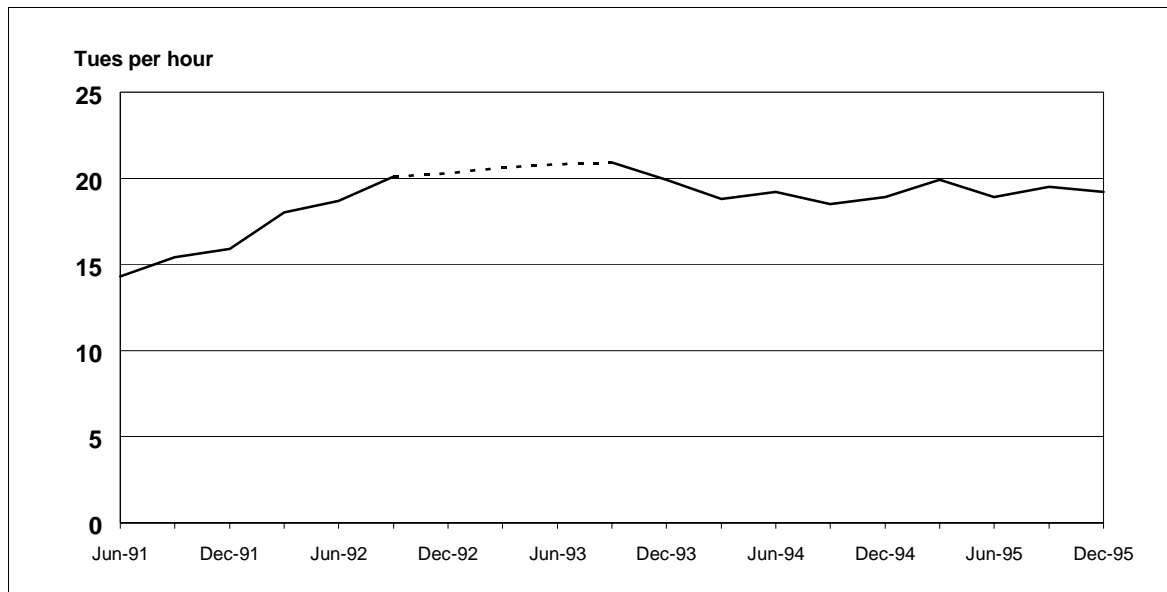
The recent performance on the waterfront tends to support assessments which question whether the WIRA reforms went far enough and whether they could be sustained in the longer term. For instance, Swan Consultants (1993) identified potential gains that would boost Australia's GDP by \$1.1 billion annually and create an additional 3900 jobs. The National Transport Planning Taskforce (NTPT) expressed concern over whether cultural changes had accompanied the move to enterprise employment, both in companies and work forces. In addition, the task force stated:

Users and operators also noted recent significant declines in workplace performance and questioned whether present levels of competition were sufficient to maintain the pressure for continuing improvement' (NTPT 1994, p. 21).

A number of participants in this inquiry attributed poor performance to high levels of industrial disputation, partly the result of single union coverage of both the shipping industry and ports (both bulk and container). Consequently, disputes which had previously only affected shipping now impact on the waterfront, and vice versa. In addition, disputes involving shipping and container operations are now affecting the bulk ports as well.

These comments are supported by evidence on the recent performance on the waterfront. From mid-1991, crane rates (containers moved per crane hour) started to show improvements, coinciding with the introduction of the enterprise agreements. The national average container rate increased from 12.8 teus per hour in 1989 to 20.1 teus per hour in September 1992. Subsequently, there have been some serious setbacks. From the September quarter 1993 to the December quarter 1995, crane rates fell at Melbourne, Sydney and Brisbane, but increased marginally at Fremantle and Adelaide. The overall five port average fell by just under 10 per cent between September 1993 and December 1995 (figure B.1). Further, the time lost due to industrial disputes was twice as high in 1994 and 1995 than during the WIRA reforms of the early 1990s (BTCE 1996b).

Figure B.1 **Crane rates, average of five major Australian ports, June 1991 to December 1995**



Source: BTCE (1996b).

The decline in crane rates, combined with continued improvements in many overseas ports, means that Australian crane rates are no longer on a par with similarly sized overseas ports (BIE 1995d). Crane rates at the best performing Australian container terminal are equivalent to some of the poorest performers in Europe. More generally, Australian crane rates are 25–50 per cent behind the better performing ports.

The BIE (1995d) found that poor productivity in container operations was reflected in:

- poor turnaround times, with 50–100 per cent longer time being required to unload and load a container ship in Australia compared with similar overseas ports;
- a sizeable proportion of container vessels experiencing delays in excess of two days; and
- container terminal charges being a major contributor to Australia's relatively high waterfront charges — lower than surveyed United States ports, on a par with Hong Kong, but higher than many ports in New Zealand, Asia and Europe.

The BIE study indicated that high charges and low productivity are also significant problems with the handling of break bulk cargoes (that is, cargoes not amenable to containerisation such as steel coil, timber and newsprint).

In contrast, waterfront charges for Australia's coal exports are low by world standards. In part, this reflects the highly mechanised nature of bulk commodity terminals. Also, coal terminals are closely integrated with mining and land transport operations. This, along with the relatively small number of organisations involved in mining, handling and transporting coal, has helped the development of close commercial partnerships.

Waterfront reform options

Reflecting the size of the performance gap and its importance for trading activities, more business organisations identified waterfront reform as a high priority than any other transport or infrastructure reform.

Waterfront performance largely reflects the poor industrial relations environment which has existed between Australia's two major stevedoring companies, Conaust and Patricks (Sealand in Adelaide), and their employees — all members of the Maritime Union of Australia. As a result, the changes in work practices needed to improve productivity have been difficult to achieve.

The evidence suggests that further labour shedding will not be enough. Waterfront reforms must now focus on creating an environment in which containers are consistently loaded/unloaded. Current programs to invest in new equipment and to introduce performance-based enterprise agreements, which reward employees for high productivity, are a step in the right direction. However, as poor performance has dogged the container and break bulk cargoes for many years, there is some scepticism about the prospects for substantial progress without changes in the regulatory environment.

The challenge for public policy is to create an environment in which high performance can be achieved and maintained.

Participants in this study and other stakeholders have suggested a range of reforms including: opening up the waterfront to non-union labour; reintroducing sections 45D and 45E of the Trades Practices Act relating to secondary boycotts; and eliminating the preference for union labour in cleaning ships' hatches. The Commonwealth's proposed labour market reforms should establish the framework to address these concerns.

However, as the waterfront is dominated by a small number of stevedoring companies, addressing only the labour supply arrangements may not be sufficient to secure the necessary productivity improvements.

One option is to increase competition in stevedoring. However, the present structure largely reflects the capital intensive nature of container operations and the relatively low container volumes at each of Australia's capital city ports. Hence, in some ports it may be some time before a new stevedore enters. Moreover, the open access arrangements under the competition policy reforms may not be suitable to generate greater competition in stevedoring.

As the major source of the entry barriers is likely to differ between ports, approaches for increasing competition need to be determined on a case-by-case basis. However, there is scope for port authorities changing licensing arrangements to facilitate competition in stevedoring activities. The Commonwealth's planned labour market reforms should address any labour sanctions which might be applied to a new entrant.

More specifically, port authorities should explore options to replace stevedores' tenured positions with fixed term franchises. Operating licences could be awarded on the basis of a transparent and competitive tender arrangement similar to those that should apply to other port services which possess significant market power (that is, towing, piloting and mooring). Any licence fees should reflect the costs of the facilities provided by the port authority and used by the stevedore. Oversight arrangements and performance targets should be included in any licence conditions to ensure that the successful service providers do not, in turn, abuse the market power they possess.

B.5 Shipping

Coastal and trans-Tasman shipping

Coastal shipping employs around 3000 persons. However, on a net tonne kilometre basis, coastal shipping's freight task is similar to that performed by rail and road. It is the preferred transport mode for the long haul movement of dry and liquid bulk commodities. Most of the coastal bulk carriers are operated by users (for example, BHP Transport, CSR and the petroleum companies) to service in-house needs such as the delivery of raw materials and the movement of intermediate products for further processing. Coastal shipping is a particularly important input into the mining industry, especially the iron ore industry (around 12 per cent of costs).

Recent coastal shipping reforms

Coastal shipping has been a reform priority since the Crawford report (1982) investigated ways to develop an efficient Australian shipping industry. The Government's response was to use a range of financial incentives (including investment allowances and accelerated depreciation) to encourage investment in new ships, with lower manning levels.

However, a 1988 IAC inquiry found that Australia's coastal shipping industry remained inefficient and uncompetitive, and that the existing environment imposed little discipline on costs and failed to reward better performance. It identified the effective exclusion of competition from foreign flagged vessels as a major cause of the industry's inefficiencies.

Trans-Tasman shipping is another problem area. It is dominated by the Australian and New Zealand Maritime and Stevedoring Accord between the relevant unions. This effectively extends domestic cabotage laws to international waters. As a result, ships crewed by foreign nationals are prevented from carrying cargo between Australian and New Zealand ports. The union accord is not backed by legislation, nor has it been ratified by the Australian and New Zealand Governments.

The IAC (1988c), and many industry representatives, advocated the progressive relaxation of cabotage as a key initiative to address the industry's poor performance. The Commonwealth rejected this approach and convened a government, industry and union task force to develop an alternative strategy. The Government ultimately accepted the task force's recommendations, which was largely a continuation of the Crawford approach. This strategy involved maintaining cabotage, but increasing the flexibility of the single voyage permit system which allows, in a limited way, foreign ships to trade on the Australian coast.

The Shipping Industry Reform Authority (SIRA) was established to implement reforms to coastal shipping. By 1992, average crew levels on Australian vessels had fallen from 28 to less than 21, which was below the OECD average. However, significant variability in crew levels still existed, with average crew levels of 25.5 on pre-1982 ships and 18 on new ships.

In April 1993 the Government extended SIRA's reform program to September 1995. The extended SIRA program completed the retraining of ratings to an integrated rating standard. Minimum average crew levels of around 18 were achieved. However, little progress was made in reducing the crewing factor, and agreement was not reached on company employment.

Further shipping reforms are being pursued through negotiations between ship owners and maritime unions under the Maritime Industry Restructuring Agreement (MIRA). The performance of coastal shipping has also been influenced by measures introduced in the 1995 Commonwealth budget which:

- introduced a grant, equal to the cost of PAYE tax payments, to ship operators for vessels operating more than 50 per cent in international trade;
- extended until 2002 the taxable grant and accelerated depreciation regime for new vessels; and
- increased the excise rate on light fuel oil, and excluded shipping claimants from receiving a diesel fuel rebate.

The ships capital grants and PAYE grants for international shipping will cease from 1 July 1996.

Some participants acknowledge the benefits of previous reforms. For example, BHP, a major user and vessel operator on the Australian coast, stated:

Australia has made some impressive achievements in the shipping industry through reducing crew numbers and multi-skilling crew members. Working conditions have also improved — for example, with the introduction of continuous employment for seafarers and the move to company-sponsored, degree based training. Australia is also at the forefront in ship technology, and has achieved dramatic improvements in cargo systems, navigation systems, hull design and communications technologies (Sub. 30, pp. 13–4).

The lower crew levels save the industry around \$50 million a year. It was anticipated that the MIRA reforms would generate additional savings of \$15 million per year, but DTRD indicated that these benefits have not yet been realised as industry and maritime unions have been unable to deliver promised industrial efficiencies.

On the other hand, the reform efforts have cost the Commonwealth around \$130 million — \$43 million for redundancy and training support payments and \$86 million for the ships capital grants scheme.

Current coastal and trans-Tasman shipping performance

Despite a long reform program which has provided the shipping industry with tax breaks which are not available to other industries, coastal shipping remains uncompetitive. A recent BIE (1995f) study concluded that Australia has among the highest vessel operating costs in the world. Of the countries surveyed, only the United States and Japan had higher vessel costs. In part, this is because high excise taxes result in high fuel costs for Australian vessels. However, this impost is more

than offset by accelerated depreciation and taxable capital grants which lower capital costs.

The impact on firms of inefficiencies in Australia's coastal and trans-Tasman shipping can be substantial. For example, ICI Australia stated that:

It is cheaper to import product from South-East Asia into Brisbane and Perth than it is to move product from Perth to Sydney or Melbourne ... [and] it is currently 50 per cent more expensive to freight containers from Melbourne to New Zealand, than it is from Melbourne to Singapore (Sub. 34, p. 2).

Moreover, Swan Consultants (1994) found that removing the union accord and increasing competition could reduce trans-Tasman liner freight rates by between 10 and 15 per cent, whilst bulk freight rates could fall by 25 per cent.

The uncompetitive position of Australian shipping is largely caused by some of the world's highest manning costs. These costs exist despite internationally low crew levels. The major cause of Australia's high manning costs are high leave and wage on-costs. Direct wage costs for Australian vessels are comparable to other developed countries which use national crews.

The BIE (1995f) concluded that cost savings under the MIRA reforms might reduce vessel costs by between 2 and 3 per cent, but that Australia's coastal shipping industry will remain uncompetitive. It argued that:

- if the current arrangements remained in place, the Australian coastal shipping industry could achieve vessel costs which are on a par with a number of overseas countries by:
 - achieving repair, maintenance and other operating costs comparable with New Zealand; and
 - maintaining a national crewing system, but achieving manning costs comparable with Norway; or
- if cabotage was removed, the Australian coastal shipping industry could achieve vessel costs which are among the lowest in the world by:
 - achieving repair, maintenance and other operating costs comparable with New Zealand; and
 - introducing mixed crewing.

The problems of the coastal shipping industry are reflected in the performance of ANL, the Commonwealth's shipping line. Over time, ANL has divested its interests in stevedoring, moved the emphasis of its operations from bulk to liner vessels and reduced the number of seagoing employees per vessel. However, ANL's financial

performance is poor. This has prompted the Commonwealth to pursue privatisation options.

Coastal and trans-Tasman shipping reform options

The failure of past approaches to deliver an internationally competitive coastal shipping industry clearly establishes the need for more fundamental reform. The Commission favours the phased reform of coastal shipping.

The first, and most critical step, involves introducing labour market reforms. The objective should be to end the remaining industry pool labour force. All labour should be subject to enterprise agreements which allow for company based employment and the further development of multiskilling and career paths. Introducing enterprise agreements should provide scope to allow for the renegotiation of remuneration packages to introduce, where appropriate, a rebalancing of wage and non-wage benefits.

The Commonwealth's proposed labour market reforms should establish the framework to address these concerns. In particular, reintroducing sections 45D and 45E governing secondary boycotts into the Trade Practices Act should allow international shipping operators to take action against any union sanctions which prohibit them from engaging in trans-Tasman shipping.

The labour reforms should be accompanied by measures to increase competitive pressures on ship operators. To this end, all vessels on international voyages to Australia should be permitted to carry cargo between Australian ports. These arrangements are similar to those introduced into New Zealand in 1995. In addition, foreign vessels crewed by Australian seamen should be free to operate on coastal routes. At the same time, the Commonwealth should ensure that the Australian Maritime Safety Authority's port control inspections are vigorously enforced to include any vessels operating in Australian coastal waters. This will help ensure that easing some of the present restrictions does not result in additional safety and environmental hazards in Australia's coastal waters. These controls should not, however, be used to introduce an unnecessary entry barrier.

The Commonwealth should also proceed with the sale of ANL, or its assets.

The performance of the coastal shipping industry should be reassessed in two years to determine if the gap with our competitors has been substantially bridged.

International conference liner shipping

Liner shipping carries most of Australia's imports and non-bulk exports. The liner trade is divided between conference and non-conference shipping. Conference liner shipping comprises collections or cartels of ocean carriers that coordinate their schedules, freight rates and other conditions of service. They have existed since 1875. Non-conference shipping includes individual operators that provide shipping services on a less frequent and structured basis.

Collusive behaviour is prohibited under section 45 of the Trade Practices Act. However, Part X of the Act, which refers specifically to conference shipping, allows both inwards and outwards conference operators to set common freight rates and pool traffic and earnings.

The protection accorded conference shipping under Part X of the Trade Practices Act is designed to ensure that:

- Australian exporters have continued access to frequent and reliable liner shipping services;
- all States and Territories have stable access to export markets, which is achieved by applying standard freight rates for cargo regardless of its port of origin; and
- Australian flag shipping is not hindered from normal commercial operations in liner cargo shipping — in effect, this provides operators such as ANL guaranteed market access by requiring liner conferences to admit ANL as a member, ensuring ANL a certain volume of trade.

Although conference shipping is a long standing and central part of the international trading system, and despite a recent review supporting the retention of Part X (Brazil 1993), it is still unclear why international liner shipping should be accorded special status under the Trade Practices Act. More thought needs to be given to the objectives of Part X and how these objectives are pursued. For example, the Commission believes that:

- Competitive pressures should determine the quality and price of services provided by liner shipping. Conference shipping is losing market share to non-conference shipping for the carriage of both inwards and outwards cargo. This indicates that conference shipping is not always essential in providing shippers with the combination of quality and price they require.

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- While it may achieve stable access to export markets, pan-Australian freight rates lead to inefficiencies. For example, it can lead to cross-subsidies from larger, more central ports to those in regional areas. In addition, pan-Australian freight rates discourage interport competition and regional specialisation.
 - The Commonwealth Government should not accord Australian-flagged shipping special treatment by granting it a guaranteed share of the shipping market (in effect putting a quota on the amount of imported shipping services).

The Commission considers that there are strong grounds for removing the Part X exemption. This would not prevent the conference shipping lines seeking a Part VII authorisation for the current arrangements.

B.6 Aviation

Aviation's importance as a transport mode in Australia is second only to road and its output is as large as both rail and water transport combined.

While it mainly carries business travellers and tourists, aviation also plays a significant role in transporting high value, time sensitive freight; in particular, international freight which has been growing at around 20 per cent a year over the past decade. Air freight can provide Australian firms with a competitive advantage over rivals in export markets. It also allows many firms to reduce inventory holdings.

Recent aviation reforms

During the 1980s, a series of reviews mapped out a reform agenda for aviation. As a result:

- aviation infrastructure services were taken out of the hands of a government department and became the responsibility of corporatised agencies:
 - the Federal Airports Corporation operates airports in capital cities as well as in larger regional centres (responsibility for the smaller airports has been transferred to local governments);
 - Airservices Australia is responsible for the provision of air traffic services (en route and airport control tower) and airport fire and rescue services; and
 - the Civil Aviation Safety Authority administers safety requirements and assesses and inspects aerodromes, aircraft, flight crews and maintenance staff;

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- operational restrictions have been relaxed enabling new airlines to operate on most of Australia's major domestic routes; and
 - agreements covering Australia's international air services were renegotiated, increasing the available capacity and ending Qantas's position as Australia's sole international carrier.

In addition, the Commonwealth Government has privatised Qantas and will further reduce its involvement in aviation through the proposed sale of leases to operate airports currently controlled by the FAC. It will, however, continue to play a major part as a provider of air services and as a regulator.

Current aviation performance

Aviation reform has delivered significant benefits to users and to the Commonwealth Government as the owner of significant infrastructure facilities.

Since the ending of the Two Airline Policy in 1990, real average air fares have declined by just under 20 per cent (ACCC 1996). This fall has been sustained by greater discounting of fares and by increasing proportions of passengers taking advantage of discount fares. (In contrast, first and business class fares have increased by around 10 per cent.) Moreover, the frequency of flights between major Australian destinations has increased by 72 per cent since deregulation.

Up until the mid-1980s, aviation infrastructure was a significant drain on Commonwealth funds (estimated by the Bosch Committee at over \$110 million a year). However, the financial performance of Australia's airports and air services infrastructure has been turned around. In 1994–95, the FAC paid the Commonwealth over \$60 million in income tax and dividend payments. In addition, the privatisation of Qantas generated \$2.0 billion — \$665 million in the sale of 25 per cent to British Airways and \$1.45 billion in the 1995 float of Qantas's remaining equity.

In a study which compared Australia's aviation industry with those overseas, the BIE (1994f) concluded that:

- Australia's domestic air fares and freight rates are among the cheapest available, being rivalled only by some fares on intra-Asian routes and by some discount fares in North America;
- air fares on international routes to and from Australia are, on average, cheaper than comparative routes overseas, and freight rates for exports from Australia are generally cheaper than freight rates for imports to Australia; and
- the performance of Australia's aviation infrastructure is mixed:

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- Australia’s airport landing and navigation en route charges are low by world standards; and
 - on-time performance of aircraft departures and arrivals is below best observed, and has deteriorated in recent years.

However, the Aircraft Owners and Pilots Association of Australia (AOPAA) argued that Australia’s aviation regulatory costs are among the highest in the world (three times higher than in the United States). The high regulatory costs were attributed to high staff levels, with the Association arguing that there is little evidence of a pay-off in terms of improved safety.

Aviation reform options

There is considerable scope to further improve the performance of aviation in Australia. Continued reform of aviation could increase the contestability of aviation and ensure that the benefits will be preserved and not be eroded over time. The IC (1995a) estimated that the application of competition policy reforms to aviation infrastructure would increase GDP by \$120 million.

The sale (or more correctly the ‘lease’) of the FAC’s airports provides an opportunity to introduce new and innovative practices into the management of Australia’s airports. This in turn may provide a greater incentive for airport management to ensure that airport facilities are in tune with the needs of the airlines and passengers. Nevertheless, regulatory controls are required to ensure that the significant market power which would continue to reside with the owners of major airports is not abused. Some care will have to be taken to ensure that privatisation does not discourage the entry of new airlines. In this context, arrangements for access to terminal facilities will be crucial.

It will also be important to finalise the introduction of location specific aeronautical charges at FAC airports prior to the start of the sale process. The new charges should remove the existing cross-subsidies between the major airports and the regional/general aviation airports. Without this, it is possible that monopoly pricing practices will be capitalised into the sale price of Australia’s major airports.

The AOPAA argued that aviation safety and air traffic management should be reformed in line with the general principles of accountability, competition, optimum safety and industry partnership. The AOPAA stated that the reforms should include: moving away from funding arrangements based on fuel excise and towards direct charging for services used; introducing competition for the supply of air traffic services; reducing the government subsidy for safety regulation to improve accountability and responsiveness to industry needs; harmonising air space

management with overseas practices; and making fire and rescue services the airport licensee's responsibility. Many of these suggestions are consistent with the recommendations in the IC's (1992d) inquiry into intrastate aviation.

Overseas experience indicates that competition is possible for air traffic, fire and rescue services at individual aerodromes. Allowing multiple suppliers could possibly erode some economies associated with supply by a single organisation. However, if this were the case, it would more likely be significant for air traffic services at the major airports that will be fully integrated into the Australian Advanced Air Traffic System. At other airports, the benefits from competition between alternative suppliers, coupled with the potential for airport operators to reduce costs by combining air traffic, fire and rescue tasks with conventional airport functions, should generally outweigh any costs associated with removing Airservices Australia's sole supplier status.

As Airservices Australia's charges constitute at least 10 per cent of an airline's costs, it is important that its activities are undertaken efficiently and that its charges are properly structured. Ideally, services should be funded by pricing structures which reflect marginal costs and are responsive to changes in demand and supply conditions. However, it is unclear that charging arrangements for air traffic services could meet all of these criteria. For example, air traffic and safety services exhibit public good characteristics. Thus, a direct charge may lead to underuse of the services. In such circumstances, the current weight/distance charges and fuel excise taxes could conceivably be an appropriate means of pricing some air traffic and safety services. Irrespective of the pricing structures used, the revenue generated should be sufficient to cover cost (that is, not be cross-subsidised from other revenue sources) and to provide a commercial rate of return on assets.

In summary, reforms to improve the provision of air traffic and safety services should encompass:

- introducing competitive tendering for the supply of air traffic, fire and rescue services at individual aerodromes; and
- modifying en route charges to eliminate, as far as is practicable, cross-subsidies between users, so that charges more closely reflect the cost of services supplied to different groups of users.

Aviation reform has eroded the traditional distinction between Australia's domestic and international air services and has removed many of the regulatory barriers to entry. However, significant entry barriers persist and some reforms have not been fully implemented.

The demise of Compass attests, in part, to the pivotal position held by Australia's two incumbent airlines. This position derives from the sunk costs invested in airport terminals, as well as the circumstances in which these airlines were able to develop their existing facilities (for a further discussion of these issues, see IC 1992d, pp. 124–7). It is important to ensure that the incumbent airlines cannot use their market position in an uncompetitive manner to ward off new entrants. The development of common user terminal facilities and use of the access arrangements under Part IIIA of the Trade Practices Act are potentially two means of providing terminal facilities to new entrants.

Another factor impinging on the competitive pressures in aviation is the restrictions on the foreign ownership of domestic airlines. New entrants into passenger air services on major domestic routes can only come from: an airline which does not operate to Australia; an existing small airline which expands; or a new airline (for example, Compass). All of these options place the new entrant at a disadvantage in comparison with the existing domestic airlines (for example, sunk costs in terminal facilities might prove to be an insurmountable entry barrier to an existing small airline). Removing the foreign ownership restrictions would allow a subsidiary of a large international airline to commence operations in Australia. Such an airline would be able to rely on the parent company to provide the financial support needed to overcome any entry barriers.

To enhance the contestability of aviation in Australia, the Commission recommends that the Commonwealth:

- finalise negotiations to implement the previous agreement with the New Zealand Government to create a single trans-Tasman aviation market, including 'beyond' rights for both countries' carriers;
- examine the case for removal of restrictions on overseas airlines (which fly to Australia) from investing in an Australian airline; and
- extend the interlining rights currently held by Qantas to include all other international airlines.

To finalise the deregulation of domestic aviation, State legislation that limits competition on intrastate routes in some jurisdictions should be repealed. Any services which are deemed 'essential', but which are unprofitable to operate, should be supported through direct subsidies rather than by entry restrictions. The size of the subsidy and the operator should be decided by a tender process.

The Commonwealth should continue to renegotiate Australia's bilateral air agreements and ensure that capacity is well in excess of forecast demand, and that the available capacity is allocated between airlines in a non-discriminatory manner. The potential benefits and scope of stepping outside the current bilateral

arrangements or introducing multilateral air agreements that provide greater access for foreign airlines to the Australian market should also be explored. International Air Services Agreements are included on the Commonwealth's Legislative Review Schedule for examination during 1996–97 (Costello 1996).

B.7 Electricity

Electricity is one of the larger infrastructure industries, contributing 2.2 per cent of GDP (\$9 billion) and 18 per cent of Australia's energy needs (ABARE 1995). On average, electricity comprises 3–5 per cent of industry costs, and considerably more of the costs of some energy intensive industry (for example, smelting and ferrous metals). In Australia, the electricity supply industry (ESI) is primarily fuelled by black and brown coal and, to a lesser extent, by hydro and natural gas.

Recent electricity reforms

The Australian ESI has been developed within State boundaries by vertically integrated public monopolies. During the 1980s, it became increasingly evident that the ESI was not performing to its full potential. Poor investment decisions led to excess capacity which, in some jurisdictions, is expected to continue until 2005 (IC 1995h). In addition, there was gross overstaffing and pricing inefficiencies in the form of cross-subsidies which penalised most industrial users. The IC's (1991f) inquiry estimated that reform of the ESI would expand the economy by around \$2.2 billion annually.

Since the mid-1980s, the ESI has undergone significant changes to improve performance. Early reforms focused on efficiency improvements, such as shedding excess labour. More recently, the emphasis has been on corporatising electricity utilities. This has involved creating a competitively neutral operating environment, as well as structural reform by separating the responsibilities for electricity generation, transmission and distribution. In addition, most utilities are winding back cross-subsidies between different user classes.

Electricity industry reforms were provided a national focus in 1991 when COAG agreed to establish a national electricity market covering the southern and eastern States. It is now scheduled to commence in October 1996, evolving in stages through to July 1999. As a precursor to these changes, wholesale electricity markets now operate in Victoria and New South Wales. The National Grid Management Council has released a draft national electricity code governing the operation of the national electricity market. Once finalised, the code has to be endorsed by governments and submitted to the ACCC for approval as an access regime.

At present, the extent and nature of the competitive neutrality and structural reforms differ between the States. This is reflected in the Pulp and Paper Manufacturers Federation of Australia's assessment that electricity reform:

... is patchy across the States — Victoria is well advanced, NSW has made some progress but the other States lag lamentably (Sub. 11, p. 1).

Victoria has implemented the most wide-ranging reforms to its ESI, including the vertical and horizontal separation of the SECV into: five distributors; five generators; PowerNet (the manager of the transmission assets); and the Victorian Power Exchange (the operator of the transmission network and the manager of the wholesale electricity market). Yallourn W power station was recently sold, as were the five distributors, each to separate consortia.

In New South Wales, 25 regional distributors have been amalgamated to form six corporatised entities. On 1 March 1996, most of the generating assets of Pacific Power were divided between two new and separate companies (Macquarie Generation and First State Generation). One power station (Eraring) has been retained by Pacific Power. Transmission responsibilities have been removed from Pacific Power and are now undertaken by Transgrid (a separate corporatised entity).

Electricity reforms in Queensland and South Australia have been less significant. Generation will be separated from other activities, but transmission and distribution have not been fully separated.

Current electricity performance

The recent performance of the ESI reflects the extent of the recent reforms. Between 1989–90 and 1993–94, the ESI maintained a 10 per cent return on assets (which increased by around 50 per cent over the period), real prices declined by 5 per cent and employment fell by 25 per cent (SCNPM 1995).

By international standards, electricity prices in Australia are low. However, there is some evidence to suggest Australia's ranking in terms of industrial electricity prices is slipping (BIE 1996h). Further efforts to wind back cross-subsidies that favour domestic customers may alter this.

Notwithstanding these gains, the gap in total factor productivity (TFP) levels (a measure of overall efficiency) between Australian utilities and United States investor-owned utilities remains as large now as it was in 1989–90 (BIE 1996h). While Queensland has traditionally been the best performing Australian system in terms of TFP, the BIE's forthcoming study shows that TFP levels in Queensland

have substantially declined since 1991–92. (Some of this decline reflects a change in accounting methodology.)

The Electricity Supply Association of Australia (ESAA) indicated that performance improvements since 1988 have led to a 30 per cent decline in operating costs. Consistent with industry views which criticise governments for capturing the majority of the gains from reform, the ESAA indicated that 44 per cent of the benefits from this ‘efficiency dividend’ have gone to government (dividends and taxes), 32 per cent have been retained by the ESI (improved cost recovery and debt reduction) and 25 per cent has been passed on to customers through price reductions.

Electricity reform options

The importance of continued reform of electricity is emphasised by estimates which indicate that the gains from improved performance could increase GDP by up to \$5.5 billion (1.3 per cent) — about a quarter of all of the benefits from competition reforms (IC 1995a).

Business, which attaches a high priority to electricity reform, expressed some concerns about the detail of current reforms. For example, the Business Council of Australia claimed that governments have captured the benefits of reform through higher charges and dividend requirements. The Council also expressed concern, that:

... governments have tended to over value or recapitalise upwards, assets of GBEs prior to privatisation, with adverse implications for users (Sub. 38, p. 3).

The ACM emphasised the need for competition to generate further reform because, given:

... the differing nature and pace of pricing reforms between states we must ensure that competition within the electricity industry remains open (Sub. 28, p. 4).

While New South Wales and Victoria have led the way in the structural reform of the ESI, the Chamber of Mines and Energy of Western Australia argued for extending similar reform to Western Australia. For example, it stated:

... electricity generation, transmission and distribution and sales should be structurally separated ... to introduce competition between electricity generating facilities and to eliminate the possibility of anticompetitive practices such as the manipulation of the transmission and distribution business to protect sales.

The open access timetable for electricity transmission and distribution, announced by the [Western Australian] Government in February 1996, also needs to be accelerated. South west consumers with an average load between 5 and 10 MW at a single point

have to wait until July 1999 to be granted open access rights. Even then, open access will be available to only around 20 of the State's largest electricity consumers (Sub. 32, p. 3).

While industry strongly supports the formation of the national electricity market, it raised concerns with some of the proposed arrangements. For instance, BHP (Sub. 30, p. 3) argued that:

- the delays encountered in implementing a competitive inter-state market have imposed considerable costs on consumers, and further delays must be avoided;
- the Code of Conduct for the NEM is overly complex; and
- the proposed approach to transmission pricing is inappropriate.

In a similar vein, the Pulp and Paper Manufacturers Federation of Australia stated:

The heavy handed and complex regulatory arrangements being established in relation to the national market are bemusing to say the least (Sub. 11, p. 2).

Recent developments have also cast doubt on whether the full benefits of electricity reform will be realised. For instance, the Queensland Government favours additions to that State's generating capacity and has cancelled the Eastlink project, which would have connected Queensland to the national grid.

To achieve the benefits of structural reforms, including open access to the national grid, State governments should ensure that the electricity supply industry is subject to the Competition Principles Agreement, including the agreed arrangements relating to prices oversight, competitive neutrality, structural reform and access to significant infrastructure. Particular attention should be paid to: finalising the arrangements for the national market; implementing pricing and access conditions which are consistent with NCC declaration and ACCC undertaking procedures; and introducing direct and transparent financial support for CSOs to facilitate the removal of cross-subsidies.

Consistent with the Competition Principles Agreement, the Commission has advocated structural separation of integrated electricity utilities to increase competitive pressures and improve efficiency. This should encompass separation of generation, transmission and distribution/retail activities. Consideration should also be given to the horizontal separation of generation and distribution/retail entities, and to subsequent privatisation (especially in generation).

B.8 Gas

Natural gas is used both as an energy source (for example, heating and as a fuel for transport and electricity generation) and as a feedstock in industrial processes (for

example, the manufacture of petrochemicals, plastics and fertilisers). As an energy source, natural gas produces lower noxious emissions than other primary fuels. Gas fired generation plants involve lower capital costs, shorter lead times in construction and greater thermal efficiency than other plant types. While only a small part of the Australian economy (around 0.3 per cent of GDP and 9 000 employees), natural gas supplies 19 per cent of Australia's energy needs (second only to petroleum products) and is the fastest growing energy source — 7.5 per cent a year (ABARE 1995).

Recent gas reforms

The exploration for, and extraction of, natural gas is largely undertaken by private companies. The transmission pipelines in New South Wales, the Australian Capital Territory, the Northern Territory and the Roma to Brisbane pipeline are privately owned, while the remainder are publicly owned. Gas distribution is undertaken: by Boral in South Australia and Queensland; by AGL in New South Wales and the ACT; and by public utilities in the other States. As transmission and distribution exhibit natural monopoly characteristics, they are generally regulated by government.

Since the early 1990s, there have been significant privatisation, regulatory and policy changes in the natural gas industry.

- The Commonwealth sold the Moomba to Sydney pipeline to a consortium of private sector interests.
- The South Australian Government sold its interests in the distributor Sagasco.
- The New South Wales Government has introduced new price controls, replaced annual licences with ongoing authorisations and established the Gas Council as the independent regulator.
- The Gas and Fuel Corporation of Victoria has been restructured and downsized to focus on gas distribution (its core activity). It is currently being restructured into two separate GBEs: a gas transmitter (Gas Transmission Corporation); and a distributor (Gascor).
- The State Energy Commission of Western Australia has been split into separate, corporatised, electricity and gas authorities (AlintaGas). Open access provisions have been introduced for large gas suppliers and users. Pre-existing purchase and sales contracts have been changed. Gas is now supplied direct by Woodside to Alcoa, Western Power, Hamersley Iron and Robe River. As a result, AlintaGas's market share has fallen from 92 per cent to 32 per cent.

In addition, the Commonwealth, State and Territory governments are cooperatively working to reduce restrictions on competition and trade, and to enable free and fair trade in natural gas. These reforms include:

- removing barriers to trade in gas within and between the States;
- introducing a uniform national framework for third party access to gas transmission pipelines;
- developing more competitive franchise arrangements;
- corporatising publicly owned gas utilities;
- vertically separating transmission and distribution activities; and
- removing any restrictions on the use of natural gas.

The ACCC argued that, given the current industry structure, ‘gas users face market power at each stage of the supply chain’. As a result, the ACCC has been working to ensure that the new gas industry arrangements take account of competition, consumer and efficiency concerns. One consequence has been the revocation and modification of the authorised supply arrangements between the Cooper Basin producers. This action is currently subject to appeal.

While some restrictions on interstate trade in gas have been removed, some government imposed barriers remain, for example:

- the *South Australian Interim Supply Act 1985* allows government to block interstate sales of gas from South Australia; and
- as a caveat to its COAG commitment, the Victorian Government will not allow the interstate sale of gas until the issues of the petroleum resource rent tax on Gippsland gas are resolved.

Current gas performance

A BIE (1994h) study found that the performance of gas transmission and distribution systems is significantly determined by external factors such as proximity to a gas basin, population density and climatic conditions. These factors tend to explain the relatively low gas prices and high productivity in Victoria compared to the higher prices and lower productivity in Western Australia. Once external factors were taken into account, SECWA was judged to be technically efficient. However, on average, the BIE found that:

- Australian industrial, commercial and residential natural gas prices compare favourably with those paid in most industrialised countries;
- Australia tends to have relatively low capital productivity; and

-
- labour productivity is on a par with overseas experience.

Gas reform options

Despite improvements in transmission and distribution of gas in Australia, there is considerable scope for further improvements. For example, the IC (1995a) estimated that the application of the competition policy reforms to the gas industry would lead to an annual increase in GDP of \$290 million. Part of this improvement is attributable to future growth which will help Australian gas utilities attain the scale economies available to leading overseas gas utilities.

For some time to come, the gas market in Australia is likely to consist of only a small number of businesses in each stage of supply. In these circumstances, measures to strengthen competition will be particularly important. In particular, the pipeline access and pricing arrangements will play an important role in stimulating supply side competition. However, some participants expressed concern about progress in implementing open access regimes. For example, BHP indicated that:

Achieving access on acceptable terms to date has been difficult, particularly for the Sydney pipeline system and the Moomba to Sydney gas pipeline. Where gas reform has clearly worked is in Western Australia, particularly for major industrial users in the Pilbara (Sub. 30, pp. 3–4).

The Chamber of Mines and Energy of Western Australia expressed concern about access limits in Western Australia:

Even when the yet-to-be announced reduction in the threshold (to attain access to the pipeline) to 100TJ is achieved, the number of customers able to take advantage of the open access regime will only number 30 or so. These users currently account for just over 50% of the gas market currently regulated to Alinta Gas. Included in the remaining 50% are 177 other users of the high pressure system which will be denied access. Included in this category are industrial users consuming more than 100TJ in total, but not 100TJ at any one site (Sub. 32, pp. 2–3).

These concerns hint at the traps in not implementing fully ‘free and open’ access to gas transmission. Major users and distributors are, essentially, competitors for the output of the transmission pipeline. Therefore, if transmission and distribution functions are vertically integrated, major users can always argue that the access arrangements for transmission are discriminatory and favour vertically integrated distributors.

To ensure non-discriminatory access, the Commission strongly supports further structural reform leading to the full separation of transmission from distribution. Once this is achieved, State and Territory governments should consider privatising publicly owned gas distributors (with the appropriate regulatory oversight).

To achieve the benefits of competition policy reform, governments should ensure the gas industry is subject to the other elements of the Competition Principles Agreement, including the arrangements relating to prices oversight and competitive neutrality. Attention should be paid also to: finalising the national grid and introducing pricing and access conditions which are consistent with NCC declaration and ACCC undertaking procedures; and introducing direct and transparent financial support for CSOs.

These reforms should be progressed immediately. The Commonwealth and Victorian Governments should also move expeditiously to resolve the dispute concerning the petroleum resource rent tax which is currently holding up the introduction of further competition in gas supply.

B.9 Postal services

Australia Post is the largest provider of mail, courier and parcel services in Australia. It is a Commonwealth GBE with the exclusive right to carry letters. This limited monopoly has been considered necessary to enable Australia Post to meet its primary CSOs — providing all Australians with reasonable access to a letter service at a uniform rate of postage for standard letters.

Recent postal reforms

Australia Post was established in 1975 when the Postmaster-General's Department was divided into separate postal and telecommunications agencies. Following the Bradley (1982) inquiry, Australia Post retained its reserved letter services, but the protection was reduced by allowing others to carry letters, provided they charge at least ten times the standard letter rate. Since it was corporatised in 1989, Australia Post has been required to operate commercially and at arms length from the government. It has also been required to continue to provide its CSOs.

An IC (1992f) inquiry recommended replacing the uniform postage rate for standard letters within Australia with a maximum affordable charge. If the uniform charge

were maintained, the IC proposed measures to increase the competitive pressure on Australia Post. It suggested reducing the minimum amount which other providers could charge to carry a letter to \$1.20, with subsequent annual reductions of 10 cents for five years.

While the IC's recommendations were not fully implemented, subsequent reforms opened up around \$250 million worth of domestic and international postal business to competition by:

- reducing the price and weight protection for domestic letters:
 - the price protection fell from ten to four times the standard letter rate (from \$4.50 to \$1.80); and
 - the weight protection fell from 500 g to 250 g;
- deregulating outward international letters, carriage of mail within an organisation and movements of documents within a document exchange; and
- allowing competitors to carry bulk letters between cities and to interconnect with Australia Post's delivery network at reduced rates (Australia Post 1995).

Current postal performance

Between 1990–91 and 1994–95, Australia Post's return on assets and dividend to equity ratios have shown strong growth. Over this period, mail volume increased on average by 4.5 per cent a year, and employment fell on average by 1.8 per cent per year, resulting in an average annual increase in labour productivity of around 6.4 per cent. Despite these productivity improvements, the standard letter rate has remained constant in real terms since 1989–90 (SCNPM 1995).

Very little publicly available work has been undertaken to measure the performance of Australia's postal services relative to overseas. Information provided by Australia Post suggests that its performance is consistent with postal services in a number of other countries (table B.2).

According to Australia Post (1995), a recent confidential report indicates that it ranks highly when compared to postal services in the Netherlands, Denmark, Sweden, the United Kingdom, France and Belgium.

Table B.2 **International comparisons of Australia Post's performance, 1994–95^a**

	<i>Australia</i>	<i>Canada</i>	<i>USA</i>	<i>UK</i>	<i>NZ</i>
Annual no. articles handled per employee ('000)	102	184	207	89	na
Standard domestic letter rate (Australian cents) ^b	45	39	40	47	35
Delivery service standard (days) ^c	1	2	1	1	1
Delivery performance (% of standard times met) ^d	93.6	97	86	92.5	96.3
Retail outlets per 10 000 people	2.4	6.5	1.5	3.3	2.9
Return on assets (%)	15.2	-1.2	3.6	9.9	23.9

^a Australia: year ending June 1995, Canada: year ending March 1995, USA: year ending September 1995, UK: year ending March 1995, New Zealand: year ending March 1995. ^b Estimates based on exchange rates at 8 May 1996. ^c Number of working days for delivery between and within cities in any State. For other areas longer delivery standards apply in all countries. In general, Australia Post's delivery standards compare favourably. ^d Advertised delivery times are one day longer than in Australia. **na** Not available.

Source: Australia Post.

Postal reform options

There are still a number of unresolved issues in the area of postal reform. However, the focus of future reforms should be on the application of competition policy principles to Australia Post, particularly in relation to the treatment of CSOs and access arrangements (BIE 1995a). This view is supported by the ACCI which argued that postal reform should include:

... opening the remaining protected elements of Australia Post's operations to private sector competition, and in time the privatisation of key segments of the mail delivery system (Sub. 16, p. 9).

Additional competition would bring a number of benefits including:

- providing consumers with more choice;
- enhancing Australia Post's incentives to lower prices, minimise costs, provide quality services and adapt quickly to changing market conditions; and
- reducing the risk that Australia Post would exploit its exclusive right to carry letters.

Recent work by the IC (1995a) indicates that applying competition policy reforms to postal services has the potential to increase GDP by \$290 million.

Applying competition policy reforms to organisations like Australia Post encompasses a range of issues associated with access arrangements and competitive neutrality, including the treatment of CSOs.

Currently, Australia Post has a range of clearly identified CSOs, and others which, to a greater or lesser extent, are implicit. To ensure that Australia Post's objectives are clearly defined, and that the Board can be held fully accountable for its performance, Australia Post's CSOs should be separately identified and included in its legislation. Ministerial directions should be limited to matters which reflect the Commonwealth's equity investment in Australia Post. Social objectives should be pursued through legislative means.

At present, Australia Post funds its CSOs through open-ended arrangements which mask performance. Cross-subsidies and lower rates of return provide no information on the cost of a CSO, or on cost-effective ways to improve its delivery. It also makes it hard to untangle whether a decline in return on equity reflects an increase in the cost of providing CSOs or a decline in financial performance. The current funding mechanisms also distort price signals.

Applying competition policies to monopoly GBEs like Australia Post would normally embody the legal regime (Part IIIA of the Trade Practices Act) to facilitate third party access to nationally significant and essential facilities. However, Australia Post's services are generally exempt from the NCC's declaration and the ACCC's undertaking procedures. The rationale for the exemption is apparently based on Australia Post's interconnect facility for its delivery services. But, the current interconnect arrangements are primarily a 'bulk mail' discount, rather than a third party access arrangement to Australia Post's network. This raises questions about whether the exemption is appropriate, and why the current interconnect facility could not be tested under the ACCC's undertaking procedures.

The level of protection for the letter service is scheduled to be reviewed in 1996–97 in the context of the recommendations of the Hilmer Committee's inquiry into Australia's competition policy. This could be part of a broader independent review to assess Australia Post's obligations under the Competition Principles Agreement. The review should also:

- examine the impact of previous reforms to increase competition in service delivery;
- identify Australia Post's most important CSOs so they can be specified in legislation and thereby enable Ministerial Directions to be limited to matters which reflect the Commonwealth's equity investment;
- examine the funding of important CSOs; and
- assess the scope to further increase competition in service delivery. In this regard, the review should consider the rationale for, and the impact of, exempting Australia Post from access arrangements under Part IIIA of the Trade Practices Act.

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