ESTIMATING THE BENEFITS OF HILMER
AND RELATED REFORMS

John Quiggin

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ESTIMATING THE BENEFITS OF HILMER
AND RELATED REFORMS

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ESTIMATING THE BENEFITS OF HILMER AND RELATED REFORMS

In a recent report (IC 1995a) the Industry Commission (IC) estimates that the implementation of the Hilmer Report and related reforms will yield a GDP gain of around 5.4 per cent. A significant component of this gain is derived, not from the Hilmer recommendations themselves, but from the broader program of microeconomic reforms that the IC has advocated for at least ten years. Furthermore, the IC interpretation of the Hilmer reforms goes far beyond anything that could be directly inferred from the Hilmer Report, including, for example, the elimination of most regulations governing the building sector and a radical extension of the self-regulation approach already adopted in areas such as meat processing and aviation.

If the IC estimates are accepted, the implementation of radical micro-economic reform is clearly the most important single element of economic policy. The estimated gains outweigh the loss in output associated with a serious recession such as that of 1989-91. Other estimates of the benefits of micro-economic reform, for example those of the Business Council of Australia (BCA 1994) and Bureau of Industry Economics (BIE 1994), imply that Australia could become the richest nation in the OECD (in terms of per capita GDP) simply by adopting the micro-economic reform package.

The IC and other estimates turn on two classes of assumptions. First there are detailed assumptions about the productivity effects of micro-economic reform in the sectors of the economy directly affected. The IC (1995a) report presents these assumptions, and the underlying rationale, more clearly than any of the previous studies. Second, there are assumptions about the flow-on effects to the economy as a whole. The crucial assumptions are built into the long-run version of the ORANI model used in the simulations. They generally imply that the long-run GDP gains associated with micro-economic reform will be at least twice the direct productivity benefits and sometimes (eg BCA 1994) ten times the direct benefits.

In this paper, both classes of assumptions are subject to a detailed critique. It is argued that most of the estimated productivity gains are grossly over-optimistic, representing upper bounds to possible achievement rather than likely outcomes. Furthermore, it is argued that the dominant flow-on effects of micro-economic reform will be negative, arising from the fact that at least some of the workers directly displaced by reform will be permanently displaced from the employed labour force.

The paper does not address the issue of revenue effects of reform. The low estimate for the total GDP effect presented here implies that revenue effects will also be small. In particular, any positive revenue effects could be permanently outweighed by
relatively small mistakes, for example, the underpricing of public assets in the process of privatisation.

The paper is set out as follows. Section 1 is a critique of the world-best practice approach as a method of estimating the benefits of micro-economic reform. Section 2 is concerned with compulsory competitive tendering and Section 3 with the Hiltmer-specific reforms in the area of anti-competitive regulation. In each of these sections, alternative estimates of the direct benefits of micro-economic reform are presented. In section 4, these estimates are aggregated and unemployment effects are taken into account to yield a total estimated benefit of 0.5 per cent of GDP. The discrepancy between this estimate and the IC estimate of 5.4 per cent is discussed and shown to relate in part to the assumed flow-on effects of reform in the ORANI model. Sections 5 and 6 contain discussion of distributional and timescale issues. Section 7 examines alternative estimates of the benefits of micro-economic reform, most of which have been more optimistic than those of the IC. Section 8 deals with welfare-reducing reforms and their implications for the analysis. Section 9 takes account of the more recent IC analysis Competitive Tendering and Contracting (CTC), presented in IC (1995b). Finally, some concluding comments are offered.

1. World best practice and government business enterprises

An important part of the Hiltmer reform program is the creation of a more competitive environment for government business enterprises. There is some ambiguity as to whether this ultimately implies privatisation, but the reforms considered in IC (1995) stop short of this. The basic approach used in evaluating the benefits of reform is to assume that reform will enable Australian government business enterprises to achieve 'world best practice'.

One method of implementing this approach would be to identify specific deviations from world best practice, show how they result from inadequate competition and estimate the benefits from removing them. Examples would include excess staffing requirements in railways and other public transport1. Such an approach would yield a lower bound estimate of the benefits of reform, since presumably some deviations from world best practice would not be identified.

This lower bound approach is not adopted by IC (1995). Instead the approach is to identify a 'benchmark' enterprise and assume, without any specification of actual changes in practices, that reform will lead to the performance of the benchmark enterprise being emulated. The assessment in IC (1995) typically begins with a comparison that is clearly untenable. For example, labour productivity (in GW/employee) in the Australian

1 As will be discussed further below, in implementing an approach of this kind, care should be taken to distinguish between transfers from employees, for example in the form of increased work intensity or reduced wages, and pure efficiency gains.
electricity industry is compared to that of a Canadian company serving a few large industrial customers. Of course, the small number of customers greatly reduces the need for line workers and service technicians. Similarly, Australian productivity in international telephone calls is compared to that of Switzerland, even though some local calls in Australia cover more distance than many international calls from Switzerland.

The world best practice measure is then taken to be something a little less than the initially chosen value. Even though the measure used is above any plausible upper bound, it is made to appear more reasonable by reference to the original, clearly invalid comparison. In electricity, the world best practice standard is less than the labour productivity of the best Canadian firms, but better than the best US and Japanese utilities, many of which have a substantial hydro or nuclear component. In telecommunications, rather than matching Switzerland, with a population density 100 times that of Australia, it is assumed that Australian telecommunications firms can match the labour productivity of Sweden where the population density is only 10 times our own.

The final step in the argument is to assume that competition will automatically bring about the achievement of these world best practice levels. There is nothing wrong with aiming high, but as predictions, these estimates must be regarded as upper bounds. We now consider the cases in detail.

1.1 Telstra

The treatment of Telstra illustrates a number of features of the IC’s treatment of the evidence. First, productivity improvements that are entirely independent of the Hilmer reforms are claimed as benefits of those reforms.

The telecommunications industry is characterised by rapid technological progress. The rate of technical progress is most satisfactorily measured by the rate of growth of total factor productivity (TFP). Typical rates of TFP growth have been in the range 4 to 5 per cent for most countries over the past twenty years, whether or not changes in the organisation of the telecommunications industry have taken place (Arena, Bahitsevanoglou and Branton 1992). It follows that, assuming stable real input prices and profit levels, and an economy wide TFP growth rate of around 1 per cent, it is reasonable to expect prices to decline on average by about 3 to 4 per cent in real terms each year. This rate should be taken as a benchmark in assessing the benefits of structural reform. A TFP growth rate in excess of 5 per cent is indicative of efficiency gains associated with structural reform.

Prior to the introduction of competition real prices charged by Telecom for domestic telephone services fell at about 3 to 4 per cent a year, exactly as would be expected. The price cap regime imposed on Telstra since then requires that prices should, on average, continue to fall at least as fast as before the introduction of competition.
Telstra has given no price reductions beyond those required to meet the price cap. Yet the IC (1995) claims the entire price reduction since the introduction of competition as a benefit of reform.

Second, over-optimistic claims are made about the potential benefits of world best practice. As has already been indicated, the assumption is made that Australia can equal the measured productivity of Sweden in terms of main lines per employee and minutes of international telephone traffic per employee. An obvious objection to this comparison has already been made — the population density of Sweden is ten times that of Australia. Moreover, the main population centres of Sweden are within 1500 kilometres of major European capitals from Moscow to London, making the international telephone traffic comparison invalid.

A more subtle objection relates to the whole notion of world best practice. In any study of this kind, there will be errors, measurement biases and random luck factors. As an example of a measurement bias, the figures used here fail to take proper account of contracting out. Firms that contract out a large proportion of their work will have spuriously high labour productivity. As an example of a ‘luck’ factor, Sweden happens to have a large electronics industry specialising in telecommunications. This has obvious implications for the supply of skilled telecommunications technicians and engineers.

If a large enough sample is collected, it is bound to include some firms or countries with exceptionally good measured performance, arising from a combination of factors of this kind. There are no grounds for supposing that these performances can be emulated by all the firms or countries in the sample.

A more plausible comparison would be with the US or Canada, both of which have average prices about 10 per cent below those in Australia (note however, that this comparison does not take account of the larger local call zones applying in Australia). Assuming that prices roughly reflect productivity (that is, that normal profits are being made in both countries) this sets an upper bound to likely efficiency gains.

Finally, the IC assumes that these gains will be achieved as a result of the abolition of the existing duopoly. Yet the move from monopoly to duopoly has not accelerated the rate of price reductions or of technical progress. It seems unlikely that the Australian market could support more than three major suppliers (the US long-distance market, which has been deregulated for more than a decade, is dominated by three firms). Moreover, US experience and the response to the entry of Optus suggests that Telecom is likely to retain at least 60 per cent of the market for many years to come. It therefore seems unlikely that competitive pressure will generate massive gains.

For the purpose of future analysis, it is assumed that competition will lead to a reduction of 10 per cent in labour and capital costs, yielding a total cost saving of 0.2 per cent of GDP. By contrast, the assumptions made by the IC imply a direct gain of around 0.5 per cent of GDP.
1.2 Australia Post

As the IC observes, labour productivity in Australia Post has improved steadily since corporatisation, rising by 24 per cent over the past six years (part of this measured improvement is a spurious improvement associated with contracting out). Australia Post currently projects that productivity will grow at 2.5 per cent per annum. The IC suggests that, under reform, a rate of 3 per cent can be achieved. That is, the extra growth attributable to reform is at a rate of 0.5 per cent per annum, or 2 per cent over the four-year time-frame considered here. However, the IC models the impact of Hilmer as capturing the entire productivity growth of Australia Post. Unless Hilmer’s associated reforms are taken to include the Whitlam government’s decision to corporatise Australia Post, and also to include technological progress in postal services, this is illegitimate. In subsequent analysis, the net gain will be taken to be 2 per cent, implying a labour cost saving of around $25 million or 0.006 per cent of GDP. The IC assumptions imply a direct gain of around 0.04 per cent.

1.3 FAC and CAA

The IC presents both time-series and cross-section evidence on productivity for airport enterprises measured in terms of aircraft movements per input unit. This evidence gives clear support to the intuitively obvious notion that the activities of airports are subject to scale economies. That is, the larger the number of flights arriving at a given airport, the lower the cost per flight. Thus, for example, Sydney, Australia’s busiest airport was the lowest-cost, and in the international comparison, the most efficient airports were Gatwick and Vancouver (both major international hubs) and the least efficient were Cairns and Christchurch. The time series evidence tells the same story. Productivity declined during the pilots strike and has risen strongly since then.

The benefit estimates for reform used by the IC are based for the FAC are based on the assumption that all Australian airports will reach the Sydney capital productivity level, yielding an 8 per cent reduction in total costs. This seems unlikely in the absence of massive increases in the numbers of flights. For both the FAC and CAA, the IC extrapolates previous productivity gains and treats the whole gain as a result of Hilmer. It seems more reasonable to assume that half the observed gains are attributable to general technological improvements and to scale economies associated with increased output. These assumptions would yield gains of 2 per cent for the FAC and 8 per cent for the CAA, compared to the 12 per cent and 16 per cent assumed by the IC. The direct cost savings are estimated to be about $5 million per year for the FAC and $48 million for the CAA, or around 0.01 per cent of GDP compared to 0.03 per cent direct gains assumed by the IC.
It seems unlikely that with the breakup and sale of the FAC will yield additional net benefits. The very limited possibilities for competition between airports located in different cities will be offset by the loss of economies of scope. In the British case, even though there were three London airports, the British Airports Authority was privatized intact to preserve these economies.

1.4 Electricity, gas and water

Reform of electricity and gas is the biggest single source of the gains estimated in the IC study, contributing a GDP gain of 1.4 per cent. The estimates suffer from most of the deficiencies already addressed in the case of Telstra. As with telecommunications, the electricity industry has been characterised by steady growth in TFP, at annual rates of 3 to 4 per cent, for many years. As the IC observes, the rate of TFP growth may even have decelerated since micro-economic reform began in earnest in the late eighties. For example, the BIE (1994) estimated a TFP growth rate of only 1 per cent for the period 1989-90 to 1991-92. EPAC, however, found a slight acceleration, estimating that the rate of TFP growth was 4.2 per cent over the period 1989-90 to 1992-93, compared to 3.1 per cent for the preceding decade.

This is despite the availability of an easy source of productivity gains. Over-optimistic demand projections in the late seventies and early eighties led to the construction of excess capacity. The gradual adjustment of capacity to demand has provided an automatic source of gains in TFP. A number of advocates of micro reform have blamed the growth of overcapacity on public ownership. But exactly the same overcapacity has emerged in the private market for office space and other construction. The basic problem is the impossibility of accurately forecasting future demand.

The evidence presented by the IC gives no grounds for supposing that micro-economic reform has thus far yielded any net gains. Nevertheless, labour productivity improvements of 50 per cent are projected, based on the world best practice approach. The application of world best practice methods in this case is totally invalid, since they are applied to a single factor of production, labour.

The different techniques for generating electricity vary enormously in labour intensity. Coal-fired stations are the most labour-intensive, followed by gas, nuclear and hydro. The greater labour costs of coal are offset by higher fuel costs in the case of gas and by higher capital costs in the case of nuclear and hydro (hydro power is also limited by the availability of suitable sites). Yet the IC uses world best practice measures of labour productivity in which the Australian industry (almost exclusively based on coal) is compared with firms which have large components of hydro and nuclear power. In addition, firms that supply a few large industrial consumers are included, even though
there are obvious cost savings that cannot be emulated by an industry serving the entire community (the IC does at least acknowledge the latter fact).

The inadequacy of the IC approach is evident even on the comparisons within Australia. The ‘best practice’ for labour productivity within Australia is that of the Tasmanian Hydro-Electric Corporation, which has been less exposed to micro-economic reform than most others. Its high labour productivity is a simple reflection of heavy reliance on hydro power.

Based on these invalid comparisons, the IC projects a 50 per cent reduction in labour input requirements, taking 1991 as a starting point. No offsetting increase in other costs (for example, contracting out) is allowed for. This would, if achieved, be a truly remarkable outcome. Labour productivity in the coal-dominated Australian industry is projected to surpass that of highly efficient US firms such as Consolidated Edison and Duke, with a substantial nuclear component.

The IC also assumes a 10 per cent reduction in capital construction costs. The evidence for this is derived from a secondary source, and is not very strong. Finally, the IC treats cost savings arising from increased use of gas-fired stations as a benefit of reform. It claims that previous reliance on coal was the product of political decisions reflecting, among other things a view that gas was too valuable a fuel to be used in power generation. On the basis of price expectations in the early eighties (when the last big construction decisions were made) this was a perfectly reasonable view. The recent swing to gas reflects the fact that real interest rates (and hence capital costs) are much higher and fuel costs much lower than was anticipated in the early eighties.

In addition, the move to gas-fired generation is apparently based on projections to the year 2020. As well as being inconsistent with the timescale for the rest of the exercise, any projection of this kind is subject to uncertainty about future prices, demand and other conditions. It is less than twenty-five years since the OPEC oil shock. In making predictions of this kind, the IC is demonstrating the same hubris that contributed to the mistaken investment decisions of the eighties.

The treatment of water is broadly similar to that for electricity, but introduces one new error in benchmarking. IC (1995) adopts the invalid practice of using one authority as its best practice benchmark for labour productivity and another as the best practice benchmark for capital productivity. Obviously, the resulting benchmark will lie outside the production possibility frontier.

For future analysis, it will be assumed that the extra TFP gain observed by EPAC, at a rate of 1 per cent per year, continues for four years, yielding a net gain of 4 per cent in productivity for the electricity, gas and water sector. This is equivalent to 0.1 per cent.

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2 The title of Table B6.4 refers to the year 2005, but all other references in the table and text are to 2020. It appears that the title is a typographical error.
of GDP. The IC assumptions imply direct gains of about 0.2 per cent of GDP from improved labour productivity, with longer run gains of about 0.4 per cent of GDP arising from reductions in construction costs associated with the switch to gas and with the assumed benefits of competition.

1.5 Rail, road and ports

Unlike other areas where the starting point for reform is taken as early as 1990, the IC attempts to use the current situation as the starting point for reform in rail and ports. This is surprising, since, unlike the areas discussed above, it appears that the removal of restrictive work practices and overstaffing has led to genuine productivity gains in the past.

The projected future gains in rail transport rely on a 20 per cent cost reduction to achieve world best practice. Although it does not appear that the projected reforms are sufficient to generate such a cost reduction (particularly as regards capital productivity), this estimate will be accepted as the basis for subsequent analysis, as will the estimated 14 per cent gain in port productivity. This yields a GDP gain of 0.08 per cent.

In the case of road transport the projected policy charges involve alterations in registration charges. An estimated 'notional' productivity gain of 5 per cent is arbitrarily assumed without any basis (except for the fact that a study by Swan consultants arbitrarily assumed a gain of 10 per cent). This gain, which would amount to about 0.1 per cent of GDP is not included in subsequent projections.

The major action in the transport area arises from price changes. It turns out that all the price changes favoured by the IC benefit the mining sector at the expense of other sectors. Because of the properties of ORANI (see Section 4) such changes yield substantial GDP benefits. As will be argued below, the arguments leading to the derivation of these benefits are invalid.

2 Competitive tendering and contracting

Another source of large gains is the contracting out of government services. The IC assumes, on the basis of work undertaken by Rimmer, and earlier work by Domberger et al, that Competitive tendering and contracting (CTC) will yield cost savings of 20 per cent. The procedure adopted is to estimate the proportion of government activity potentially open to competitive tendering, subtract the proportion currently contracted out, and apply the 20 per cent figure to compute the reduction in costs. The extent of CTC envisaged by Rimmer is very substantial. For example, the Rimmer envisages contracting out 20 per cent of recurrent expenditure in primary and secondary education and 40 per cent to 50 per cent of recurrent expenditure in higher education. In both cases, this corresponds to the great majority of the budget, with the exception of teaching staff. In
recognition of this the IC (1995) bases estimates of gains on the assumption that only half the estimated potential for CTC will be achieved.

There are a number of difficulties with the estimates of potential gains. First, the extrapolation of previous estimates of gains to a comprehensive program of CTC is unjustified. On average, the areas that have been characterised by the highest rates of CTC in the past will be those where the cost savings are greatest. Activities like garbage collection and cleaning, which have formed the basis of the studies yielding the 20 per cent estimates are dominated by unskilled labour and admit relatively easy monitoring of quantity (as well as substantial potential for wage cuts, tax evasion and work intensification). They are by no means typical of the public sector as a whole. For example, contracting out of fire protection services raises much more complex issues of accountability and quality control than does contracting out of garbage collection. It follows that studies of cases where governments have chosen to contract out a very limited subset of their activities are of little value in assessing the benefits of the procedure. The only real basis for comparison is a comprehensive program of compulsory competitive tendering of the kind now in place in the United Kingdom. However, even this program is far less ambitious than that envisaged by the IC.

The Domberger et al studies are based on the early stages of the process of compulsory competitive tendering. The 20 per cent figure they obtained was less than estimates derived from the first stages of competitive tendering. Many early tenderers went bankrupt or found that the price had been set too low for profitability, with the result that cost savings were smaller in later rounds of tendering. More recent estimates are lower still (Paddon 1991, 1992). The British Department of the Environment (Walsh 1991) estimates overall savings in the first year of competitive tendering at 5.7 per cent. The UK government now uses the figure of 6 per cent in justifying the extension of compulsory competitive tendering to other services (Public Service Action 1991, cited by Paddon 1991).

Another objection raised by Paddon is that cost of managing the competitive tendering process have not been taken into account. Some UK opponents of competitive tendering (Manchester City Council 1990, cited by Paddon 1991) argue that these costs amount to around 6 per cent of the value of the contract and therefore completely negate the benefits of the process. In distributional terms, the cost savings from reducing the number of low-paid workers are being spent at least in part, in additional employment of highly-paid managers and consultants.

It also appears that compulsory competitive tendering has led to a decline in service quality, and the danger of reduced quality is heightened by unrealistic expectations of productivity gains. The recent work of Rimmer and Domberger (1994), while maintaining support for the 20 per cent estimate, cautions that a majority of studies that
have examined the question have found a deterioration in service quality, and notes that this area requires further study.

Another problem is the possibility that apparent cost savings in areas such as cleaning and garbage collection are achieved, at least in part, through tax evasion. Contract services such as cleaning and garbage collection have regularly been found to be areas where tax evasion is highly prevalent (see, for example, Taazi 1982). By contrast, government employees have almost no opportunities for tax evasion. To some extent the government may simply be handing money from one pocket to the other.

A final issue on which there is broad agreement (Domberger et al, Ganley and Grahl 1988, Milne and McGee 1992, Quiggin 1992, 1994, Rimmer and Domberger 1994) but which is not considered at all by the IC (1995) is that at least some of the cost savings from compulsory competitive tendering arise from reductions in wages and increased work intensity. Such cost savings should be modelled as a reduction in wages and not as a productivity gain.

The IC estimates direct savings of $2.7 billion or nearly 0.7 per cent of GDP from compulsory competitive tendering of current expenditure and $1.2 billion or 0.3 per cent of GDP from tendering of capital expenditure. As noted above, however, in recognition of the scope for error in these estimates, only half of these gains are incorporated into the analysis, implying a net gain of 0.5 per cent of GDP. Allowing for the costs of the tendering process, the apparent over-optimism of the 20 per cent estimate and the fact that at least some of the apparent gains are actually transfers, it is estimated that the true cost saving is closer to 5 per cent. This implies a gain of around $400 million or about 0.1 per cent of GDP.

The estimates presented in IC (1995a) have subsequently been modified in the Draft Report on CTC (IC 1995b). The modified estimates and their implications are discussed below.

3 Anti-competitive regulation

The reform measures discussed in previous sections are only tangentially related to the original Hilmer Report which was concerned with competition policy. Looking more specifically at the Hilmer part of the study, the IC model assumes much more extensive deregulation than that envisaged by Hilmer. In particular, the IC report is very enthusiastic about the potential gains to be achieved by replacing direct government regulation with self-regulation. As examples of the successes already achieved, it cites the meat industry. No mention is made of recent meat contamination scandals. Similarly, the IC assumes, on flimsy evidence, that existing regulations can be removed without any ill effects.
3.1 Statutory marketing arrangements

The removal of statutory marketing arrangements is in line with the recommendations of the Hilmer Committee. The only economically significant arrangements are those applying to dairy products, sugar and tobacco. For milk, the IC estimates that the arrangements are equivalent to a 20 per cent tax, resulting in a transfer of $230 million from consumers to producers. A standard method for approximately estimating the welfare costs of a tax, due to Harberger uses the estimate

$$\Delta = 0.5 e \tau^2$$

where $\Delta$ is the cost of the tax, expressed as a proportion of total output, $e$ is the sum of the elasticities of demand and supply and $\tau$ is the tax rate. Assuming $e = 2$, this yields a welfare loss of $46 million from the dairy arrangements. Similar reasoning suggests a loss of $21 million from the tobacco arrangements. The case of sugar is more complex, as the regulations include restrictions on land use. It will be assumed here that the transfer of $24 million is associated with a welfare cost of $48 million, implying that both producers and consumers are made worse off.

The estimates above are quite generous, and imply a welfare loss of $115 million (0.025 per cent of GDP) from statutory marketing arrangements. The IC generates a GDP gain of more than $600 million from the same source. It is hard to see how this result can be achieved. Unfortunately, the lack of transparency in the ORANI simulation results is too great to permit the resolution of this issue. It is reasonable to conjecture, however, that benefits to mining and to export-oriented agriculture play a major role.

3.2 The professions

The IC study here is relatively close to the spirit of the Hilmer enquiry and most of the reforms considered may be regarded as increasing competition. However, there is a noticeable tendency to overestimate gains. Estimated reductions of 1/3 in the cost of conveyancing and 'up to 50 per cent' reductions in the costs of barristers services are translated into assumed 50 per cent cost reductions across the board.

For the purposes of future estimates, the IC suggested gains of an efficiency improvement of approximately 0.3 per cent in the health industry are accepted, implying a gain of about 0.02 per cent of GDP or $80 million. For legal services, the estimated gains appear excessive. It is assumed that the reforms generate a reduction of 1 per cent in the input costs for business services, implying a GDP gain of around 0.04 per cent or $160 million. The IC estimates would imply a direct gain of 0.07 per cent.
3.3 Building regulations

The IC suggests that the Hilmer recommendations on anti-competitive regulation extend to building regulations which it regards as unnecessarily stringent. As an example, it quotes claims by the University of Tasmania that reductions in the width of pavements and nature strips can be made "without loss of safety or amenity". Total savings of $100-$150 million a year from this source and of $350 million a year in total (0.09 per cent of GDP) are estimated.

The IC brings this issue within the ambit of its study by claiming that such regulations reduce the competitiveness of the industry. This appears to be a deliberate misuse of words. Cost increases are generally seen as reducing the ability of Australian firms to compete with overseas firms and thus inducing a loss of 'competitiveness', though this issue appears irrelevant to land development. Hilmer is concerned with regulations that might reduce the degree of competition between firms.

More generally, the claim that narrower footpaths do not reduce amenity seems indefensible. It may be the subjective judgement of the IC and the University of Tasmania that communities would be better off with less land being devoted to footpaths and nature strips and more being devoted to private houses. But it is difficult to see how this issue can be resolved except by the democratic process which has, so far, opted for wider footpaths.

Cost savings arising from reductions in quality must be discounted and may be negative. No doubt there are benefits to be obtained from relaxing regulations in some areas, and from tightening them in others, and the normal processes of government should include continuous review of the regulatory setup. But the IC makes no case for a general relaxation in regulations and such a change could not, in any case, be seen as falling within the ambit of the Hilmer reforms.

Similarly, the IC observes that 'unwarranted delays' in gaining approval for building projects fail the 'public benefit' test. This is true by definition. Equally, 'warranted delays' by definition pass the public benefit test. The IC provides no basis for distinguishing between warranted and unwarranted delays. It observes that one local council has achieved a median processing time of 28 days compared to the NSW median time of 49 days. However, the estimates used by the IC are based on the assumption that all regulation is unnecessary. Making the still optimistic assumption that the a general reduction of 40 per cent can be achieved (equal to that given in the IC's single piece of evidence) the net saving is reduced to $300 million a year (0.08 per cent of GDP) from the $750 million (0.18 per cent of GDP) cited in the IC study.

3 Work by Sturgess is cited for this example, but the source is missing from the reference list.
3.4 Private sector monopolies

The monopoly associated with restrictions on taxi plates is estimated to represent an impost of $320 million a year on consumers. Most of this is capitalised into the price of taxi plates, so that the removal of restrictions would in large measure constitute a transfer rather than a net social welfare gain. The net gain would presumably be well below $320 million. The process appears to be modelled correctly. Nevertheless, the simulations yield a net gain of $460 million. This may be due to the extreme sensitivity of the ORANI version used here to any reduction in transport costs.

Assuming that the elasticity of demand for taxi services is 1 and that an average fare is $10 (so that the license scheme is equivalent to a 20 per cent tax) standard partial equilibrium techniques yield a net welfare gain of $60 million from the elimination of the scheme. Similar analysis applied to the case of newsagents suggests a gain of $75 million. The estimated increase in consumer welfare is 0.03 per cent of GDP.

3.5 Self-regulation

On the basis of very limited evidence, the IC predicts large gains from a switch to self-regulation. The examples given are those of meat inspection and defence procurement. The recent disastrous failures of the self-regulation system in meat inspection are not discussed. The IC observes gains of $4 million dollars from the removal of various charges. However, without any evidence at all, it assumes that the long run gains will be between 5 and 10 times this figure.

In the meat inspection case, the IC takes account of the costs of the private inspectors who replaced public inspectors. In the case of Defence procurement, no such allowance is made. A claimed savings of 600 positions is then converted (without explanation) into a saving of $50 million. It would seem more reasonable (though still optimistic) to assume that these 600 public positions were replaced by 300 private positions, yielding a savings of 300 positions. Assuming salary and related costs of $40,000 per person, the net savings is $12 million.

Both meat processing and Defence purchasing are activities which are closely regulated, and many other regulated sectors of the economy (eg building and construction) are dealt with elsewhere in the report. Nevertheless, it is assumed that about 10 per cent of the economy could be moved towards self-regulation with an average production benefit of 1 per cent, implying a gain of 0.1 per cent for the economy as a whole. The multiplicative effects of ORANI eventually convert this into a gain of 0.28 per cent.

The observed gains in the meat industry from self-regulation come to 0.15 per cent of total cost and the gains in defence procurement computed above amount to 0.25 per
cent of total costs. Assuming that productivity gains of 0.2 per cent could be achieved for the ten per cent of the economy postulated by the IC, a net gain of 0.02 per cent would be generated.

Against this must be set any losses associated with declining standards of quality under self-regulation. The examples of the meat industry, airline regulation and banking all suggest the reality of this possibility. Final social gains are likely to be no more than half those computed above, if indeed they are positive.

4 Estimating the total benefits

Adding up the direct benefits of microeconomic reform for the areas examined above, yields a total gain of approximately 0.7 per cent of GDP (see column 1 of Table 1). However, most of the big productivity gains are achieved by reducing employment, in short by sacking people. It seems reasonable to assume that some of the workers dismissed as a result of the micro-economic reform process would not be re-employed but would take early retirement or join the long-term unemployed. So it is likely that the final gain will be less than the direct impact. To assess this possibility, column 2 of Table 1 shows estimates of gains on the assumption that 25 per cent of any gain arising from reduced employment is dissipated in higher unemployment or exits from the labour force. The resulting value for the total gains from micro-economic reform is 0.5 per cent.

Obviously this figure is much lower than the 5.4 per cent gain estimated by the IC. In part, this disagreement arises from the fact that the optimistic projections of direct gains made by the IC have been modified downwards. However, there is another important factor. The procedure used by the IC to estimate the long-run gains has the effect of multiplying the direct benefits. This is illustrated by Columns 3 and 4 of Table 1. Column 3 shows an estimate of the direct benefits of reform, assuming that IC projections are correct, totalling around 2.5 per cent of GDP. Column 4 shows the long-run GDP gain estimated by the IC. The total gain is more than double the direct productivity impact of reform. By contrast, the arguments presented above suggest that the estimated direct gain of 2.5 per cent of GDP should be discounted to around 2.1 per cent to take account of unemployment effects.

How is this multiplication of the initial benefit achieved? Not surprisingly, no account is taken for the potential of large-scale sackings to raise the base level of unemployment. The modelling framework adopted is one where such adjustments are assumed to take place smoothly.
Table 1

<table>
<thead>
<tr>
<th>Estimated gains from Hilmer and related reforms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Estimated benefits</td>
</tr>
<tr>
<td>Direct</td>
</tr>
<tr>
<td>Telstra</td>
</tr>
<tr>
<td>Australia Post</td>
</tr>
<tr>
<td>FAC &amp; CAA</td>
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<tr>
<td>Electricity, gas &amp; water</td>
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<tr>
<td>Rail, road &amp; ports</td>
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<tr>
<td>Competitive tendering</td>
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<td>Statutory marketing</td>
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<tr>
<td>Professions</td>
</tr>
<tr>
<td>Building industry</td>
</tr>
<tr>
<td>Private monopolies</td>
</tr>
<tr>
<td>Self-regulation</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

¹: The IC gives no estimate of direct gains for reform of statutory marketing and private monopolies. Gains computed by the standard procedures described in the paper have been ignored.

However, the key assumption, built into the ORANI model used in the simulations, is that reform will stimulate a massive increase in capital investment. Mining in particular, is seen as having massive potential for growth, even though most of the reforms have no direct impact on the mining sector. The assumed sensitivity of mining is often too great to be believed. To take just one example, suburban newspaper delivery is not normally seen as a key concern of the mining sector. The IC projects that removing the local monopoly currently held by newsagents would increase national output by a modest, but useful 0.03 per cent. But mining output would increase at five times this rate, by 0.15 per cent. In fact, projected indirect benefits to the mining sector are the main source of estimated gains from this, and many other, reforms.

The fact that the estimated GDP gains depend on a substantial expansion in the capital intensity of the economy (an expansion of around 6 per cent in the capital stock is anticipated) means that GDP is inappropriate as a welfare criterion. The extra growth in capital stock must come either from increased savings in the adjustment period or from increased foreign debt. In either case, the increase in GDP overstates the welfare gain. A
more reasonable (but still not ideal) basis for assessment is the increase in consumption. At 3.4 per cent, this is higher than the estimated direct productivity gain, but not a lot higher.

A further source of welfare gains arises from price changes modelled as part of the micro-reform process. Because no welfare measures are provided as part of ORANI output, the model provides no way of capturing the standard neoclassical welfare benefits associated with marginal cost pricing. Price changes in ORANI tend to raise GDP if they reduce input costs for business, and particularly if they benefit the mining sector. In particular, starting from a neutral tax system, a tax-financed subsidy to mining will raise GDP and yield a long-term improvement in the government’s fiscal position.

It happens that nearly all of the price changes modelled, in electricity, gas, water and other areas have the effect of reducing the prices charged to business users and the mining industry in particular, relative to those paid by consumers. Even the road pricing changes happen to have this effect because charges fall in NSW which is the main state where trucks are used to transport coal.

To the extent that they are captured in ORANI modelling, the price changes modelled by the IC are simply backdoor methods of subsidising the mining industry. A direct policy of exempting inputs to mining from taxation would yield greater (modelled) gains. The desirability of such a policy is obviously open to debate. However, if such a policy is rejected, it would be foolish to implement inefficient substitutes for it.

For completeness, we may observe that if the estimates of direct gains presented in this paper are combined with the ORANI assumptions about the consequences of reform, it is likely that the net welfare gain (as measured, for example, by the increase in the present value of consumption) would be around 1 per cent.

In summary, although some of the reforms proposed by Hiimer are undoubtedly beneficial, the magnitude of the benefits has been grossly over-estimated. It seems unlikely that the real benefits will exceed 1 per cent of GDP.

5 Timescale

In a comparative static model such as ORANI, the time-frame is necessarily indefinite. Typically, it is suggested that the time-frame is that required for capital stocks to adjust, normally assumed to be about five years. However, the estimated time-frame in this study is particularly confused. The estimates of potential for productivity improvements in the telecommunications industry takes performance in 1990 as the starting point (although labour productivity has risen significantly since then) and the reforms modelled extend beyond the end of the duopoly in 1997. For electricity, the starting point is June 1991 and the projected reforms extend beyond 2000. However, the shift to gas-fired generation is apparently projected to the year 2020. For railways, the
starting point is 1993-94 and the projected reforms extend at least to 1999-2000. In the case of Australia Post and the FAC, the timescale of reform is explicitly set at four years beginning in 1995 (note however, that most of the benefits modelled are attributable to reforms undertaken in the past). In addition to this mixed timeframe, there is an indefinite period of adjustment before the new long-run equilibrium is reached.

This inconsistent approach creates many difficulties. First, there are difficulties noted in the report, in comparing projections put forward here with those of other studies. Second, it is difficult to make any test of the validity of the projections. Third, it is difficult to distinguish between the effects of specific proposed future reforms and gains attributed to policies that have either already been implemented or would be implemented regardless of Hilmer.

To illustrate these points, observe that the projections offered here, and the sectors covered, are broadly similar to those presented by the IC (1990). Yet the 1990 report was implicitly taken to have a 5-year timeframe, and to encompass the much more limited set of micro-economic reforms being debated at that time. If we regard the current report as having a timeframe of ten years, it is apparent that the earlier report was excessively optimistic. This would also be evident from the observation that the long-run average rate of growth was no higher over the 1990-95 period than over the previous decade, despite extensive micro-economic reform. But assuming that the policies considered in 1990 did generate gains, it is apparent that some of these gains are being included in the current study, while others are not. By confusing the time-frame, the IC avoids addressing these issues.

6 Net gains and transfers

The IC projects that nearly everyone will be better off as a result of micro-economic reform. This reflects the failure to take into account the fact that the apparent cost savings from policies such as competitive tendering result primarily from cuts in wages and increases in working hours.

Increasing the intensity of work has been one of the characteristic features of micro-economic reform. Cost savings from increased work intensity are not properly regarded as net increases in social welfare, but simply represent a transfer from workers to employers. Moreover, they are a step in the wrong direction. At a time when technological improvements offer the potential for increasing leisure, the full-time workforce is being pushed to work harder and longer.

In addition, a number of the pricing policy changes recommended by the IC are regressive. This is particularly evident in water pricing, with the gradual removal of any element of land taxation in pricing policies.
7 Other studies

A number of other studies [IC (1989, 1990), BCA (1994), BIE (1990), EPAC (Filmer and Dao 1994, Dao and Jowett 1994)] have examined the benefits of micro-economic reform. All have taken some version of the ORANI model as a starting point, and all have examined roughly the same set of reforms and assumed roughly the same direct productivity impacts. In the absence of further adjustments, all give a net impact of around 6 per cent of GDP, similar to that obtained by the IC.

Among other things, this means that the many studies yielding large estimates for the benefits of micro-economic reform cannot be regarded as independent pieces of evidence. Rather, they are variations on a common theme. Most of the criticisms set out above in relation to the IC (1995) apply with equal force to all of the other models mentioned above.

The key difference between the models is that, in addition to the optimistic assumptions about the direct impact of reform discussed above, some studies have arbitrarily assumed additional benefits, in the form of across-the-board productivity increases and reductions in the ‘natural’ rate of unemployment (this euphemism refers to the rate at which inflation is stable).

For example, the BIE (1990) assumed a doubling of the rate of productivity growth. Extrapolated over ten years, this yields a GDP gain of 16 per cent. Subsequent studies by the BCA and EPAC made more modest assumptions about productivity gains (ranging from 3.5 to 7 per cent), but compensated for this by assuming employment gains of around 5 per cent. The assumed employment gains are particularly striking in view of the fact that most of the reforms modelled involve employment cuts. With these adjustments, the projected benefits range from 12.7 per cent of GDP (EPAC) to 21 per cent (BIE and BCA).

A check on the plausibility of projections of benefits of micro-economic reform can be obtained by considering projections of the macro economy. The growth rate of the labour force is around 2 per cent a year (this should be adjusted upwards slightly to take account of increasing education levels). If we assume that the combination of the trend increase in capital stock per worker and exogenous technological change yields an annual rate of productivity improvement of 1.5 per cent in the absence of reform (this is about the rate observed over the past twenty-five years), this yields a long-term growth rate of 3.5 per cent (assuming constant unemployment). Higher rates can be achieved only when unemployment is falling.

The average growth rate over the past ten years has been around 3 per cent. The shortfall from the long-term growth rate reflects rising unemployment associated with the recession. If unemployment levels had remained unchanged over the decade it appears that the long-term rate of 3.5 per cent would have been realised, but not exceeded.
On the basis of this evidence it does not appear that microeconomic reform has had any significant impact on economic growth so far. This conclusion is accepted by advocates of microeconomic reform such as Fane (1994) and is also implicit in the presentation of the IC's own results. It does not exclude the possibility that past microeconomic reforms have yielded small benefits, on the scale of those estimated in this paper. Such small benefits would have no discernible impact on the ten-year growth rate and would have been swamped by the recession. However, if past microeconomic reform had yielded benefits of the order of 5 per cent of GDP, this would have been evident in the growth performance of the economy.

It therefore seems reasonable to treat all of the model results as projections of the additional growth that would be generated by microeconomic reform over the 5-year period commencing in 1995. Thus, the IC estimates would call for additional growth of 1 per cent, implying a sustainable growth rate of 4.5 per cent. The EPAC estimates (which assume a reduction in unemployment) require annual average growth rates of 6 per cent. Finally, the BCA estimates require growth rates of 7.5 per cent. By contrast, the estimates offered in this critique suggest that micro-economic reform will continue to have no discernible impact on the rate of economic growth.

It is apparent that current macro-economic projections implicitly assume that micro-economic reform will have little or no impact on economic growth, productivity or on the level of unemployment. These projections call for economic growth to stabilise around 3.5 per cent and assume that the rate of unemployment will be around 7 per cent (the so-called natural rate estimated on the basis of labour market experience in the eighties). This is exactly what is generated on the basis of the estimated impact of micro-economic reform derived in this paper.

8 Welfare-reducing reforms

All of the analysis presented above has focused on reforms that would be expected, on an \textit{ex ante} basis, to improve social welfare (at least if adverse distributional effects were offset by low-cost tax-transfer policies). Indeed, the very term 'reform' has strong connotations of beneficial change. Nevertheless, any actual package of policy changes is likely to contain some welfare-reducing elements resulting from erroneous analysis or interest group pressure.

Since the publication of IC (1995a), for example, it has become apparent that competition policy in telecommunications is likely to result in the provision of duplication cable networks for pay-TV and local telephony, at least in the major cities. Although, due the commercial confidentiality which has increasingly prevented scrutiny of public policy decisions in the micro-economic reform era, it is impossible to precisely determine the cost of this duplicate provision, study of a variety of sources suggests an excess cost of
around $4 billion or 1 per cent of GDP. Spread over a five-year period, this would imply an annual loss of 0.2 per cent of GDP. Continuing costs could be expected from excessive maintenance and from welfare costs associated with the excess of prices required to recover average costs over the marginal cost of provision of services (which is essentially zero). On the basis of the analysis presented above, this policy error will wipe out the productivity benefits of telecommunications competition. An identical policy has been adopted for digital (though not for analog) mobile telephony. The costs of this policy are difficult to estimate, since they will be greatly affected by the fulfilment or otherwise of the present commitment to withdraw analog services. Other areas where micro-economic reform is probably welfare-reducing include privatisation (Quiggin 1995) and many private infrastructure projects, particularly private toll roads (EPAC 1995a, b, Quiggin 1996).

The most important point arising from these examples is that the estimates discussed above should be regarded as stating the potential gains that might be achieved through optimal public policies in the area of micro-economic reform. They should not be regarded as predictions of the benefits to be achieved from current policies. Prior to detailed scrutiny of any given policy package, it would seem reasonable to assume that some mistaken or negative elements will be included, and that the estimates represented above represent upper bounds.

9 The IC Draft Report on Competitive Tendering and Contracting

A number of the reforms discussed in IC (1995a) have been subject to a more detailed analysis in the IC Draft Report on Competitive Tendering and Contracting (IC 1995b). Although some important difficulties remain, the analysis in IC (1995b) represents a considerable advance on that of IC (1995b). In particular, the need to distinguish between pure efficiency gains and transfers arising from wage reductions or increased work intensity is accepted. Also, the estimates for the potential scope of competitive tendering appear less optimistic than those of IC (1995a).

IC (1995b) presents a range of eight simulations, implying GDP benefits of between 0.3 per cent and 1.7 per cent for a program of competitive tendering and contracting. All of the simulations allow for some element of transfer. The key distinguishing points between the simulations are:

(i) Assumed cost savings take the values 10 per cent and 20 per cent;
(ii) The component attributed to pure efficiency gains takes the values 50 per cent and 75 per cent; and
(iii) In Scenario A it is assumed that CTC will be pursued to the maximum extent deemed feasible. In Scenario B the assumption used in IC (1995a), that only 50 per cent of the maximum potential for CTC will be realised, is adopted.
The most optimistic assumption for each case is presented in Scenario 1A, yielding gains of 1.7 per cent. The least optimistic is Scenario 4B, yielding gains of 0.3 per cent.

There is a strong case for focusing on Scenario B. The estimated scope for CTC in total is $35 billion. By contrast the fairly comprehensive program undertaken in the United Kingdom is estimated to have subjected expenditure valued at only 7 billion stg (around $A15 billion) to CTC even though its economy is around three times as large as that of Australia (against this, it should be noted that the UK estimates cover only general government expenditure). Similarly, the US program of $US 300 million is substantially smaller in relation to the US economy than that proposed here. The estimate used in the Scenario B, implying total scope for CTC of $24 billion (around $12 billion of which appears to apply to general government) would appear to be an upper, rather than a lower, bound. The average 5 per cent net efficiency gain of Scenario 3B is most consistent with the arguments presented above.

The sectors of the economy dealt with in IC (1995b) (general government and GBE's) account for direct gains of 1.85 per cent of GDP and total gains of 3.6 per cent of GDP in IC (1995a). This is around two-thirds of the total benefits estimated to arise from Hilmer and related reforms.

In the GBE sector, there are gains projected beyond those that might be achieved through CTC. However, in most sectors, it seems reasonable to attribute at least half of the attainable gains to CTC. Most GBE dominated sectors have an estimated potential for CTC around 30 per cent of total expenditure (Table G.1). Assuming that unit savings from competition policy in areas where CTC is feasible are twice those in areas where it is not, CTC would account for half of the total gains in these sectors. Electricity, where only one-third of the savings projected in IC (1995a) relate to labour is an exception to this pattern, and it seems reasonable to suggest that for this sector, the IC (1995b) estimate covers one-quarter of the total possible savings. Using these assumptions, the reforms modelled in IC (1995b) account for about 1 percentage point of the direct savings modelled in IC (1995a) and 1.85 percentage points of the final savings.

Thus, the estimate presented in IC (1995a), is quite close to the upper bound estimate presented in IC (1995b, Scenario 1a). The close agreement between Scenario 1A and IC (1995a) reflects the fact that the very optimistic estimates of Scenario A for the scope of CTC are offset by the recognition that at least some of the measured cost savings represent transfers.

Acceptance of any Scenario other than 1A implies a significant scaling down of the total benefits of Hilmer and related reforms presented in IC (1995a). Scenarios 3B and 4B, especially if modified to take account of unemployment effects, are broadly consistent with the analysis presented above, with direct benefits of around 0.7 per cent of GDP from Hilmer and related reforms, with final benefits falling to 0.5 per cent of GDP as a result of unemployment effects.
10 Concluding Comments

Australians have been promised for at least a decade that the process of micro-economic reform would yield substantial improvements in living standards. This promise represented the payoff for accepting the painful effects of reform on many people, and particularly on public sector employees. No such improvements have been evident so far. Careful analysis of BC (1995a) indicates that even a comprehensive program of micro-economic reform is unlikely to yield welfare gains that would be detectable over the noise generated by macro-economic fluctuations in the economy. The direct gains from the entire program are likely to be less than 1 per cent of GDP and these will be offset by the consequences in terms of higher unemployment.

None of this implies that reform should be rejected outright. Many individual reforms may have benefits that exceed the costs. However, the notion that micro-economic reform is a process that must be pursued regardless of the short-term costs should be recognised as a mistake. Reform should be assessed on a case-by-case basis with careful attention to the consequences for consumers, employees and the public as a whole.

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