



Australian Government
Productivity Commission

Structural Reform Australian-Style: Lessons for Others?

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The Government's commitment to reform, its willingness to commission expert advice and to heed it, to try new solutions, and to patiently build constituencies that support further reforms, is ... something that other countries could learn from. OECD, Economic Survey of Australia, 2004.

Introduction

Australia has undergone sweeping structural reforms over the past two decades that have helped transform its economic performance.

To most economists, especially in international economic agencies, the reforms themselves would no doubt appear unexceptionable. In the broad, they typically apply conventional prescriptions for improving growth by removing policy-related distortions and impediments to a well-functioning market economy. However, given the magnitude of the reform requirements in Australia, and the entrenched political obstacles to reform, the manner in which the reforms were introduced and sustained may be of wider interest and relevance.

My purpose in this paper therefore is not to focus on the *why* of reform, which I shall take to be understood in this company. Rather, I will briefly outline *what* reforms were undertaken in Australia and provide some indication of their outcomes, before focussing on aspects of *how* we went about it.

I will look in particular at some institutional innovations that appear distinctive to Australia and which have attracted the attention of a number of other countries — both developed and developing — as well as within international organisations concerned with promoting economic development.

* Based on presentations to the IMF and World Bank (Washington DC, 26-27 May 2005) and OECD (Paris, 31 May 2005). All Productivity Commission publications and speeches are available on www.pc.gov.au.

Paradise lost – and (partly) regained

Economic reformers in Australia often observe that our country had the highest per capita income in the world at the dawn of the twentieth century. This was partly luck: the result of having a small population blessed with abundant natural resources fetching very high world prices. But it was also attributable to a set of laws and institutions inherited from Britain that favoured productive endeavour (and an influx of adventurous spirits to benefit from them).

Like some others in that privileged position (Argentina, New Zealand), Australia's position on the global income ladder steadily declined in succeeding decades, beyond what might be justified by the fortuitous nature of its starting point.

A head start forfeited

In retrospect, the causes of our relative decline seem fairly clear. Just as Australians have been blessed with special resource advantages, we managed to devise some special institutions that, whatever their merits in the short-term, ended up significantly handicapping our economic performance.

As the respected Australian journalist Paul Kelly has chronicled, Australia's structural policies following Federation in 1901 were shaped by a social compact that came to be known as the 'Australian settlement' (Kelly, 1992).

- Trade barriers were erected to foster domestic manufacturing activity and employ the (white) immigrant labour at the relatively generous wages and conditions that were determined Australia-wide by the Industrial Relations Commission.
- Those states of the Federation most disadvantaged by this were compensated over time through fiscal redistribution from the Federal Government.

Meanwhile, in all jurisdictions, statutory government monopolies were created to provide public utility and other services at 'fair' prices to the expanding populations.

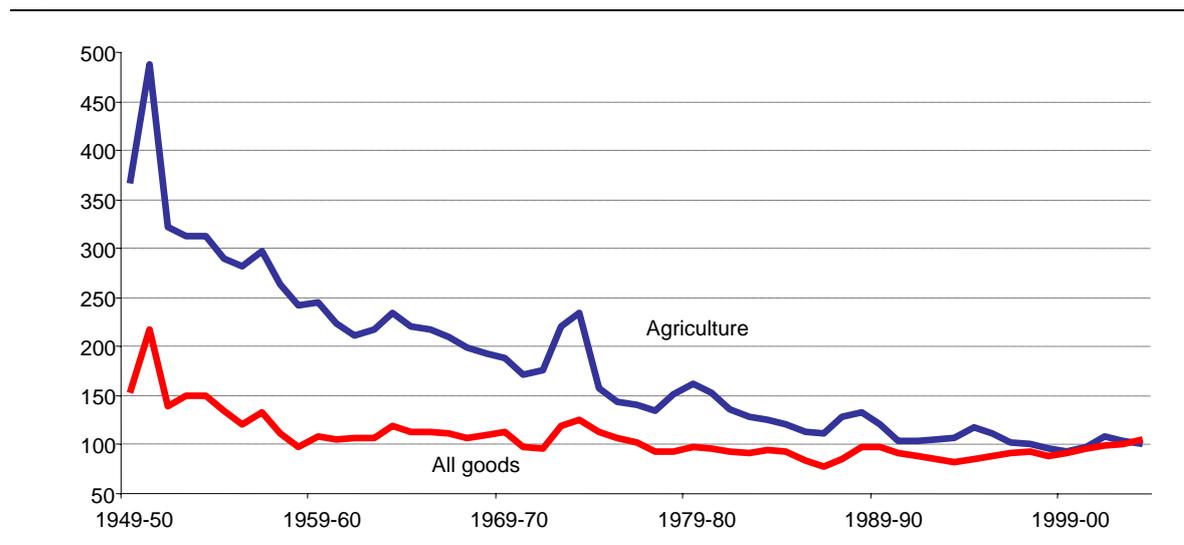
The regime was highly regulated, anti-competitive and redistributive: captured nicely by the expression 'protection all round' — a policy that for much of the last century had bi-partisan support and wide community acceptance.

For many years the economic costs of this regime were masked by the performance of our broad-acre agricultural and mining industries. Until the early 1970s, Australia was still managing to 'ride on the sheep's back'. The terms of trade favoured our primary commodities, and we had benefited from a world-wide expansion in

demand following the War. Australians enjoyed close to full employment with incomes still higher, on average, than those in most other OECD countries.

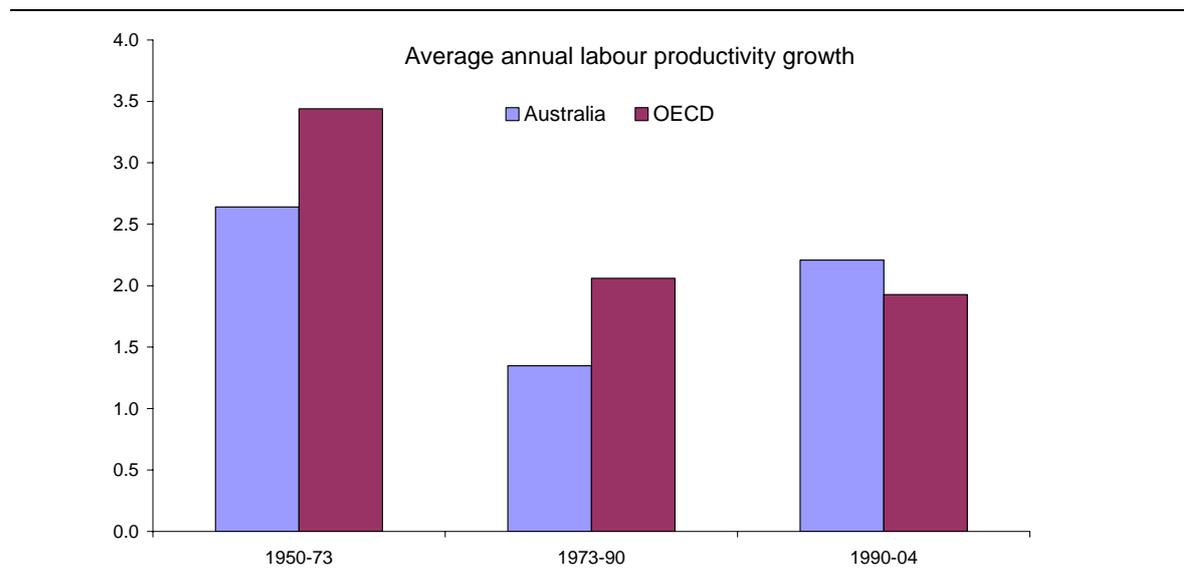
But we were riding for a fall. During the 1970s, the prices we received for our commodity exports commenced a long decline, while the costs of imports began to rise. The resulting terms of trade deterioration (Figure 1) would, in turn, expose the underlying problem of Australia's poor productivity performance.

Figure 1 Australia's terms of trade



Even in the post-war 'boom' years, Australia's productivity lagged. Between 1950 and 1973, our annual productivity growth averaged 2½ per cent, compared to 3½ per cent for OECD countries as a group (Figure 2).

Figure 2 Australia's relative productivity performance



The reasons for our relatively poor productivity performance, given the policy environment just described, are not hard to find:

- a fragmented, high cost manufacturing sector, focussed on the domestic market;
- indulgent, inflexible work practices, powerful unions and lack-lustre management;
- outmoded technologies, low rates of innovation and skill development; and
- high cost infrastructure services like power, transport and communications, which effectively taxed business users, while cross-subsidising households.

Australia's poor productivity performance, together with the declining terms of trade, translated into what seemed an inexorable slide in our comparative living standards. Whereas Australia was still ranked 5th in the world in 1950 in terms of GDP per person, we had fallen to 9th by 1973 and to 15th by the late-1980s. It is sobering for Australians to consider where we might be today had we kept our prior course.

Wide-ranging 'microeconomic reform'

Instead, Australia embarked on a sustained and comprehensive program of trade liberalisation and other structural reforms. In essence, the reforms freed up markets, promoted competition and generally sought to ensure that prices did their job of signalling costs and relative returns.

Structural reform could be said to have commenced with a false start in 1973, when the government introduced a dramatic 25% across-the-board tariff cut. However, the measure turned out to be a one-off. In conjunction with other events, the cut precipitated a backlash against reform and there were only 'piecemeal' further reductions in tariffs for over a decade.

Following the election of a new government in 1983, and with Australia's economic malaise becoming increasingly apparent, the reform of border protection arrangements was reinvigorated — with the conversion or elimination of import quotas as well as reductions in tariffs themselves. At first, these reforms were introduced on an ad hoc industry-by-industry basis. Then in 1988, the government introduced the first in a series of phased reductions in tariffs across most industry sectors such that, by 1996, virtually all tariffs (other than for autos and TCF, which were on their own liberalisation paths) had fallen to 5 per cent or less.

The early 1980s had also seen the floating of the Australian dollar (facilitating subsequent adjustment to tariff liberalisation) followed by significant liberalisation of the finance sector, including the removal of exchange and interest rate controls.

Increased international competition in Australia's traded goods sector led to pressures for reductions in input costs, notably in labour markets and (non-traded) public utility services. Previously, local firms had simply been able to pass excessive input costs on to consumers through accommodating 'made-to-measure' increases in tariffs. But now, faced with a government intent on reducing protection, local managers and their workforces needed to improve their own performance and get value from their suppliers.

In turn, pressure mounted for the reform of government policies and institutions that were impeding these changes, and an increasingly broad-ranging program of domestic microeconomic reform was hatched. The reforms ultimately embraced all product (goods and services) markets, factor markets (including the labour market), and the public and private sectors (Box 1).

Over the same period, macroeconomic reforms brought low inflation and greater stability, and tax reforms reduced distortions and improved business incentives. (These reforms played an important role in their own right, as well as complementing structural reforms, but are not the focus of this paper.)

In 1995, strands of the structural reform process were consolidated and extended in a coordinated National Competition Policy (NCP) agreed to by all governments in Australia's federal system. Among other things, the NCP program entailed: an extension of anti-competitive conduct laws to cover previously exempt government and unincorporated enterprises; the review of some 1800 items of anti-competitive regulation; reforms to public monopolies, including 'competitive neutrality' mechanisms, certain structural reform requirements and prices oversight mechanisms where public monopolies were retained; and an access regime for network infrastructure (PC, 2005a).

Box 1: Two decades of economic reform

Trade liberalisation — reductions in tariff assistance (that began in 1973) and the abolition of quantitative import controls — mainly in the automotive, whitegoods and textile, clothing and footwear industries — gathered pace from the mid 1980s. The effective rate of assistance to manufacturing fell from around 35 per cent in the early 1970s to 5 per cent by 2000.

Capital markets — the Australian dollar was floated in March 1983, foreign exchange controls and capital rationing (through interest rate controls) were removed progressively from the early 1980s and foreign-owned banks were allowed to compete — initially for corporate customers and then, in the 1990s, to act as deposit taking institutions.

Infrastructure — partial deregulation and restructuring of airlines, coastal shipping, telecommunications and the waterfront occurred from the late 1980s. Across-the-board commercialisation, corporatisation and privatisation initiatives for government business enterprises were progressively implemented from around the same time.

Labour markets — the Prices and Incomes Accord operated from 1983 to 1996. Award restructuring and simplification, and the shift from centralised wage fixing to enterprise bargaining, began in the late 1980s. Reform accelerated in the mid 1990s with the introduction of the *Workplace Relations Act 1996*, further award simplification (through limiting prescribed employment conditions in enterprise bargaining agreements) and the introduction of individual employment contracts (Australian Workplace Agreements).

Human services — competitive tendering and contracting out, performance-based funding and user charges were introduced in the late 1980s and extended in scope during the 1990s; administrative reforms (for example, financial management and program budgeting) were introduced in health, education and community services in the early 1990s.

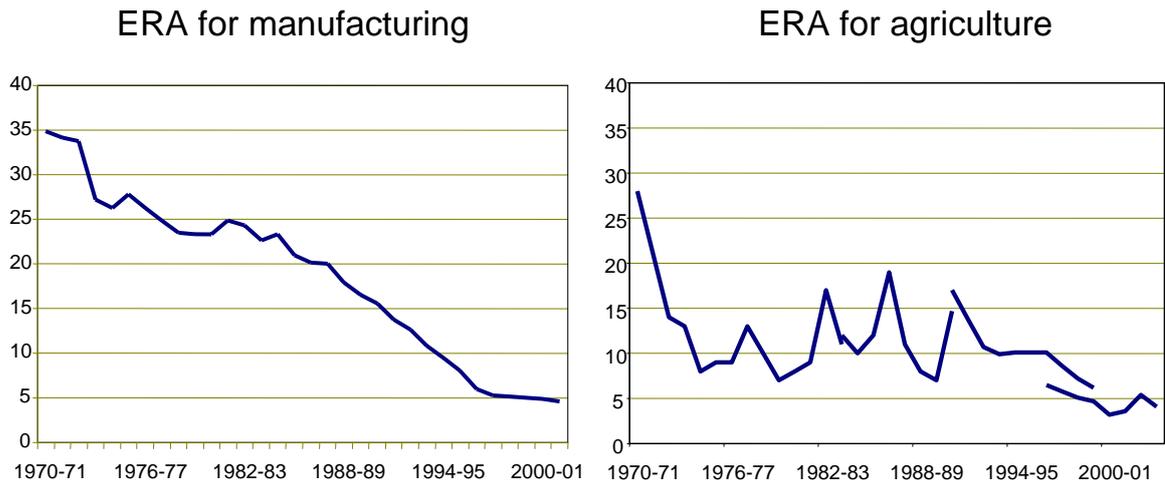
'National Competition policy' reforms — In 1995, further broad-ranging reforms to essential service industries (including energy and road transport), government businesses and anti-competitive regulation was commenced by all Australian governments through a coordinated national program.

Macroeconomic policy — inflation targeting was introduced in 1993. From the mid 1980s, fiscal policy targeted higher national saving (and a lower current account deficit) and, from the mid 1990s, concentrated on reducing government debt, primarily financed through asset sales (privatisation).

Taxation reform — capital gains tax and the dividend imputation system were introduced in 1985 and 1987, respectively. The company tax rate was lowered progressively from the late 1980s. A broad-based consumption tax (GST) was implemented in 2000, replacing the narrow wholesale sales tax system and a range of inefficient state-based duties. And income tax rates were lowered at the same time.

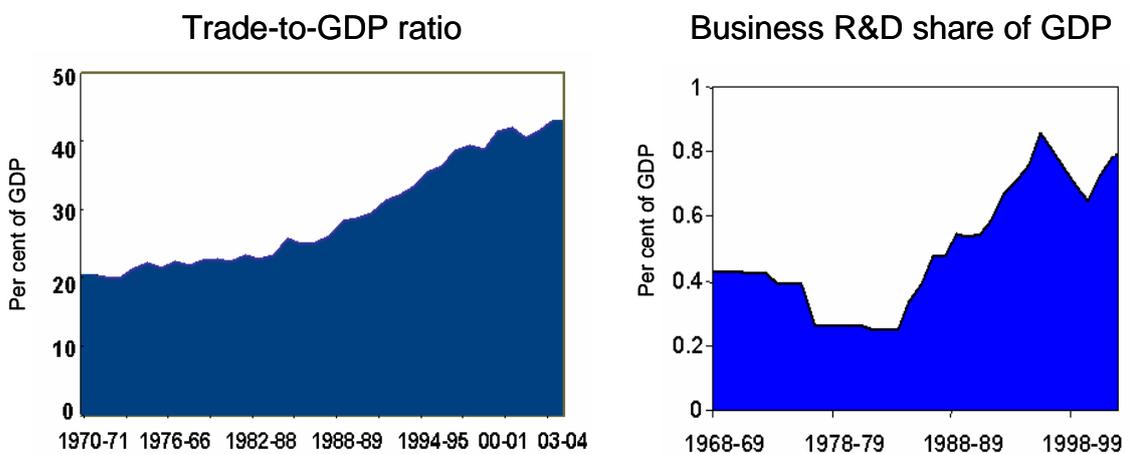
If any single indicator could convey the extent of structural reform in Australia, it would be that essentially Australian measure of relative net protection levels, the effective rate of assistance (ERA). The ERA for manufacturing has declined from 25 to 5 per cent over the past two decades, while agricultural assistance has also fallen (Figure 3).

Figure 3 **Falling effective protection**



Equally, it would be hard to find more striking illustrations of consequent structural and behavioural change than the coincident rise in the trade intensity of Australia's economy, from 27 per cent in the mid 1980s to 44 per cent in 2003, and the sharp increase in business R&D spending as a share of GDP (Figure 4).

Figure 4 **Increased trade and R&D intensity**



A more productive economy

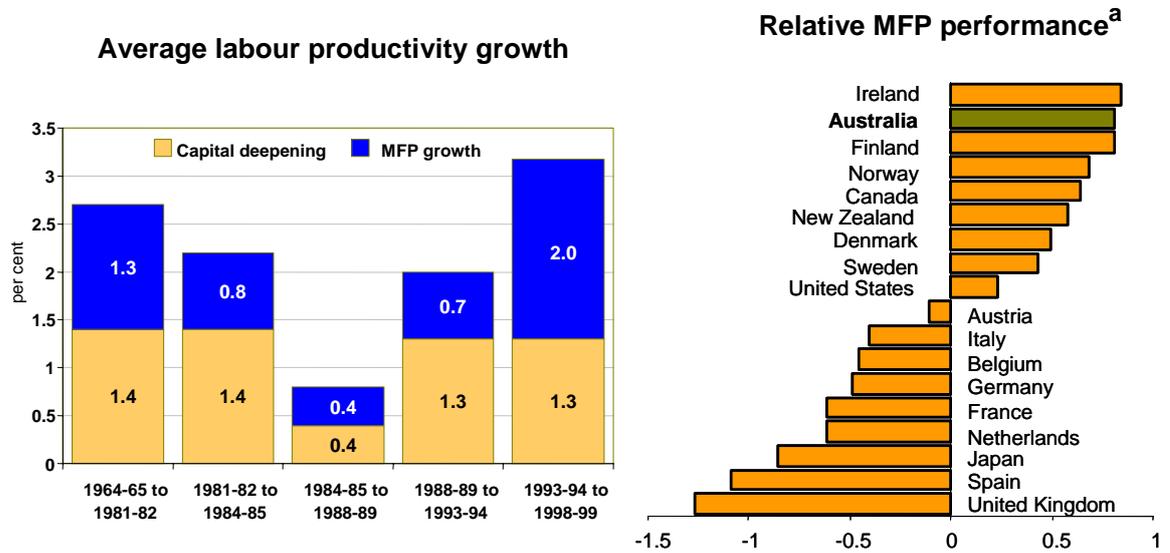
As a consequence, important changes have been wrought in each of the areas previously identified as contributing to our poor productivity performance. For example, there has been:

- a marked decline in high cost labour-intensive or standardised manufacturing activities and a rise of ‘elaborately transformed manufactures’ (PC, 2004). (For example, textiles, clothing and footwear production has fallen in real terms by 40 per cent since 1985, but the manufacturing sector has grown by 40 per cent over the same period);
- major changes in work practices in all sectors, including to accommodate new technology;
- a rise in the intensity of business R&D, and increased innovation generally, with Australia having one of the highest rates of ICT uptake among OECD countries in the past decade (OECD 2004a)

These and other forces are reflected in the productivity performance of a range of industries. For example, multi-factor productivity (MFP) growth in electricity, gas and water jumped by 60 per cent in the 1980s; and the MFP growth rate in transport/storage and communications doubled in the 1990s. Empirical analysis by the Commission found that the price reductions and productivity gains in the infrastructure sector alone yielded a 2½ per cent gain in GDP. The reform program also contributed, indirectly, to sharp productivity improvements in wholesale trade and the finance and insurance industries, where business reorganisation involving the innovative use of ICT was driven by the heightened competitive pressures on customers as well as within the industries themselves, facilitated by a more accommodating industrial relations framework (Johnston et. al. 2000; Parham 2004).

At the aggregate level, Australia experienced a surge in MFP growth during the 1990s, averaging almost 2 per cent, more than double its previous rate (Figure 5). Australia’s MFP performance was also among the best in the OECD and its labour productivity growth exceeded even that of the USA. (OECD 2004b).

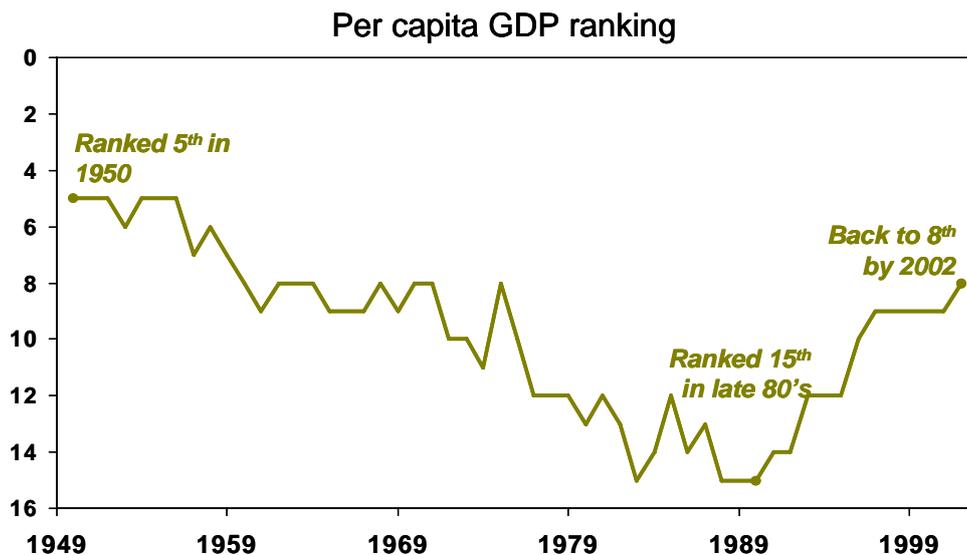
Figure 5 **Australia's productivity turnaround**



^a Percentage points change to average annual MFP growth 1980-1990 to 1990-2000

Accompanied by rising labour utilisation, this translated into annual growth in per capita incomes of around 2½ per cent in that decade, well above the previous average and that for the OECD as a whole (1.7 per cent). As a consequence, Australia has seen its position on the international per capita GDP scale rise again from 15th to 8th over the past decade or so (Figure 6).

Figure 6 **Fall and rise of Australia's economic ranking**



Some (unusual?) features of the reform program

As noted, many of Australia's structural reforms could be said to have followed standard economic prescriptions. However, the way the reforms were implemented in Australia had some features that are perhaps more distinctive.

'Opening the borders' became the first domino

A basic question that has exercised the minds of economic reformers, including those in international agencies, is 'what is the optimal sequence of reforms?' For example, it has been logically argued that, in economic terms, it is better to address domestic distortions and inefficiencies before exposing an economy to international competitive pressures, to minimise adjustment costs. On this logic, reform of the labour market, being the slowest to adjust, should precede trade liberalisation, with financial and exchange markets being last in line.

However, as described previously, the Australian approach effectively turned this sequence on its head. This was a conscious decision to create political momentum and constrain the scope for backsliding. The floating of the dollar was seen as creating an anti-inflation discipline. But it also provided an adjustment safety-valve to mitigate the effects in subsequent liberalisation of import barriers on unemployment and the balance of trade (Corden, 1997).

Opening the borders to foreign goods, services and capital played a critical role in exposing 'upstream' inefficiencies, generating political pressure for reforms in government utility service provision and in labour markets. In particular, it is difficult to imagine that industrial relations reforms could have gone as far as they did without the increased discipline that international price competition placed on unit labour costs.

In a way, it was the very prospect of adjustment costs that provided the motivation for further reforms that, together with a gradualist approach (see below) and a floating exchange rate, ultimately served to contain those costs. In political economy terms, therefore, a lesson from Australia's experience is that external liberalisation has distinct advantages as a first-mover strategy.

We liberalised unilaterally

Unlike other OECD countries, most of Australia's trade liberalisation has been undertaken unilaterally, rather than in exchange for reciprocal concessions by other countries. This has not reflected any failure to engage in or support the then GATT

(now WTO) system, but rather the reality that multilateral trade negotiations for many years did not encompass agricultural trade — which at that time was Australia’s main export interest. This meant that there was little incentive to do reciprocal deals.

Perversely, this turned out to be an advantage for Australia, as we were forced to consider whether reducing our own import protection would yield national gains, regardless of what other countries chose to do. Moreover, Australia generally got ‘credit’ for its liberalisation measures in subsequent multilateral trade negotiations while, through the non-discrimination rule, benefiting from the reciprocal liberalisation of the larger trading powers.

In more recent years, partly out of frustration at lack of progress within the WTO, Australia has been active in pursuing preferential trade agreements. Among others, these include a major agreement with the USA and one currently under negotiation with China. There are signs that Australia’s (unexpectedly) greater success in such bilateral forums may be eroding our traditional willingness to undertake trade-related reforms unilaterally. However, our previous reforms have not left much in the way of trade or investment barriers or other restrictions anyway.

We hastened slowly

Another issue that has exercised reformers is the optimal breadth and pace of reform. For example, some economists have advocated a ‘big bang’ approach of rapidly introducing substantial reforms across an economy, to offset distributional impacts in any one sector and bring forward gains that might otherwise be delayed or forgone as ‘reform fatigue’ or opposition set in. Australia’s neighbour New Zealand could be said to have gone down this route.

Australia adopted a more incrementalist approach, though ultimately with a broad reach. Its early experiment with the 25% tariff cut may have been influential in Australia’s subsequent approach.

The 25% tariff cut was an abrupt change that was not pre-announced by the government. Nor, at that stage, had a significant domestic constituency for trade liberalisation been built. Indeed, the government justified the cut on macro-economic grounds — to constrain inflation — rather than for its potential microeconomic benefits. That this cold shower descended upon an unsuspecting, out-of-shape manufacturing sector just as Australia was about to enter a recession anyway did not help. In hindsight, this bold initiative probably set back the case for tariff reform. It was followed by protection hikes in the ‘sensitive’ sectors, through

the (re)introduction of quotas, which served to widen assistance disparities and the costs of protection, notwithstanding lower average assistance rates.

Later tariff liberalisation programs involved pre-announced and graduated reductions. For example, the phased tariff liberalisation programs that ran from 1988 to 1996 generally involved annual reductions of less than three percentage points.

Likewise, in the 'sensitive' sectors, including steel, autos and TCF, 'industry plans' were devised to provide incremental reform. For instance, under the first auto industry plan, which commenced in 1985, quotas were initially converted into tariff-quotas and then abolished, and the tariff of 57.5 per cent was phased down to 35 per cent in 1992. Subsequent plans have involved gradual, pre-announced tariff reductions, such that auto tariffs fell to 10 per cent at the start of this year and are scheduled to decline to 5 per cent in 2010. Industry plans have also variously included export, investment and R&D subsidies and, in some of the early plans, specific restructuring targets and incentives.

Australia has also taken a gradual or incremental approach to reform in the other key areas.

- In the case of public utilities, for example, the commercialisation and then corporatisation of what became 'government business enterprises' started to spread across different jurisdictions from the mid-1980s. In time, this was followed by more 'hard edged' reforms involving structural separation, privatisation (in some jurisdictions), the entry of new players and, for network infrastructure, regulated provision for third-party access.
- Similarly, labour market reforms have seen a gradual transition from the traditional, highly centralised prescriptive arrangements to decentralised enterprise bargaining constrained by limited core requirements. During most of the 1980s, labour market reforms were restricted to some award restructuring together with an 'accord' between the government and the unions to limit wage demands. Subsequent reforms involved a shift from centralised wage fixing towards enterprise bargaining, and later the introduction of individual employment contracts. The proportion of employees having wages set by collective enterprise agreements or individual agreements has steadily increased from 32 per cent in 1990 to almost 80 per cent in 2002 (PC 2005a).

We acted on a broad front

While Australia's structural reforms could be said to have begun sequentially and were incremental in nature, the program evolved in a cumulative way to encompass reforms across much of the economy.

This brought many of the benefits attributable to 'big bang' approaches, but without all the costs. Potential losses in some sectors from reductions to protection were at least partly offset by benefits derived from reforms in other sectors, thus avoiding undue adjustment and making reform more 'palatable'. For example:

- The Commission's modelling of the economy-wide impacts of reducing trade barriers while also implementing reforms to energy, communications and the public sector, demonstrated that although trade liberalisation alone would reduce manufacturing employment by 0.3 per cent, reforms across all the areas would increase employment in the manufacturing sector by 1.3 per cent (IC, 1996).
- While reforms to public utilities have seen apparently regressive price rises for households, modelling of the indirect effects on other prices and factor incomes has demonstrated net benefits across all household income bands (though greater at higher income levels) (PC, 2005).

Moreover, as virtually all sectors were subjected to reform, the complaints of individual sectors seeking to avoid reform — 'why me?' — were harder to justify and less effective. And the grouping of reforms into 'packages' meant that their estimated net benefits amounted to billions of dollars (see below) and commanded considerable public attention.

We 'oiled the wheels' in sensitive sectors

In the main, Australia used the phasing of reforms to minimise adjustment costs, relying on general retraining schemes and the (relatively generous) welfare safety net to address the needs of displaced workers.

However, particularly in sensitive sectors, governments also introduced some specific measures to deal with adjustment issues. The industry plans often entailed specific retraining schemes or assistance for displaced workers. For example, the post-2005 TCF plan includes \$50 million for this purpose. These measures are in addition to the other assistance tailored to the restructuring needs of these industries. For example, under the PMV plan, automotive tariff reductions have been accompanied by assistance of around \$600 million annually under the Automotive Competitiveness and Investment Scheme (PC, 2002).

In other cases, reform has been accompanied by direct compensation for the economic losses entailed. For example, when price support mechanisms in the dairy industry were abolished in 2000, existing farmers were provided with a substantial stream of payments, financed from a levy on milk consumers, to reflect the reduction in the value of their dairy holdings and to facilitate adjustment within (or out of) the industry.

Governments have also provided specific support for regions in which the costs of reform were concentrated. For example, energy reforms commencing in the early 1990s led to significant labour shedding from electricity generation in the Latrobe Valley in Victoria, which in turn led to a severe downturn in the region. Support has ranged from grants to encourage industry relocation to the region, to retraining, and social and development initiatives. These measures have contributed to strong employment growth since the mid-1990s (PC 2005).

Two institutional innovations in Australia's reform story

Structural reforms of the kind Australia has implemented have long been recognised as economically desirable by most economists, but have faced strong political obstacles in all countries.

This reflects the fact that many of the policies or regulations that have efficiency costs also have pronounced distributional effects. Reform (by definition) is intended to benefit the wider community. But in doing so it typically threatens the privileges or perceived entitlements of a minority, the members of which individually have more at stake — and thus more incentive to be politically active — than the often diffuse beneficiaries. This political asymmetry has featured in the public choice literature, but has been known to economists since at least Pareto.

It is reinforced by the lack of awareness by the potential beneficiaries of what is at stake in reform. Indeed, the general community will often find the arguments of vested interests intuitively more appealing and persuasive than those of the reformers — particularly where identifiable job losses are involved. These political difficulties are compounded by a government bureaucratic structure that tends to be aligned with particular groups or sectors, and that makes it hard for governments to see the big picture.

The inherently adverse political calculus of structural reform is made worse by the front-loaded timing of the losses relative to the benefits. Given the three year electoral cycles that obtained in all Australian jurisdictions until very recently, this almost guaranteed that an incumbent government would experience more of the pain than gain from reforms that it introduced — while potentially seeing the reverse

occur for its successor. The bicameral nature of most jurisdiction's parliamentary systems provided a further obstacle to reform, particularly at the wrong end of the political cycle.

Finally, in some countries, including Australia, there are the additional challenges for nationally beneficial structural reforms posed by a Federal system of government. In Australia, the six states have regulatory powers and responsibilities in all relevant areas. Federations can provide valuable opportunities for constructive policy competition and inter-jurisdictional learning. But in areas that require national systems, diversity can merely manifest itself as productivity-sapping fragmentation. (The best (worst) example of this in Australia was the variation in railway gauges that for many years made a change of trains obligatory for interstate movements of people or goods.)

Such political economy obstacles to reform (summarised in Box 2) are inherent to democratic governance. They have of course not always precluded successful reforms. However, as Mancur Olsen has shown, it can take a crisis to pave the way for wide-ranging reform. This has indeed been the precursor to reform in a number of developed and developing countries (often under the 'guidance' of the Fund or World Bank). This was not the case in Australia, although public perception of a looming crisis in the absence of reform has at times been actively promoted by the government — most famously in the mid-1980s, when it was suggested that Australia risked becoming a 'banana republic'.

Box 2: Five political obstacles to structural reform

1. The costs of reform are concentrated on particular groups, whereas the benefits are more diffuse.
2. The potential winners from reform tend to be (rationally) poorly informed about the tradeoffs.
3. Bureaucratic structures are typically aligned with particular sections of the economy or community.
4. The costs of reform tend to be front-loaded, whereas the benefits arise over time.
5. Multiple jurisdictions increase the difficulty of achieving nationally consistent approaches.

International surveys and case studies have identified a range of other conditions conducive to reform. These include strong and well-motivated political leadership (perhaps the pre-eminent requirement), 'technocratic' capability within government (sometimes at the political level itself), 'good timing' and the emergence of pro-reform lobbies. All of these of course presume the existence of a body of

broadly accepted reformist thinking — a condition arguably satisfied in the 1980s under the so-called ‘Washington Consensus’ (Williamson, 1992).

These various ingredients have applied to varying degrees in different countries over time. Where Australia appears to have differed is in fashioning domestic institutional arrangements expressly to promote and sustain reform by, in part, neutralising the power of vested interests and building wider political and community support. The two institutions that are arguably the most distinctive of the Australian approach in this respect are the Productivity Commission (and its direct forebears, the IAC and the Industry Commission) and the inter-jurisdictional framework for National Competition Policy.

The role of ‘the Commission’

Australia has, over many years, gradually unilaterally reduced protection for its industries, and much of the credit could be attributed to the work of the Commission (Corbet and Stoeckel, 2002, p. 49).

Paradoxically, the institution most identified in Australia with the microeconomic reforms of the past few decades, had its origins in an institution that had underpinned the protectionist side of the Australian settlement for much of the preceding 50 years.

The Tariff Board was created by statute in 1922 as an independent inquiry and advisory body on tariff making. At the government’s request, it would examine the claims of particular industries for increased protection through a public inquiry process, and issue public reports with formal recommendations. Reflecting the consensus of the time, and vague statutory guidance, for most of its life the Board’s recommendations were essentially designed to offset local industry’s ‘margin of cost disadvantage’ against imports (while avoiding ‘excessive’ protection).

In the mid-1960s, under the combined influence of new leadership, a separate public inquiry into Australia’s economic policies (the Vernon Committee) and developments in protection analysis fostered by Australian academics (notably Max Corden), the Board began to question the effects on the wider economy of its long-standing practice of granting protection to individual industries according to need. At the instigation of its new Chairman, G. A. Rattigan, and despite considerable opposition from the Government, the Board increased its analytical capacity, began estimating and publishing ‘true’ relative protection levels of different industries (using the relatively new concept of effective rates of protection) and generally provided more transparent information on the costs of Australia’s protection regime.

The Board's tentative re-evaluation of its tariff-advisory responsibilities had more influence on the Opposition than the Government. When the socially reformist Labour Government swept to power in the early 1970s, it created a new organisation, the Industries Assistance Commission (IAC), to provide a stronger and more wide-ranging institutional vehicle for arms-length advice in the national interest about the costs and benefits of tariff and other assistance to industry. This was predicated on the (then) radical notion for the political left that the fiscal requirements of social programs depended on having an efficient and productive economy.

It is clear from the report which the Government commissioned to create the blueprint for the new organisation (Crawford, 1973) that, in providing for 'public scrutiny' of industry assistance measures and their costs, the IAC was designed to provide a counterweight to the sectional and other political pressures that militated against liberalisation.

There are three features of the organisation's design that have collectively distinguished its contribution:

- *Independence.* The Commission was established by Act of Parliament. Its role was purely advisory, having no judicial, executive or administrative functions. Members of the Commission were appointed by the Governor-General for up to five years and could not be removed by the Government of the day.
- *Openness.* By statute, the government was obliged to obtain advice from the Commission before changing any tariff or financial assistance to industry. The Commission was required to hold public hearings and release draft reports before finalising its recommendations to government. The Commission was also required to prepare an annual report covering its operations and analysing the structure of assistance to Australian industry and its effects. And the government was obliged to release publicly all Commission reports within a specified period.
- *Economy-wide mandate.* Guidelines in the legislation stated that the Commission should be concerned with improving the efficiency with which the economy uses its resources and take account of the interests of consumers and users of products affected by its proposals.

With some variation, these three features remained fundamental to the role and operations of the two organisations that succeeded the IAC; namely the Industry Commission (from 1990 to 1998) and today's Productivity Commission, which was established in April 1998. (For a short history of the Commission, see PC, 2003c). The main differences between the organisations have been in their coverage, which has been progressively extended beyond industry assistance matters to cover structural reform issues across all sectors of the economy, and in social and

environmental as well as economic spheres. (Box 3 indicates the breadth of matters addressed in recent years.)

Box 3: A selection of Productivity Commission studies

Trade liberalisation/industry assistance

- Review of Australia's general tariff arrangements
- Review of automotive assistance
- Post-2005 TCF assistance arrangements
- Pig and pigmeat industries: safeguard action against imports
- Review of the pharmaceuticals industry investment program
- Multilateral liberalisation of services trade
- Trade and investment effects of preferential trading arrangements
- Removing tariffs on goods originating from Least Developed Countries

Productivity studies

- Productivity in Australia's wholesale and retail trade
- ICT use and productivity
- Microeconomic reforms and Australian productivity: exploring the links

Infrastructure reform issues

- Review of the gas access regime
- Price regulation of airport services
- Telecommunications competition regulation
- Progress in rail reform

Labour market issues

- Independent review of the Job Network
- Labour hire employment
- Work arrangements in container stevedoring
- The role of training and innovation in workplace performance
- National workers' compensation arrangements

Environmental issues

- Impact of foot and mouth disease in Australia
- Pricing of irrigation water
- Water quality in the Great Barrier Reef
- Energy efficiency
- The environmental performance of commercial buildings

Social issues

- Australia's gambling industries
- Indicators of indigenous disadvantage
- Social capital
- Review of the Disability Discrimination Act
- Nursing home subsidies
- Inquiry on first home ownership

Regulatory reviews

- Reform of building regulation
- Impact of native vegetation and biodiversity regulations
- Regulation of the taxi industry
- Review of the Prices Surveillance Act
- Review of mutual recognition
- Review of legislation regulating the architectural profession

Other studies

- Cost recovery by Commonwealth Agencies
- Report of Government services
- Resourcing universities
- GP compliance costs
- Impact of indirect taxes on exporters
- Impacts of medical technology in Australia
- Public liability claims management

How has the Commission assisted reform?

In the context of the previously described political asymmetries, the Commission has been able to assist reform in a number of ways.

Firstly, it has provided Government with a source of well researched advice on structural reform that is impartial and concerned with the longer term interests of the community as a whole. As noted, while governments face no shortage of information and advice, much of it can be self-serving or too narrowly focussed to allow for a balanced assessment.

The Commission's processes also ensure that the arguments of vested interests will be subjected to rigorous scrutiny, weakening their influence if they don't hold up. For example:

- Claims by opponents of NCP that depopulation and other problems in regional Australia were attributable to the policy were examined in a 1999 inquiry. The Commission found that longer-term factors — including technological advances, changing consumer tastes and lifestyle preferences, and declining prices for agricultural commodities — were primarily responsible. Further, modelling undertaken as part of the inquiry indicated that NCP was likely to increase net income in all but one region.
- To help justify the proliferation of gaming machines during the 1990s, gambling industry interests (and some State governments) promulgated a number of studies, incorporating 'multiplier analysis', that suggested that growth of the industry created significant additional employment. These and other claims were examined in the Commission's 1999 inquiry into *Australia's Gambling Industries*. It showed how gambling industry expansion had largely displaced other forms of economic activity, with little net effect on job numbers. Claims of major employment benefits appear to have been made less frequently (and treated more sceptically) since.

Second, the Commission's findings and recommendations to government generally have the advantage of having been shaped in the light of extensive public input, and feedback on a draft report. This means that they are more likely to have taken into account all relevant considerations and thus be more robust and reliable.

Many areas of structural policy involve complexities and the potential for impacts on different groups such that the best approaches can really only be determined through public consultation. Even tariff reform, where the economic theory is perhaps the most straight-forward, requires a number of judgements about pace, timing and adjustment for which there are no 'textbook' answers. When it comes to issues such as the regulation of monopoly infrastructure services, or activities with

important social or environmental dimensions (health, welfare, conservation), the need for public feedback to inform judgements is even more critical.

This is illustrated by the fact that, in a number of cases, the Commission's final findings and recommendations to government have differed in significant respects from those in its draft reports. Recent examples include its report on the regulation of third-party access to gas pipelines, where it changed and refined its proposed criteria for using more light-handed regulation; and its report on an assistance program for the pharmaceuticals industry, where it changed its position from recommending termination of the scheme to re-focussing it as an R&D support measure (PC 2002, PC 2003).

Third, the Commission's processes — including public submissions, hearings, draft and final reports — provide governments with an opportunity to gauge at arms length the likely reactions of the community and interest groups to different policy approaches. This can reduce the prospect of unanticipated responses which could ultimately force policy reversals.

As noted, a good example of such a reversal was the 25% tariff cut, which provoked a protectionist counter-reaction in key industries that took decades to unwind. However, the subsequent major liberalisation program involved approaches that had been publicly tested and has stuck.

Another example was the Commission's 1997 inquiry into Private Health Insurance, which led to changes to the Community Rating System. This system — which prevented health funds discriminating on the basis of age — was thought 'fair' by many and seemed politically off limits. However, the Commission showed that it led to adverse selection problems and ultimate inequities, with younger people not contributing to the pool causing premiums for remaining (generally older) members to spiral up, resulting in further exits. The Commission's recommendations that people entering insurance late pay higher premiums than those who enter early, gained more support than expected and were eventually adopted by the Government (to considerable effect).

Fourth, governments can use the Commission's reports and analyses in making the case for policy changes, or in resisting pressures to introduce policy measures that would be costly nationally. Thus, for example:

- Commission modelling in the late 1980s suggested that across-the-board tariff liberalisation and some other micro-economics reforms could increase Australia's GDP by some \$16 billion, or \$1600 per household per year (1988 dollars). These headline grabbing numbers proved important in the subsequent successful implementation of reforms (IAC, 1989).

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- The Commission's analysis of the effects of NCP on regional Australia (noted above), together with modelling indicating that the program would generate significant net benefits, blunted attacks on the NCP and contributed to its renewal and extension in 2000 (see below).
 - The Commission's detailed analyses of work practices in key industries, including the waterfront and construction, exposed cost padding and productivity-sapping arrangements. The studies provided independent support for government and business claims about the urgent need for further reform in those areas.

By the same token, such informational ammunition can be directed against a government that is unwilling to reform existing policies. Opposition parties from different sides of politics have frequently used Commission reports in this way. Contemporary examples include the Commission's recommendations to remove barriers to competition in broadcasting and to review Commonwealth tax provisions for housing investment. In this way the Commission's processes can be a discipline on government itself, as well as on the claims of vested interests.

(Of course, this means that government will sometimes be reluctant to send politically contentious issues to the Commission. It may also help explain the periodic backlashes against the institution (PC, 2003c); and perhaps the lack of comparable bodies overseas – see later.)

Finally, the Commission's public inquiry processes and reporting can in themselves engender a wider awareness within the community of the costs of existing policies and the benefits from reform. This does not mean that the community *at large* would necessarily become active in supporting reform — or even become strongly in favour of it. (Even today, for example, surveys of community attitudes in Australia typically reveal considerable support for import protection.) However, there is at least likely to be a more neutral position.

More importantly, the Commission's processes and reports can help enfranchise and activate those interests who would benefit most from reform, by alerting them to the costs they are currently bearing, and by providing a ready public forum in which to put their case.

The Commission's detailed analysis of the costs borne by the mining and agricultural sectors as a consequence of manufacturing protection is perhaps the clearest (and most significant) example. The evidence it produced helped to galvanise those sectors as major political forces for tariff liberalisation in Australia. Given the traditionally passive, or even supportive, stance of the rural sector and its

political representatives, this was an important development. The then head of the peak farming organisation's secretariat has observed:

The catalytic role played by the IAC during the 1970s in lifting the economic debate and explaining the impact of protection cannot be overstated. We fired the 'bullets' made by the IAC (Trebeck, cited in Kelly, 1992, p. 45).

Similarly, the Commission's detailed analysis of the costs borne by all sectors of the economy as a consequence of inefficiencies in government business enterprises producing utility services helped to marshal business groups behind GBE reform in Australia.

In a quite different context, the 1999 report on gambling provided informational firepower for social groups concerned about the spread of gaming machines. The Commission's analysis confirmed that one-third of the revenue from gaming machines was derived from 'problem gamblers', and that the operation of the machines generated substantial social costs that potentially outweighed the benefits.

The Commission's role in perspective

These observations should not be interpreted as suggesting that the Commission has been the sole driver of liberalisation. At various times other review bodies have been used to perform a similar role, particularly for financial and tax reforms, but also extending to such wide-ranging reforms as National Competition Policy (see below). Indeed, Australia could be said to have a long-standing proclivity for 'expert' or independent inquiries, dating back at least to the Brigden Tariff Review of 1929.

Moreover, as for all such bodies, the Commission's role is informational and advisory. It is reliant on others to help take up its message and, ultimately, to implement reforms — a process which has not always delivered, or sometimes taken a considerable time.

The Australian press has often played an important part in promoting the Commission's findings to a wider audience, as well as in encouraging governments to implement its recommendations (Kelly, 1992). Ross Garnaut, an academic and influential adviser to Labor Prime Minister Bob Hawke in the 1980s, has reflected on the early relationship between the Commission's predecessor and the press:

By the end of the 1960s, the financial press, led by the *Australian Financial Review*, was giving extensive coverage to the Tariff Board's heresy and was itself playing a major role in publishing the case against protection. The Tariff Board perspective gradually became more influential in other areas of government (Garnaut 1994, p. 63).

Political leadership has of course been crucial both in selling reform and implementing it. Australia has been fortunate over the past two decades in having leaders who were willing to expend short-term political capital in pursuit of the longer-term benefits of reform. At critical stages, such reform leadership coincided across jurisdictions and, at least at the Commonwealth level, was bolstered by a reformist opposition.

It is also clear that political will is not formed in a vacuum. It is shaped by perceptions of what is at stake in reform, and the extent to which the expenditure of political capital will be rewarded or punished electorally. The Commission's processes and reports are generally seen as having helped clarify such tradeoffs for governments, as well as engendering a political environment that has been more receptive to reform.

The National Competition Policy

A second distinctive institutional innovation in Australia's structural reform story has been the mechanisms for the national coordination of pro-competition reforms across the nine jurisdictions of the Australian federation. The need for such coordination did not arise with the initial waves of trade and financial market liberalisation, as these policy areas were within the realm of the federal government. However, in many other areas of structural policy, the States (and Territories) held sway.

As noted, faced with political pressure from businesses increasingly exposed to international competition, some State governments began to reform their public utilities and other infrastructure service provision from the mid-1980s. While some progress had been made over the next decade, it was variable across jurisdictions. Moreover, different approaches were emerging which lacked national coherence in areas where national consistency was important. European countries were seen as having done more to advance a single market through the 'Community' than Australia, a single country, had managed to achieve.

These problems were discussed in a series of Special Premiers' Conferences convened in the early 1990s, as part of the (then) Prime Minister's 'new Federalism' initiative. In October 1992, an independent review (the Hilmer Review) was established to devise a framework for progressing pro-competitive structural reforms across all jurisdictions. Following further discussions and analysis, the National Competition Policy — comprising a comprehensive program of reforms — was agreed to by government leaders (through what had by then become the Council of Australian Governments (CoAG)) in 1994.

Again the identified reforms, while having some special features, were for the most part not novel. What *was* new and unprecedented in Australia, was the manner in which the reform program was implemented and adhered to across jurisdictions. A recent review of the NCP by the Productivity Commission singled out a number of features that contributed to its success.

Key success factors in the National Competition Policy

An essential condition was the acceptance by government leaders that reforms were needed and would yield net benefits. Broad agreement was achieved on some key reform principles, priority areas and policy prescriptions. This was cemented by the Hilmer Review process, but reflected a decade of preceding policy discussion, analysis and learning facilitated by Industry Commission inquiries, as well as the work of other government agencies (such as the Economic Planning and Advisory Council and Bureau of Industry Economics), privately funded think tanks, industry organisations and academics.

A cornerstone principle of the National Competition Policy is that arrangements that inhibit competition should be retained only if they can be shown to be in the public interest. This represented a reversal of the traditional onus of proof, under which it is up to the proponents of change to demonstrate that it would yield net benefits.

That such a reversal was endorsed by all governments was testimony to the extent of political agreement about the benefits of competition. It may also have reflected recognition of the political economy benefits of effectively placing the onus on those who benefit from restrictions to demonstrate that the *community* would lose from removing them. This of course is a hard thing to do, especially since many such regulatory restrictions got there in the first place because their wider costs had not been adequately accounted for. Nevertheless, some restrictions have rightly been retained on public interest grounds — for example, involving consumer protection or public health and safety considerations.

There were a number of other design features of the NCP that contributed to its success in driving structural reform across different jurisdictions.

One was that while establishing agreed principles and approaches to reform, it allowed for some flexibility in how individual jurisdictions met their commitments. For example, each government was free to implement its own approach to competitive neutrality and structural reform for government monopolies; they could initiate their own regimes for third-party access to ‘bottleneck’ infrastructure; and each could identify which legislation required review and the manner and sequence in which the reviews were conducted. This was critical to the political acceptability

of a common program across jurisdictions with different circumstances. It also facilitated implementational experimentation and learning. The inevitable downside was some variability in performance and ongoing fragmentation in key areas like rail freight.

A second important feature was the establishment of another independent statutory body — the National Competition Council — to monitor reforms across jurisdictions, to report on progress and to identify where commitments had not been met or where actions fell short. This brought transparency to the process and helped ensure that jurisdictional flexibility was consistent with the agreed high-level principles and objectives of the reform program.

A third critical ingredient was provision within the agreement for financial payments from the Federal Government to the States and Territories. These were based primarily on the logic that reforms would generate income gains that would in turn yield tax revenue accruing disproportionately to the Commonwealth, given the marked vertical fiscal imbalance in Australia's federation. The 'competition payments' were calculated on the basis of projections undertaken by the Industry Commission, and amounted to an allocation of \$5.7 billion spread over nine years. Whether particular States received their payments in full depended largely on the assessments of their progress undertaken by the NCC.

As the Commission noted in its recent review of NCP, the payments played a critical role in maintaining adherence to the reform program despite rising political resistance. With the payments dependent on progress, they gave teeth to the NCC's monitoring role and provided an important discipline for sustained action and against backsliding.

While these three core features produced an effective and integrated program, the implementation of NCP was not without deficiencies. As the Productivity Commission has documented, legislative reviews of anti-competitive regulation were of variable quality and the public interest provisions were not well understood by the community, nor always properly followed by governments. In some areas more attention could have been given early on to the adjustment consequences of pro-competitive reforms.

A resulting backlash against NCP was greater than it might have been had governments been more active in selling the benefits of reforms. Instead this was left to the NCC, which created a perceived conflict with its 'umpire' role. Moreover, States often depicted the NCC's recommendations to withhold competition payments as an unfair penalty, rather than a (justified) decision not to pay a dividend where agreed reforms had not been implemented.

Notwithstanding such problems, Heads of Government agreed to renew the whole NCP process after five years, with only minor modifications, and it has held together now for a decade. It represents an achievement in inter-governmental economic reform that is without precedent in Australia (and possibly in other federations as well).

Further reform challenges for Australia

After more than two decades of seemingly relentless reform, it might be supposed that Australia had ‘arrived’ in a structural policy sense; that there would be little more to do, or little need to do more. Indeed, there are many within Australia who would take that view. There is some evidence of reform fatigue, of a desire to relax and enjoy the dividends — and even of complacency about Australia’s prospects.

However, the reality with which many Australians and their governments are currently coming to terms is that there remains considerable scope and indeed a pressing need for further reform if our country is to realise its potential, and successfully manage some major challenges that lie ahead.

While Australia’s productivity growth has been among the highest in the OECD, this has reflected a need to catch up from a low base — we still have a fair way to go. For example, in terms of GDP per hour worked, in 2004 we were at 81 per cent of the US level, only slightly above where we were in 1950. Our manufacturing productivity in particular remains well below US (and other OECD) levels. (OECD, 2005).

Equally, while many Australians have benefited from the strong growth in household incomes over the past dozen years, and Australia’s relatively even distribution of incomes has been maintained, it would be difficult to argue that standards of living should not be any higher, that current disparities between indigenous and other Australians were satisfactory, or that historically high levels of welfare dependency should not be addressed.

Moreover, there are both external and domestic challenges to our living standards that would make it very unwise to rest on our laurels.

The biggest looming imperative for further reform is the pronounced ageing of Australia’s population. Though not unique to Australia, and largely a consequence of beneficial increases in longevity, this will significantly reduce the potential labour supply relative to the population and substantially increase demands on health and aged care. Projections by the Commission suggest that, in the absence of policy responses, this will in turn cut per capita growth rates by as much as a half.

At the same time, it will create a fiscal gap rising to some 6½ per cent of GDP, which would imply a cumulative debt burden twice as large as Australia's GDP by the middle of this century (PC, 2005).

Responding to such challenges will clearly require Australia to pursue whatever reform opportunities are available to enhance income growth and achieve cost-effective service delivery.

Recent major reviews of the structural policy landscape by the Productivity Commission have revealed considerable scope to achieve a more productive and sustainable Australia by building on past reform efforts in economic infrastructure and regulation, as well as by extending reform into areas of social infrastructure and national resource management.

Box 4: The Commission's proposed reform agenda, 2005

Priorities for future reform identified in the recent Productivity Commission reports on NCP and Ageing include:

- strengthening the operation of the national electricity market;
- enhancing water allocation and trading regimes to better address scarcity and negative environmental impacts;
- delivering a more efficient and integrated freight transport system;
- addressing uncertainty and policy fragmentation in greenhouse gas abatement policies;
- improving the efficiency and effectiveness of consumer protection policies;
- introducing a more targeted legislation review mechanism, while strengthening arrangements to screen any new legislative restrictions on competition;
- re-energising reform in the vocational education and training area;
- introducing incentives to improve labour force participation rates, especially among males;
- increasing productivity in the health sector by improving flexibility, encouraging adoption of evidence-based medical practices, and enhancing coordination within and between jurisdictions; and
- deepening reform in other key policy areas, including industrial relations and taxation, and generally reducing regulatory burdens.

Source: PC 2005a; PC 2005b.

The agenda is broad and in some respects even more challenging than the early reform programs. It goes beyond purely 'economic' issues, involving relatively well-established pro-competitive prescriptions, to areas that also have important social or environmental dimensions. Even in the economic sphere, policy makers

face new complexities in refining pro-competitive regulation to achieve a better balance between market failure and regulatory failure. Moreover, the future agenda largely occupies inter-jurisdictional terrain and will require coordination and cooperation among several governments.

All of this provides an important new test for the ‘Australian approach’ to reform. There are positive early signs in the continuing willingness of Federal and State Governments alike to commission ‘expert advice’ and promote public awareness of the challenges that require further reform. However, unlike the lead-up to the National Competition Policy, there appears to be less agreement about the best ways forward, including the priority areas. This partly reflects the complexity of the issues in areas like health or natural resource management, and is a reason why in such areas the Commission considered that, as in the past, the best initial step would be for heads of government to sponsor public reviews of the options.

Lessons for others?

There are a number of features of the Australian reform story that appear to resonate with other countries’ reform experience. These include effective political leadership, opposition parties that were supportive of (or at least not strongly opposed to) key structural reforms, an economically literate cadre of political advisers and bureaucrats (drawing on ideas internationally — including from international agencies), mostly ‘good timing’, in terms of political or business cycles, and the emergence of coalitions in favour of reform.

Such circumstances can clearly help overcome the political obstacles to reform. However some of these conditions can be temporary and may be quickly reversed, as we have seen in a number of countries.

If Australia has any special insights to offer from its experience of the past few decades, it is about achieving enduring reforms. Apart from the ‘false start’ of 1973, reforms have generally stuck, and reform programs developed under one government have largely been maintained by new governments. The tariff liberalisation program and the NCP are two important examples. Features of the Australian story that help explain its success in this respect include the institutions and implementation strategies detailed here that were devised to promote an awareness of the benefits from reform, to help build political support, weaken resistance and promote adjustment.

Those Australian innovations could be said to have been born of necessity, given the magnitude of the political challenges resulting from decades of perceived entitlement under the Australian Settlement. That said, my reading of the

international literature suggests that the political-economy problems we have faced are not unique to us and therefore that Australia's approach to reform may also have wider relevance. (This impression has been reinforced by reading papers prepared for a recent workshop at the World Bank.)

I am further encouraged in this belief by the considerable interest that other countries have shown over the years in the role and operations of the Productivity Commission and its predecessors. This has not been confined to developed countries. If anything, there has been more interest shown by developing countries.

The fact that no equivalent to 'the Commission' yet appears to have been established in any other country (I would gladly stand corrected!) may not augur well for its wider applicability. However, that such an institution has in-principle relevance would seem vindicated by its promotion some years ago within the UNCTAD and WTO, in the context of mooted international initiatives to encourage domestic transparency of the costs of protection. (Rattigan and Carmichael, 1996.)

The reality is that the creation of institutions to promote and sustain reform is likely to fall prey to the same political forces that those institutions are intended to address. In Australia, the reformist tendencies of the Tariff Board and the establishment of the IAC were strongly resisted by protectionist interests and their political and bureaucratic sponsors. It took strong political and organisational leadership to achieve those changes. On reflection, perhaps that very fact provides a final lesson from the Australian experience. Political leadership is critical to structural reform, but its influence on policy in the longer term can be ephemeral. Its most enduring legacy may well come from more fundamental actions to entrench institutions and processes that can facilitate ongoing reform beyond the life of any one government.

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