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The Hilmer reforms and NSW agriculture

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Introduction

The implementation of National Competition Policy, also known as the Hilmer reforms[1] will require one of the most comprehensive processes of policy review and reform ever undertaken in Australia. The reforms will affect government business enterprises, the provision of public services and the regulation of markets for goods and services.

The implementation of the Hilmer process raises important issues for agriculture in New South Wales. The basic premise of the Hilmer process is that any form of market organisation or public policy that diverges from a simple free-market model is *prima facie* uncompetitive and must therefore be justified by the application of a public benefit test. Much of the analysis underlying the Hilmer reforms is based on a misinterpretation of the role of competition in the economy. If the Hilmer process is not to lead to undesirable policy outcomes, it is important that a more balanced approach be adopted.

The object of this paper is to describe the process leading up to the adoption of National Competition Policy by Commonwealth, State and Territory governments and the key provisions of the policy, with particular attention to the public benefit test required for the assessment of policies that restrict competition. The National Competition Policy process is considered as a policy process and compared to the standard economic approach to policy design. The claim that increased competition will engender improvements in technical efficiency is critically assessed.

[1] In this paper, the term ‘reform’ will be used with its original meaning of 'form again', to apply to structural change in government business enterprises or policy frameworks, rather than in the sense of 'change for the better'. No judgement that any particular change is beneficial, or harmful, is implied by description of that change as 'reform'.

The paper is organised as follows. Section 1 describes the key provisions of National Competition Policy as implemented by the *œ* and the Competition Principles Agreement. Particular attention is given to consideration of the National Competition Policy as a policy process, the relationship between competition policy and the design of economic policy, access rules and the effectiveness of competition in promoting improvements technical efficiency. Section 2 deals with the public benefit test to be applied to policies that restrict competition. The Industry Commission 's view that public benefit should be interpreted solely in terms of efficiency is criticised, and the distinction between efficiency improvements and transfers is considered. Section 3 deals with the relationship between agricultural policy and competition policy. Issues addressed include marketing policies and bargaining power, co-operatives, risk and stabilisation, and the implementation of environmental policy. Section 4 presents suggestions for the development of agricultural policy in the wake of the Hilmer reforms. Finally, some concluding comments are offered.

1. The Competition Policy Reform Act and the Competition Principles Agreement

The Hilmer Committee was appointed in 1992 to inquire into and advise on appropriate changes to legislation and other measures in relation to the scope of the *Trade Practices Act 1974* and the application of the principles of competition policy. The Committee's Report (Hilmer et al 1993) was issued in 1993. Its greatest significance lies in the fact that it was used as the basis of the Competition Principles Agreement reached at the 1995 meeting of the Council of Australian Governments (COAG). The term 'Hilmer reforms' is now used to refer to processes arising from the intergovernmental Competition Principles Agreement and the associated *Competition Policy Reform Act 1995* (Cwlth). These reforms are generally consistent with the spirit of the original Hilmer Report, but, in some instances, go beyond the specific recommendations contained in the Report.

Advocates of reform within Federal government policy circles used the Hilmer Report as the basis for a renewed push for public sector reform, centred around the COAG. By virtue of its reliance on inter-governmental negotiations and remoteness from open political debate, the COAG process permitted further extensions of the reform process to be presented as a *fait accompli*, embodied in the Competition Policy Reform Act, and the associated Competition Principles Agreement.

At the time of the 1995 meeting, it was envisaged that COAG would form the basis of a co-operative Federal–State approach to competition policy and to microeconomic reform in general. Among other things, it was expected that the Council would oversee the implementation of National Competition Policy. However, since the 1996 election the significance of COAG has diminished, and the Council has not met for more than a year. The involvement of elected governments in the implementation of National Competition Policy has diminished accordingly and the process is now being handled primarily by bureaucratic bodies such as the National Competition Council.

At the 1995 COAG meeting it was agreed that Commonwealth payments to the States would be linked to the implementation of National Competition Policy at the State level. State governments argued that the benefits of reform in State government business enterprises would flow primarily to consumers rather than taxpayers, and that, in view of the continuous pressure on State finances, some redistribution of the proceeds of reform was appropriate. The Commonwealth therefore agreed to make a series of 'Competition Payments' to the States, conditional on the implementation of reforms. The annual payment to the States was to be $200 million (1994-95) dollars for 1997-98 and 1998-99, rising to $400 million in 1999-2000 and 2000-1 and $600 million thereafter. The payments were to be indexed to allow for inflation, but not adjusted for growth in population or national income. Each 'tranche' of payments was conditional on satisfactory progress being made by the States in the implementation of Competition Policy.

The payments have been referred to as ‘bonus’ payments. However, because of previous and subsequent cuts in general purpose grants, they are in fact only partial compensation for the steady erosion in the State share of the national revenue base. Moreover, ambiguity has arisen as to whether eligibility for payments depends on the implementation of the competitive reform process including the public benefit test, or on the adoption of particular reform options, with or without a *bona fide* public benefit test.

1.1 Key provisions of National Competition Policy

The central objective of National Competition Policy, as it applies to the public sector, is to achieve the most efficient provision of publicly provided goods and services through reforms designed to minimise restrictions on competition and promote competitive neutrality. The principal reform required under the policy is the application of a public benefit test to justify the maintenance of any public policy which *prima facie* restricts competition. Policies for which a public benefit cannot be demonstrated must be repealed or modified so that they do not reduce competition. In this regard, the Competition Principles Agreement calls for a wide-ranging program of legislation review, stating in clause 5(1):

> The guiding principle is that legislation (including Acts, enactments, Ordinances or regulations) should not restrict competition unless it can be demonstrated that:
> (a) the benefits of the restriction to the community as a whole outweigh the costs; and
> (b) the objectives of the legislation can only be achieved by restricting competition

and in clause 5 (9):

> Without limiting the terms of reference of a review, a review should:
> (a) clarify the objectives of the legislation;
> (b) identify the nature of the restriction on competition;

(c) analyse the likely effect of the restriction on competition and on the economy generally;
(d) assess and balance the costs and benefits of the restriction; and
(e) consider alternative means for achieving the same result including non-legislative approaches.

The public benefit test referred to in (d) is discussed in detail in Section 2.

The idea of competitive neutrality is defined in clause 3(1) of the Competition Principles Agreement:

> The objective of competitive neutrality policy is the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities: Government businesses should not enjoy any net competitive advantage simply as a result of their public sector ownership. These principles only apply to the business activities of publicly owned entities, not to the non-business non-profit activities of these entities.

Other areas of National Competition Policy require structural reform of public monopolies and require owners of monopoly facilities to negotiate access with other users.

The main institutional change arising from National Competition Policy was the creation of two new bodies: the Australian Competition and Consumer Commission (ACCC), formed from the amalgamation of the Trade Practices Commission and the Prices Surveillance Authority, and the National Competition Council (NCC), a body designed to supervise the progress of Federal and State governments towards the implementation of competitive reform.

1.2 The National Competition Policy as a policy process

Unlike previous microeconomic reform initiatives, National Competition Policy is a comprehensive program, which has been imposed from the top levels of government

without any consultation with those affected, and which is not subject to significant democratic accountability or control. All of these characteristics are important in considering the appropriate implementation of requirements imposed under National Competition Policy and particularly the application of the public benefit test.

The comprehensive nature of National Competition Policy is the most obvious departure from previous microeconomic reform initiatives, which involved the reform of particular classes of policy, such as tariff policy, or particular industry sectors, such as telecommunications. By contrast, National Competition Policy establishes general requirements that must be satisfied by any government policy or private agreement. In combination with the short deadlines imposed for the assessment of policies, the comprehensive nature of National Competition Policy creates significant difficulties for groups concerned with the outcomes of the policy process, including producers, workers and consumer organisations.

Since the Policy is required to apply to all sectors of the economy and to many social arrangements that would, in the past, have been regarded as lying outside the scope of economic policy, it is phrased in very general terms, which give little guidance to the appropriate conduct of public benefit tests in specific sectors. Nevertheless, it is required that the public benefit tests be conducted in a manner that the National Competition Council deems to be consistent with the Act. Government agencies and private organisations that do not comply with this rather vaguely specified mandate are subject to legal and financial sanctions, including the loss of Commonwealth funds and the possibility that existing arrangements will be deemed to contravene the Act.

The discussion above also illustrates one aspect of the top-down nature of National Competition Policy. In the past, policies affecting particular sector of the economy were normally formulated in consultation with the groups most directly concerned, including producers, workers and consumer organisations, sometimes collectively described as

'stakeholders'. Similarly, the boards of statutory authorities typically included representatives from these groups as well as members appointed by government.

By contrast, advocates of microeconomic reform, such as Sieper (1982), generally regard groups representing producers and employees as vested interests, which should be excluded, as far as possible, from the policy process. The only interest recognised as legitimate is that of consumers, and consumer interests, it is argued, are best protected by competition rather than by consulation with consumer groups.

Under National Competition Policy, consultative approaches to policy formulation are generally discouraged. In particular, corporatised statutory authorities are required to maximise profits subject to specified community service obligations. Their managers must therefore satisfy their fiduciary obligation to shareholders without regard to the effects of their decisions on other concerned groups, even where the concerned groups may be supported by the majority of the shareholders, that is, the public, in their capacity as taxpayers and ratepayers.

Another top-down aspect of National Competition Policy is the strict subordination of local government to State government. The operating arrangements of local government authorities have been removed from the control of the governments concerned and required to conform to policies laid down by State governments in accordance with Competition Policy.

Finally, National Competition Policy is largely exempt from democratic accountability. It is, of course, open to the Commonwealth Parliament to amend or repeal the Competition Policy Reform Act. But apart from this theoretical possibility, it does not matter whether policy changes required under National Competition Policy have majority public support or, indeed, any public support at all.

1.3 Competition policy and the design of economic policy

National Competition Policy involves an approach to policy design which differs in important respects from the standard economic approach to policy discussed in the Appendix. Competition policy is linked to the economic approach to policy design by the fact that, under ideal assumptions, competitive processes lead to ideal outcomes. The key difference is that, whereas the standard approach to policy is concerned primarily with the equity and efficiency of outcomes, competition policy focuses on the nature of market processes.

The divergence between the two approaches is noted by the Industry Commission (1995a). Section 44X.(1) of the Competition Policy Reform Act directs the Australian Competition and Consumer Commission to take account of 'the public interest in having competition in markets'. From a standard economic perspective, as the Industry Commission (1995a, p. 39) observes, such references 'tend to confuse means (competition) with ends (efficiency)'. Other economists would agree, but would specify a set of ends including equity and employment objectives as well as efficiency.

The standard economic approach to policy normally involves a willingness to consider government intervention in situations where the ideal assumptions are not satisfied. By contrast, advocates of competition policy tend to prefer imperfectly competitive markets to any form of government intervention. Where markets diverge radically from the conditions under which perfectly competitive outcomes can be expected, the aim of competition policy is to create rules under which the market participants are forced to behave as if they were competitive firms.

Competition policy differs from the standard economic policy framework with respect to the role and definition of competition. In economic analysis, a market is competitive only if it contains a large number of firms, each of which is too small to affect the market price. By contrast, in competition policy, a market supplied by a few firms, or even by just two firms may be regarded as competitive if firms do not collude in

setting prices. Such industries would be regarded as oligopolies or duopolies in a standard economic analysis.

Prior to 1992, the Trade Practices Commission took the view that a market served by two equally matched firms was adequately competitive (Trade Practices Commission 1986, quoted by Williams 1989), in that there was no firm which displayed 'market dominance'. The Trade Practices Act was amended in 1992 to prohibit mergers which have, or are likely to have, the effect of substantially lessening competition, unless authorised. This amendment had the effect of increasing the discretionary powers of the Trade Practices Commission and its successor the Australian Competition and Consumer Commission. However, at least in agricultural markets, neither Commission appears to have prevented the emergence of sitations where large numbers of sellers face one or a few buyers.

Much discussion of competition policy reflects a confusion in terms by which the struggle for market share between two or more large firms is seen as evidence of a market that is 'highly competitive'. Indeed, because struggles between two firms are more visible than the operation of the price mechanism there is a widely held view that duopolies and oligopolies are more competitive than markets involving large numbers of dispersed firms. This view is consistent with the ordinary usage of the term 'competition', but not with the way in which the term is used in economic analysis.

In economic analysis of strategic interactions between small numbers of firms, there is no presumption that competition for market share will yield long term benefits to consumers. Where competition among a few firms involves a struggle to dominate strategic areas of the market, it is likely to involve a waste of resources, and the adoption of pricing policies that are not closely related to costs.

1.4 Economies of scale and access rules

Economies of scale arise when average costs of production are lower for firms with higher total production. Most economic activities display economies of scale to some extent, in that there is a 'minimum efficient scale' of production, below which average costs will be high, for example, because essential items of capital are not fully utilised. If the minimum efficient scale is large in relation to the size of the market, only a few firms will be able to operate at the minimum efficient scale, and the market will therefore not be perfectly competitive.Scale economies often extend to the point where an activity is more efficiently undertaken by a single enterprise rather than by two more competing firms. Such an activity is referred to as a 'natural monopoly'.

There are many examples of natural monopoly relevant to agriculture, arising primarily in the transport and processing of agricultural commodities. For commodities with high transport costs, natural monopolies arise because the processing needs of a given area are most efficiently served by a single plant. Examples include milk processing, grain storage, handling and transport, and sugar refining.

The problem of natural monopoly is dealt with, in the National Competition Policy framework, through the imposition of access rules. If scale economies are such that a given market is most efficiently served by a single facility, that is, the market is a 'natural monopoly', that facility may be declared 'essential', and the owner may be required to provide access to all users on nonmonopolistic terms. For example, a railway company may be required to transport freight cars belonging to its competitors at a price that covers costs but does not allow for a monopoly profit. Alternatively, concern about the possibility that firms may use control of an essential facility to extend monopoly to downstream markets may be overcome by 'ring-fencing' that is, requiring the owner to divest assets in downstream markets. The former approach has been favored under National Competition Policy.

The owner of an ‘essential’ facility may be required to reach an agreement with other firms seeking access to the facility. If such an agreement cannot be reached, an access rule may be imposed by arbitration.

This policy approach is largely untested, and significant difficulties can be expected. If the access price is set in excess of long run average cost, the owners of essential facilities will receive monopoly profits, even where they do not discriminate between their own downstream operations and those of competitors. On the other hand, if access prices are set too low, the owners of essential facilities will not receive an adequate return on their capital and will therefore be unwilling to invest in the maintenance of their facilities.

In the short term, the second danger appears greater than the first. At present, regulators see their job as promoting competition and are likely to pursue this goal by setting low access prices, thereby harming incumbent firms and benefiting their competitors. In the long term, however, regulation is likely to favour incumbent firms. The fact that regulators must seek the co-operation of incumbent firms to do their work raises the danger of ‘regulatory capture’, that is, the phenomenon by which regulators come to identify the public interest with that of the incumbent firm.

Even if regulators are not predisposed in their favour, incumbent firms can back up their claim that access prices are too low by allowing the quality of service they provide to be degraded over time through inadequate capital expenditure. The Competition Policy Reform Act empowers the Australian Competition and Consumer Commission to direct owners of essential facilities to undertake extra investment when it is needed, by requiring the owner to ‘extend’ the facility, and the user to pay for the extensions.

Despite the appealing theoretical qualities of access pricing mechanisms, in the long term they will be reduced to rate-of-return regulation, in which prices are set so as to guarantee the incumbent firm an acceptable rate of return to capital. The result is to

eliminate incentives to control costs and encourage excessively capital-intensive production systems. These unattractive features of wrate-of-return regulation have been demonstrated over many years in the United States, where private operation of essential facilities such as electricity and water supply systems has been the norm.

The alternative solution, adopted in Australia and many other countries, has been public ownership of essential facilities. Public ownership has been criticised as providing inadequate incentives for cost minimisation. The desire to achieve the efficiency gains associated with a profit maximisation objective, while preventing the exploitation of monopoly power has been one of the major factors motivating the application of competition policy to firms currently in the private sector. However, examination of the experience of the United States suggests that it will be difficult to achieve benefits that are sustainable in the long term.

1.5 Competition and technical efficiency

The idea that competition will promote improvements in technical efficiency is often referred to using a distinction between the static benefits obtained from eliminating price distortions and the 'dynamic gains' claimed to be generated by competition. The dynamic gains hypothesis may be summarised by the statement that, over time, competitive markets will generate improvements in technical efficiency additional to any that might be derived directly from the removal of regulations that increase costs of production. The nature of these dynamic gains is not usually described in detail, although statements about dynamic gains are often made in terms that suggest that that there is a well-developed body of theoretical and empirical work supporting the dynamic gains hypothesis. In fact, there is no such body of work.

Many claims about the existence of dynamic efficiency gains are based on the concept of X-efficiency. Leibenstein (1966) argued that firms exposed to the bracing

atmosphere of competition will respond by eliminating internal inefficiency and seeking out opportunities for innovation. Leibenstein refers to the productivity gains arising from this process as improvements in 'X-efficiency'.

The idea of X-efficiency has been criticised by writers such as Stigler (1976). Stigler argues that what is represented as a gain in X-efficiency is in fact simply an increase in the intensity of work or, equivalently, a reduction in on-the-job leisure. At an empirical level, Stigler's critique has a great deal of force. In many of the recent cases where labour productivity has increased following competitive reforms, there is evidence of increased work intensity (Ganley and Grahl 1988, Australian Council of Trade Unions 1995). These observations suggest that the increased competition associted with micro-economic reform has led to a general increase in work intensity, rather than an improvement in technical efficiency.

2 . The public benefit test

Although the Competition Policy Reform Act allows for a transitional period, the time allowed for implementation is quite short in view of the comprehensive scope of the policy. Under the Competition Principles Agreement, the first stage of implementation, encompassing a comprehensive review of regulations and government business enterprises to promote competitive neutrality must be undertaken by 1 July 1997. A great many existing policies and institutions must be subjected to public benefit tests in the absence of adequate information about how such tests should be conducted.

The public benefit test required under the Competition Policy Reform Act is fairly similar to the standard process of policy analysis that would be undertaken by economists. The main difference is the strength of the presumption in favour of competition. Under the Act, policies held to reduce competition, including restrictions on access to essential facilities which have been imposed by government or by the owners of those facilities,

can be justified only if it can be shown that removal of these restrictions would be contrary to the public interest. The term 'public interest' is not explicitly defined, but the Competition Principles Agreement, Section 1(3), provides that:

(3) Without limiting the matters that may be taken into account, where this Agreement calls:

(a) for the benefits of a particular policy or course of action to be balanced against the costs of the policy or course of action:
(b) for the merits or appropriateness of a particular policy or course of action to be determined: or
(c) for an assessment of the most effective means of achieving a policy objective:

the following matters shall, where relevant, be taken into account:

(d) government legislation and policies relating to ecologically sustainable development;
(e) social welfare and equity considerations including community service obligations:
(f) government legislation and policies relating to matters such as occupational health and safety, industrial relations and access and equity;
(g) economic and regional development including employment and investment growth;
(h) the interests of consumers generally or of a class of consumers:
(i) the competitiveness of Australian business; and
(j) the efficient allocation of resources.

In terms of the standard framework set out in the Appendix, criterion (j) refers directly to the concept of economic efficiency, and criterion (i) is most usefully interpreted as referring to technical efficiency in production. Criteria (e) and (h) are related to the economic concept of equity. Criteria (d) and (f) cover the main non-economic concerns arising from competition policy. Criterion (g), referring to economic development and employment, encompasses a mixture of efficiency, equity and non-economic concerns and provides scope for consideration of cases in which the presumption in favor of

competition is not satisfied.

2.1 Approaches to the public benefit test

The public benefit test is the only point in the National Competition Policy process at which concerns other than those of the simple competitive model can be taken into account. It is, therefore, crucial that the scope of the public benefit test should be interpreted as broadly as possible. The criteria set out in the Competition Principles Agreement will not all be relevant in every case, but each of the issues they raise should be considered before a public benefit test is undertaken.

Many of the criteria which must be considered in public benefit evaluations cannot be evaluated in simple monetary terms. A public benefit test will normally involve a balance of monetary and non-monetary costs and benefits. There is no objective and value-free method of reaching such a balance. Rather, these are social decisions which must ultimately be made by governments rather than by bureaucrats or experts. The process of reaching such a decision may be assisted by expert advice about the consequences of particular policies, but evaluation of the desirability of those consequences should be a matter of public consultation rather than analyses undertaken behind closed doors.

This issue is particularly important in considering the environmental implications of policy decisions. Environmental issues pervade all aspects of modern agriculture and cannot be separated neatly from issues related to competition. For example, the replacement of systems of food safety regulation, and other regulations governing product quality, with self-regulation, advocated by the Industry Commission (1995b) as a significant component of 'Hilmer and associated reforms' has implications, not only for the quality assurance received by consumers but for environmental practices throughout the production and marketing chain.

The Industry Commission's claims that self-regulation would not lead to any decline

in quality were contrary to the predictions derived from basic economic analysis. Self-regulating firms will not take into account adverse consequences of regulatory failures for the industry as a whole, and will therefore take fewer precautions against such failures than an external regulator dealing with the industry as a whole. Recent incidents of food contamination in several states suggest that the predictions of economic theory are being borne out.

2.2 The Industry Commission view

In a submission to the National Competition Council, the Industry Commission (1997) argues that all but the last of the criteria set out in the Competition Principles Agreement, that is, the efficient allocation of resources, should be disregarded. The Commission gives three main reasons for this view:

(i) Economic efficiency is conducive or essential to the achievement of other objectives;

(ii) The pursuit of multiple, and potentially conflicting, objectives may put at risk the achievement of the most appropriate third party access outcomes; and

(iii) Alternative instruments are appropriate to the achievement of goals other than efficiency.

In procedural terms, the Commission's suggestion rests on the basis of the claim that the requirement to take account of public interest criteria 'where relevant' permits the National Competition Council to ignore these criteria whenever it sees fit, or, equivalently, that the Council may determine in advance that public interest criteria are never relevant. The legal validity of such a claim is a matter for the courts, but the impropriety of the Commission's suggestion should be self-evident.

The arguments put forward by the Commission are criticised by Quiggin (1997a). In that paper it is argued that:

(i) The benefits arising from improvements in economic efficiency are not, in general, large enough to justify the exclusion of other

objectives;

(ii) Conflict between objectives is an inevitable feature of the policy process and cannot be resolved by arbitrarily assigning particular objectives a dominant role in any given area of policy; and

(iii) The Industry Commission's claim that alternative instruments are available to deal appropriately with equity issues is incorrect in general, and especially in view of current constraints on public expenditure and taxation.

2.3 Efficiency improvements and transfers

In applying the public benefit test, it is important to distinguish between efficiency improvements and transfers. An efficiency improvement arises if, in principle, the aggregate gains from a policy initiative are large enough to permit compensation to be paid to everyone made worse off by the initiative and still leave a net surplus. By contrast, a policy may generate gains to one group, such as consumers or taxpayers, by transferring costs to other groups, such as producers or employees. In the application of the public benefit test, such transfers should cancel out, resulting no net benefit.

The need to take such transfers into account has often been neglected in assessments of the impact of competition policy. For example, the Industry Commission (1995b) analysed the effects of a large-scale program of competitive tendering and contracting. Following Domberger et al (1986, 1987) and Rimmer (1993), the Industry Commission assumed that budgetary costs savings from competitive tendering and contracting would average 20 per cent. It was estimated that the program of competitive tendering and contracting considered in the study would yield a net public benefit equal to 1.7 per cent of GDP or between $7 billion and $8 billion. In its report on competitive tendering and contracting (Industry Commission 1995c), the Commission examined the same issue taking into account the possibility that some budgetary savings were generated through reductions in wages and quality of services. In a simulation taking both factors into

account, the estimated net benefit was reduced to 0.3 per cent of GDP or a little over $1 billion.

Similarly, changes in agricultural pricing policy frequently give rise to transfers of wealth between farmers, processors, and consumers that are substantially larger than any net social welfare gain. A policy analysis which focuses on, for example, the gains realised by consumers from a reduction in prices, without taking account of the corresponding loss to producers, is clearly inadequate. Unfortunately, such incomplete analyses have been very common in the debate over competition policy.

2.4 The process of the public benefit test

The implementation of National Competition Policy includes the requirement to apply public benefit tests to a wide range of activities in a short space of time. Assuming that a broad definition of public interest, such as that embodied in the Competition Principles Agreement, is adopted, it is difficult to object to the principle that policies should be subject to review and that those found not to yield a net public benefit should be abandoned. An ideal version of such a policy process might be based on public inquiries, similar in form to those of the Productivity Commission, but undertaken by a body free from the partisan precommitment that has always characterised the Commission.

In practice, the scale of the review required and the short timescale has meant that such inquiries have not been feasible. Most of the public benefit assessment required under National Competition Policy have been undertaken by consultants without detailed knowledge of the policies under examination. The most that can be obtained from such an assessment is a statement of general principles, with indications as to possible application to specific policies, such as is offered in the present paper. Such an assessment can be a useful input to the policy process, but does not remove the need for elected governments to make the final decision on whether the net public benefits of particular policies are

positive.

The incentives facing consultants raise the danger of far less satisfactory outcomes. Firms undertaking a large number of public benefit assessments may reduce their costs by providing superficially differentiated versions of a 'one size fits all' report, with no serious attempt to take specific policy issues into account. Alternatively, consultants may produce reports containing apparently authorative recommendations in support of the policy options favored by their immediate clients. In the absence of any process of public review, excessive power over policy outcomes accrues to those participants in the policy process responsible for hiring and briefing consultants.

In general, the scale and pace of implementation of National Competition Policy greatly reduces the value of public benefit assessments as a check on the unaccountable, 'top-down' nature of the reform process. Within the constraints imposed by the policy, however, all possible steps should be undertaken to make the public benefit assessment process an opportunity for public input and debate.

3 Agricultural policy and competition policy

3.1 Marketing policies for agricultural commodities

The Hilmer Report (Hilmer, Rayner and Taperell 1993, pp. 194-5) identifies rural marketing as an area in which government regulation has restricted competion, stating

> Governments have created quasi-monopoly markeitng rights in a number of agricultural boards, sometimes accompanied by a power of compulsory acquistion of crops, controls over pricing and/or production quotas.
>
> The rationales for domestic monopoly arrangements of this kind have varied over time, including increasing returns to farmers, stabilising prices or providing farmers with countervailing power vis-a-vis buyers. The costs of these arrangements to the community have become

apparent in recent years, with reforms in areas including domestic wheat marketing, domestic barley marketing in some States and egg production and marketing in most States.

The Industry Commission (1995a) identifies the removal of existing marketing arrangements for dairy products, tobacco and sugar as part of 'Hilmer and related reforms', and estimates that removal of marketing arrangements would raise Australia's annual gross domestic product by around 0.15 per cent or around $600 million. Quiggin (1997b) shows that the Commission's simulations lack any basis in microeconomic theory, and argues that, if existing arrangements are interpreted as a tax on consumers, removal of the taxes would yield net benefits of no more than $80 million per year.

The Competition Policy Reform Act and Competition Principles agreement do not make explicit reference to agricultural marketing, but the general process of regulatory review required under the Act includes a review of agricultural marketing regulations. In this review, there is a presumption that marketing regulations restrict competition, since they place limits on the prices and conditions under which goods may be sold. Regulations imposed by State and Federal governments will therefore, in general, be required to pass a public benefit test if they are to remain in force under National Competition Policy.

If marketing regulations raise the price paid by final consumers for agricultural products, an efficiency-based approach to the public benefit test will result in the conclusion that the costs to the public exceed the benefits. This conclusion is unlikely to be overturned on equity grounds, because the equity effects of policies that raise the price of agricultural commodities are normally unfavourable. Low income consumers suffer the largest losses, expressed as a proportion of income, while farmers with large operations are the biggest gainers.

It may, in some circumstances be possible to show that public benefits arise from non-price effects of marketing policies. For example, controls on marketing may be

required to achieve a consistent reputation for high quality or for 'clean, green' production methods. However, it is important to consider whether alternative approaches, such as certification of quality, could achieve the same goals at lower cost.

3.2 Bargaining power

In many agricultural industries, a large number of farmers deal with a small number of firms engaged in processing and marketing. Examples include:

(a) dairy industry: three milk processors hold 89 per cent of the market, and four major retailers hold in excess of 80 per cent of the market;

(b) oilseeds: one end user/buyer holds 95 per cent of the market;

(c) malting barley: two end user/buyers hold 85-90 per cent of the market; and

(d) sugar: one refiner processes all sugar in Queensland and New South Wales.

The potential imbalance of market power is exacerbated where storage and transport costs are high, as in the case of milk, sugar and wine grapes, implying that processing must be undertaken close to the point of production. In many cases, this implies that farmers face a single buyer for their products.

Farmers have long been concerned that the inequality of bargaining power inherent in such situations will lead to low farm-gate prices and excessive margins and profits for processors and marketers. This concern is dismissed by Hilmer, Rayner and Taperell (1993, p. 195), who base their conclusion that 'providing rural producers with countervailing market power will only rarely be justified on efficiency grounds' on the analysis of the Industry Commission (1991). As with most analysis undertaken by the Commission, this work is based largely on *a priori* arguments rather than empirical analysis, and is pervaded by an institutional bias in favour of free market policies. In particular, the Commission adheres to the view that duopolies and oligopolies are effectively the same as competitive markets.

Since these views are likely to be shared by the National Competition Council, it is important, in considering changes to marketing arrangements to take into account the need to demonstrate a net public benefit. If marketing arrangements are designed to correct imbalances in bargaining power between farmers and processors, the public benefit test may be addressed by an analysis showing that the prices prevailing in the presence of marketing arrangements are similar to those that would prevail in a perfectly competitive market, where neither buyers nor sellers possessed significant market power. If this is so, the imposition of marketing arrangements would be expected to lead to higher farm-gate prices and lower marketing margins with final consumers facing the same or lower prices than in the absence of marketing arrangements.

3.3 Risk and stabilisation

Agriculture is a risky activity. Farmers face price risk because of fluctuating demand, particularly on world markets, and climatic risk particularly with respect to rainfall. Duirng much of the postwar period, a variety of stabilisation schemes were designed with the stated objective of reducing the price risk faced by farmers. Some of these schemes, such as the wheat industry stabilisation schemes, were reasonably successful in reducing fluctuations around the average price that would prevail in smoothly operating competitive markets over the medium term.

In other cases, however schemes were used to raise prices to levels well above the average market price. Such schemes generally proved unsustainable. Where schemes were based on buffer stock stabilisation, as in the case of the wool industry, an attempt to raise prices above the average market price inevitably resulted in an unsustainable growth in stocks and the eventual collapse of the scheme. Similarly, a scheme based on a buffer fund will break down through the exhaustion of the fund if prices are set too high. In principle, it is possible to hold prices at high levels indefinitely if a single marketing

agency restricts the amount sold, as in the case of the egg industry. Such policies have tended to break down, however, as a result of illegal production and consumer resistance.

It has often been suggested that futures markets could take the place of stabilisation schemes. For a variety of reasons, futures markets for agricultural commodities have not flourished in Australia. In this, as in many other instances, it is necessary consider market solutions without maintaining a dogmatic assumption that the market solution is always best.

Under National Competition Policy, most stabilisation schemes will be seen as reducing competition and will therefore be subject to the public benefit test. As observed in Section 3.2, schemes that lead to an increase in average prices paid by final consumers will generally fail the public benefit test.

However, where schemes stabilise prices around their mean values, consumer welfare will generally be unchanged or slightly improved. The critical issue in such cases is whether the benefits to producers of reductions in price risk offset the costs of administering the scheme, which must normally be financed by some form of industry levy. Because the benefits of risk reduction vary from farmer to farmer, this issue is hard to assess on the basis of external evidence. The most promising basis for a public benefit test is an analysis of producer support for, or opposition to, the scheme. Such a test may be institutionalised by requirements that producers vote, at regular intervals, on whether the scheme should be kept in operation.

3.4 Co-operatives

The establishment of regulations governing the marketing of agricultural commodities has been one of the main responses to concern over unequal bargaining power and risk. The second has been the establishment of co-operatively owned processing enterprises. Although the situation is less clear-cut than in the case of marketing regulations, some

co-operative arrangements may be seen as reducing competition, and may therefore be subject to challenge under the Competition Policy Reform Act.

One issue that must be addressed is the possibility that co-operatively owned processing facilities will be declared to be essential and required to grant access to competitors or to farmers who are not members of the relevant co-operative. In addition, where co-operatives have been established with some form of legislative backing, the relevant legislation may be subject to review with respect to impacts on market competitiveness and competitive neutrality. Further analysis of this question is required.

3.5 Environmental issues

Externalities arise in agriculture when the actions of one farm affect other farms, households or the natural environment; an example is when runoff from applications of fertiliser enters streams and leads to algal blooms, harming downstream water users. In these circumstances, unless environmental regulation is applied, profit maximisation will lead to excessive levels of fertiliser application and environmental damage.

The relationship between competition policy and environmentally sustainable development policy is difficult to predict in detail, but there is a fundamental conflict between the ideas underlying competition policy and the ideas of the environmental movement. The case for competition is based on the assumption that externalities are rare exceptions to a general rule that the actions of one individual or firm do not affect others except through market transactions. By contrast, the environmental movement is based on the view that externalities are a pervasive feature of economic activity, and agricultural production in particular, a view that may be summarised by the catchphrase ‘everything is connected to everything else’.

The conflict between competition policy and sustainable development policy is exacerbated by the fact that both represent comprehensive approaches to all aspects of

policy. The principle that competition should be the primary consideration in policy design will therefore inevitably come in to conflict with the view that policies should be based on environmental sustainability, although it is difficult to predict in advance where conflict will arise.

One possible area where conflict may arise is that of access to infrastructure, for example, the water supply system. Governments have often used infrastructure planning as a tool for managing environmental problems and regional development issues. For example, development of sensitive areas can be constrained by a decision not to supply the necessary infrastructure services. Under National Competition Policy such a decision could be challenged as a denial of access to an essential facility.

In principle, these problems can be resolved by the use of the public benefit test, which requires that the principles of environmentally sustainable development be taken into account. However, the arguments of the Industry Commission that these principles should be disregarded may be influential. In any case the policy process associated with the public benefit test gives clear primacy to the objective of promoting competition.

A further difficulty in predicting the nature of conflict between competition policy and environmentally sustainable development is the existence of interactions between the effects of market pressure and environmental externalities. In general, the shorter the time horizon of decision-makers the less the incentive to preserve the environment. Since farmers under severe financial pressure must operate with very short time horizons, market pressure is likely to be associated with environmental degradation.

4. The way forward

The implementation of National Competition Policy is likely to lead to the abolition of some existing agricultural policies which are seen as reducing competition and which fail to pass the public benefit test. However, it appears unlikely that there will be significant

positive action by the Australian Competition and Consumer Commission to promote competition, for example, by enforcing the breakup of firms that dominate markets for the processing and distribution of agricultural commodities.

In considering responses to policy problems in the future, therefore, the Hilmer reforms will be less a guide to action than a constraint on the kinds of policies that can be adopted. Policies must be designed so that any restrictions on competition can be justified on the basis of a public benefit test. Furthermore, alternatives that do not restrict competition must be considered. The main positive lesson from the Hilmer reforms is that policy should be designed so that opportunities for beneficial competition are not unnecessarily precluded.

In designing policy for the future, it will be necessary to steer a middle course between the excessive reliance on regulation that characterised agricultural policy for much of the postwar period and the naive faith in competition that motivates the Hilmer reforms. It is important to recognise the possibility of a market solution, without assuming that market solutions will always be optimal.

Careful consideration of the debate over the public benefit test will also prove useful in designing future policies. In particular, the discussion above demonstrates the need to take account of a wide range of considerations in policy design, including efficiency, equity and environmental sustainability. Conversely, approaches based on the dominance of a single objective such as the promotion of competition, must be rejected.

Concluding comments

Both the content of the Hilmer reforms and the nature of the reform process raise issues of concern to New South Wales agriculture. The process has been undertaken in a way that precludes significant consultation. The reforms involve a misunderstanding of the nature and role of competition in the economy. There is a danger that issues such as

equity and environmental sustainability will be neglected. The specification of the public test offers an opportunity to take these issues into account. It is important, however, to reject suggestions that the public benefit test should be narrowly focused on economic efficiency.

National Competion Policy was designed to accelerate the pace of microeconomic reform. As a result, reform is proceeding with little time for adequate consideration of the costs and benefits of reform, or of the most appropriate choice of policy. In the present paper, some of the issues relevant to New South Wales agriculture have been discussed. Considerably more work is required for a comprehensive review of the costs and benefits of existing and proposed policies.

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Appendix The economic approach to public policy

Economists use a variety of approaches in analysing public policy questions. Most commonly, policies are assessed in terms of four criteria

(i) economic efficiency;

(ii) equity ;

(iii) employment effects; and

(iii) non-economic effects (social, environmental and so on).

Broadly speaking, the concept of economic efficiency refers to the impact of a policy on aggregate national income, without regard to effects on income distribution, while equity refers to effects on income distribution. Thus, the total effect of a given policy on the income of members of the community may be divided into efficiency and equity effects.

The economic efficiency criterion may be further divided using the concepts of technical and allocative efficiency. Technical efficiency corresponds fairly closely to the ordinary language use of the term ‘efficiency’, and refers to the requirement that a given output should be produced without any waste of inputs. The concept of allocative efficiency is somewhat more complex. The basic idea is that allocative efficiency is achieved when resources are allocated to produce those goods most valued by society. Under appropriate assumptions, it can be shown that allocative efficiency is achieved when the value of output, calculated using the prices generated by a set of competitive markets, is maximised.

The distinction between technical and allocative efficiency may be illustrated by considering a farm producing wheat and wool. If it is impossible to increase the output of both wheat and wool without additional inputs, the farm is technically efficient. However, if the price of wheat is high and the price of wool is low, it may be possible to increase

profits by diverting resources from wool production to wheat production. This would result in an increase in allocative efficiency.

In the context of agricultural policy, consideration of the employment effects of a policy proposal should be taken to include effects on self-employed workers such as farmers, as well as effects on workers employed in agriculture and related industries. Hence, consideration of employment effects of a policy must take into account its effect on the viability of farms. In principle, employment effects are included in the analysis of efficiency and equity effects. Many economists therefore do not give separate attention to employment effects. However, the methods of economic analysis normally used to assess economic efficiency and equity effects are based on the assumption of full employment. Hence, if effects on employment and farm viability are not considered separately, there is a danger that they will not be taken into account at all.

The social and environmental effects of policy proposals must also be taken into account. In some cases, such as the loss in land value associated with increases in erosion rates or salinity, which might be caused by policies encouraging more intensive short-term land use, these effects can be expressed in monetary terms. In many cases, however, the assignment of monetary values will be inappropriate or impractical. It is important not to ignore the social and environmental effects of policy simply because they may be hard to value.

The role of competition

Economic policy analysis usually takes as a benchmark the allocation of resources that would be generated by perfectly competitive markets on the basis of an equitable initial distribution of wealth and other resources. The term ‘perfectly competitive’ refers to a market with a large number of buyers and sellers, each so small that their actions have no significant effect on the market price, and all perfectly informed about the price

and quality of the goods traded in all relevant markets. Under certain ideal assumptions, discussed further in the next section, it can be shown that the equilibrium arising from perfect competition and an equitable initial allocation of wealth will be socially optimal.

In the standard economic framework, competitive markets are not regarded as an objective in themselves, nor is it supposed that competition promotes technical efficiency. Competitive markets are seen as desirable because, under the ideal conditions, the price signals they generate ensure that resources are allocated to the use in which their value is greatest. In addition, competitive markets are seen as promoting the equity objective by preventing the redistribution of wealth from buyers to sellers that arises under conditions of monopoly. Such redistribution, referred to as the transfer of monopoly 'rent', is often seen as unfair.

Failure of the competitive market assumptions

Unrestricted competition is not always beneficial. Important exceptions to the general presumption that competition will favour efficiency arise in the presence of

(i) unemployment;
(ii) externalities;
(iii) scale economies ;
(iv) market power; and
(v) financial market failures

Unemployment

Unemployment is the most important single violation of the competitive market assumptions. In the standard competitive model, the fact that farmers may go bankrupt and employees lose their jobs as a result of the competitive process is not a cause for concern, since it is assumed that workers will immediately find new jobs elsewhere and farmers' capital will be transferred into more productive uses. In reality, this is not the case. Farmers and workers displaced by competition may experience prolonged

periods of unemployment. Although it is often asserted that the losses experienced as a result of higher unemployment will be offset by gains in other sectors of the economy, there is no theoretical basis for the supposition that the two effects will cancel each other out.

Externalities

Externalities arise when the actions of one firm or individual affect other firms or individuals directly, rather than through market prices. In these circumstances, unless environmental regulation is applied, profit or utility maximisation will lead to excessive levels of environmentally damaging activities.

Economies of scale

Economies of scale arise when average costs of production are lower for firms with higher total production. Most economic activities display economies of scale to some extent, in that there is a ‘minimum efficient scale’ of production, below which average costs will be high, for example, because essential items of capital are not fully utilised. If the minimum efficient scale is large in relation to the size of the market, only a few firms will be able to operate at the minimum efficient scale, and the market will therefore not be perfectly competitive.

Market power

Scale economies often extend to the point where an activity is more efficiently undertaken by a single enterprise rather than by two more competing firms. Such an activity is referred to as a ‘natural monopoly’. The most appropriate solution, in many cases, is that the activity should be undertaken by a co-operative or publicly owned enterprise. Problems of market power are closely related to economies of scale. In markets where there are only a few buyers and many sellers, the buyers can use their greater

bargaining power to offer lower prices to sellers. The opposite is true when there are many buyers and few sellers.

In many cases, including those of the dairy, wheat and sugar industries and some horticultural industries the processing of agricultural commodities after they leave the farm displays scale economies. The result is that large numbers of farmers deal with a relatively small number of firms engaged in processing and marketing. In the absence of regulation or of frameworks for collective negotiation over prices, processing firms will be able to set prices paid to farmers below the level that would prevail in a competitive equilibrium.

Financial market failures

The actual operation of financial markets is not as smooth and efficient as the ideal competitive model requires. The result is that market outcomes for problems involving credit, risk and insurance are rarely optimal. In some, but not all, such cases, government policies such as price stabilisation schemes may yield a superior outcome.

The fact that many markets do not satisfy the ideal assumptions of the competitive model means that the welfare of farmers, consumers and the public in general may be improved by appropriately designed government policies or by co-operative action. However, the existence of so-called ‘market failures’ does not imply that any particular scheme of intervention will improve welfare. To determine whether this is the case, it is necessary to examine the equity , efficiency and non-economic effects of such schemes.