Reforming Australia's Commonwealth Business Programs

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INDUSTRY policy is once again being debated in Australia. Continuing high unemployment has prompted some commentators to argue that government should not only 'get the basic economic framework right', but must adopt a more interventionist approach to industry development.

This debate has already had an impact on public policy. For example, the Howard Government in 1997 decided to freeze import tariffs on motor vehicles and textiles, clothing and footwear from 2000 to the end of 2004, at levels several times higher than those applicable to most Australian industries.

As well, several recent reports on budgetary and other kinds of government support for industry display a more interventionist stance. Among these are the report of the Information Industries Taskforce (1997) (the Goldsworthy Report) and proposals by the Metal Trades Industry Association of Australia (MTIA/EIU, 1997). More rigorous and wide ranging is the Review of Business Programs (1997) (the Mortimer Review), which contains numerous recommendations designed to improve the overall framework for assessing and applying Commonwealth business programs. But parts of it also suggest a more interventionist role for government.

Apart from their direct cost to taxpayers, business programs influence resource allocation within the economy and alter the incentives facing industry. It is therefore important to ensure that business programs are appropriate and well designed.

Developed while the Howard Government was preparing its response to the recent reports, this article provides an overview of current Commonwealth business programs and of the proposals for change. Rather than offering a comprehensive assessment of existing programs or of the proposed changes, it concentrates on the underlying arguments for business programs. It also discusses the practical constraints on effective intervention and ways to improve program design and delivery. In doing so, it draws heavily on the Industry Commission's (IC) submission to the Mortimer Review (IC, 1997a).

Overview of Commonwealth Business Programs

The IC has estimated that Commonwealth support to industry, in all sectors of the economy, exceeded \$8 billion in 1996/97. Of this, tariffs and agricultural marketing

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arrangements accounted for close to \$5 billion. Government-funded programs and tax concessions assisting business activity accounted for the remainder.

Australian businesses also benefit from other Commonwealth measures which are not easily quantified, such as the anti-dumping system and government procurement policies. State and Territory governments provide a further \$2 billion a year of direct support to business, and more than \$3 billion a year in payroll tax exemptions.

The manufacturing sector is the major beneficiary of Commonwealth budget outlays on business programs. In 1996/97, it received around 40 per cent of the \$1.8 billion spent on these programs (Figure 1). Agriculture accounted for around 30 per cent. However, as a proportion of sectoral value added, agriculture is the major beneficiary. It received budget outlays equivalent to more than 3 per cent of sectoral value added in 1996/97: three times the proportion for manufacturing and 15 times that for the services sector.

Figure 1: Outlays on Commonwealth-funded business programs, by sector, 1989/90-1996/97 (\$m, 1995/96 prices)

Source: IC estimates.

Support for research and development (R&D) accounts for more than 35 per cent of total budget outlays on business programs. Export assistance programs are

¹ The IC's estimate of the cost of these programs is less than the \$4 billion cost in 1997/98 of the 70 programs covered by the Mortimer Review. Apart from timing discrepancies, the difference mainly reflects: the IC's exclusion of the \$1.5 billion Diesel Fuel Rebate Scheme (which it views as the removal of an inefficient tax on business inputs rather than 'support'); the Mortimer Review's inclusion of various tariff concessions (which are counted in the IC's tariff data); and, partly offsetting these, the IC's wider coverage of programs.

the next most significant category of expenditure. (Figures 2 and 3 provide details on the break-up of program support in agriculture and manufacturing.)

Figure 2: Commonwealth outlays on agriculture, by type, 1996/97

Source: IC estimates.

Figure 3: Commonwealth outlays on manufacturing, by type, 1996/97

Source: IC estimates.

The Commonwealth also provides a range of tax concessions to assist industry. The major concessions include the 125 per cent (previously 150 per cent) tax concession for R&D and income tax averaging arrangements for primary producers. Tax revenue forgone on such concessions totalled \$1.6 billion in 1996/97.

Recent Industry Policy Proposals

The Mortimer Review. The Mortimer Review makes both general and specific recommendations to government. These include: adopting a per capita GDP growth target; boosting national savings; aggressively pursuing microeconomic reform; rationalising the current suite of business programs; applying consistent principles to the introduction, operation and evaluation of all programs; and establishing Invest Australia (with funding of \$1 billion over five years) to attract additional domestic and foreign investment.

In some respects, the Mortimer Review's findings are consistent with the IC's submission to the review. For example, both support the need to apply a market failure rationale to government intervention; to rationalise the current plethora of programs; to apply consistent and transparent principles, including cost/benefit tests, to all business programs; and to fund generic activities, such as innovation, rather than particular sectors or industries.

However, there are some important differences. Notable among these are the review's call for the government to adopt a long-term economic growth target; its advocacy of a \$1 billion fund to attract investment; its adoption of a much wider concept of 'market failure', including its extension to policy actions by foreign governments detrimental to Australian industries; and its acceptance of market failure as a strong rationale for government support for exports.

The MTIA Report. The MTIA Report has a narrower focus on manufacturing and an emphasis on investment attraction. It stresses the need for good macroeconomic outcomes and for reform of taxation and industrial relations. But it also calls for the establishment of an investment agency, grants and tax concessions for major investments, and a 200 per cent R&D allowance.

The Goldsworthy Report. The Goldsworthy Report on the information industries also proposes measures to attract new investment. Its recommended National Information Industries Strategy includes: an investment attraction agency offering grants or tax holidays for new investments; 200 per cent tax deductions for R&D salaries; and the establishment of an Information Economy Development Fund to undertake feasibility studies on new opportunities. In addition, it argues for tax reform to ensure that Australia's taxes are 'internationally competitive'; the removal of taxes on business inputs; and higher rates of depreciation for information technology to better match economic lives.

Rationales for Government Business Programs

In its submission to the Mortimer Review, the IC argued that soundly based and well implemented business programs can boost productivity and economic growth. However, the submission also stressed the need to focus programs in areas where governments can improve on market outcomes for the benefit of the community as a whole.

As all of the recent reports on industry policy emphasise, the most important form of government support for industry is a sound economic policy regime. Business needs a stable and sound macroeconomic environment, effective laws and institutions, and a business environment that rewards efficiency, flexibility and innovation. Recognition of the last of these has driven the microeconomic reform program over the past decade.

Yet clearly there are circumstances in which sound fundamentals and market competition alone do not result in the best outcome for the community and in which government business programs can help. The key issue, therefore, is how to determine when business programs benefit the community as a whole rather than merely the recipient firms and industries.

The following discussion indicates that the circumstances in which intervention by way of business programs is warranted are typically overstated. Moreover, in implementing programs, governments have often failed to recognise the practical difficulties and the costs of intervention. The upshot has been a range of business programs of doubtful benefit to the community as a whole.

The Mortimer Review recognises this and proposes rationalisation of existing programs into five main groups: investment, innovation, exports, business competitiveness, and sustainable resource management.

However, the review's finding that all of these areas have clear rationales for government support is debatable. The MTIA and Goldsworthy Reports' proposals for new or expanded government investment incentives are equally questionable.

Investment. Project-specific incentives to attract internationally mobile capital are a feature of recent industry policy proposals. One argument advanced for such subsidies is that they are needed to match similar support available in other countries. The Mortimer Review (p. 88) advances the further argument that foreign investment can bring positive externalities, such as new technology and skills transfer, which may warrant subsidies.

However, it does not automatically follow from the fact that some other countries provide investment subsidies that Australia should do likewise (IC, 1997d). In an economic sense, the provision of assistance by the governments of other countries is no more a 'market failure' than those countries enjoying lower costs because, say, labour is cheaper. Selective investment incentives must be paid for by taxpayers and other Australian industries. Hence, while investment is important to economic growth, such subsidies tend to shuffle investment among activities rather than boost investment overall. So, in the absence of external benefits, the case for incentives to attract investment is not compelling.

Moreover, even if some foreign investment brings external benefits, identifying and quantifying those benefits is difficult, especially in advance. It is hard to know whether a particular project would locate in Australia even without special inducements. Added to this is the difficulty of judging whether, once established, the activity would remain in Australia without continuing incentives. Where competition from other countries is intense, companies can play off one government against another, and so reduce or eliminate any benefit to the country that ultimately hosts the investment.

Indeed, domestic experience with investment incentives should warn against attempts to raise the stakes in this area. State and Territory governments continue to engage in competitive bidding for major investments and 'events'. The IC (1996b) has found that this, at best, shuffles jobs between regions and, at worst, burdens taxpayers and ratepayers, and reduces the competitiveness of Australian industry and the income of Australians as a whole. The States' experience in targeting individual firms to promote economic development sounds a similar warning. For example, the Victorian Economic Development Corporation, abolished in 1993, left taxpayers a debt of \$110m.

A government that chose to implement investment incentives would therefore need to be extremely alert to the potential pitfalls. It would require stringent assessment and review procedures to determine whether the incentives were delivering national benefits, and a commitment to terminating such measures promptly if net national benefits were not forthcoming.

Innovation. R&D is the prime example of a business activity whose social benefits can often be significantly greater than the private benefits. Thus, in its report on R&D, the IC (1995) endorsed the need for government assistance to encourage firms to undertake additional, socially beneficial R&D activity. For the same reason, the Mortimer Review recommends continuing support for R&D.

Of course, determining the degree of externality, and therefore the required level of government support, is problematic. In its R&D inquiry, the IC effectively endorsed the then 150 per cent tax concession for business R&D. The Mortimer Review's proposals (p. 107) would roughly restore that level of support. In contrast, the Goldsworthy (p. 88) and MTIA (p. 29) Reports call for much greater 'average' support; but both reports lack an analytical argument to support their proposals.

On some other R&D issues, there are significant differences between the IC's report and the Mortimer Review's approach. For example, the IC (1995:14) considered that CSIRO's principal role is to undertake 'public good' research. It raised some concerns about the potential for the existing 30 per cent external revenue requirement to 'privatise' CSIRO's publicly funded resources. In contrast, the Mortimer Review (p. 124) contains a recommendation for CSIRO to increase its level of external funding to 50 per cent.

The Mortimer Review (pp. 112-18) supports the facilitation of information on management practices and new technology, and their uptake by small- and medium-sized firms. The common argument for such support is that it can be a catalyst for

improving firm practice and culture. For example, enterprise development and business network programs are said to foster a 'best practice' culture.

Yet many firms already face strong commercial incentives to seek out better management practices, technologies and processes. This suggests that the absence of a best-practice culture must reflect more fundamental information problems or other impediments that retard the uptake of better business practice. Moreover, the presence of information deficiencies does not automatically establish a case for government intervention. Often, firms and markets develop ways to improve information: for example, there are many private consultants who can advise on appropriate business management.

It is easy to misinterpret problems in this area. For example, the high per unit cost for small firms of obtaining information is not necessarily a market failure. Small firms face relatively high costs for many inputs. The cost of obtaining information may be evidence of ideal business size rather than of malfunctioning in the marketplace.

Nevertheless, there are some information-related problems which markets may not address well. For example, a firm generating or purchasing information on best practice may have difficulty in preventing other firms benefiting from its efforts through demonstration effects. As with R&D, this may lead to the underprovision of such information. As well, firms may not fully appreciate the benefits of information on best practice, leading them to undervalue it. And firms may not properly use the available information. Where these problems are significant, program-style intervention may be appropriate.

It is essential to be clear about the source of the problem and about whether a business program would be the best way to address it. For example, where inflexible industrial arrangements prevent the adoption of better work practices, the problem should be addressed directly rather than through compensatory, 'best practice' assistance.

Exports. In seeking greater government support for exports, the Goldsworthy Report (pp. 48-9) highlights the growth of Australia's information and communication technology trade deficit. Similarly, the MTIA Report (p. 18) points to the deficit in Australia's trade in manufactured goods generally.

However, the rationale for trade rests on the presumption that the economic strengths of individual countries vary, creating the possibility of specialisation which benefits all. Viewed in these terms, deficits in some sectors and surpluses in others are inevitable and desirable rather than a cause for concern.

Export assistance can increase targeted exports, but raises costs for non-assisted exports and import-competing production. The broad-based nature of Australia's export growth in recent years suggests that factors operating to enhance economy-wide performance are more important to improving export performance. Indeed, in its microeconomic reform stocktake, the Commission (PC, 1996) found that reductions in the costs imposed on exporters by tariffs, and the speeding up of microeconomic reform, had met the preconditions for the removal of export market de-

velopment assistance set by the last comprehensive review (Committee for Review of Export Market Development Assistance, 1989).

Yet the Mortimer Review (p. 129) advances an externality argument for continuing government support to facilitate exports: 'The main justification is the need to provide information and overcome private costs of entering or operating in foreign markets which exceed the net costs to society'.

The significance of such externalities is open to debate. Some pioneering firms may help to establish Australia's reputation in overseas markets and provide market intelligence to other domestic firms. But where is the evidence that such spillovers arise from *all* export market development activity, or are generally sizeable? Moreover, in some industries, it may be possible to 'internalise' spillovers from export market development through an industry levy. That is, the levy, rather than government subsidies, would be used to fund generic export market development.

Business competitiveness. Under this heading, the Mortimer Review covers programs which seek to encourage adjustment or which offer compensation to business for the adverse impacts of other government actions.

Governments have an important role to play in facilitating adjustment to economic change, helping those adversely affected by that change and redistributing income more generally. However, the usefulness of business programs in promoting these objectives is often less clear.

To encourage adjustment, the Mortimer Review (p. 167) proposes short-term assistance for capital investment in plant and equipment, and one-off grants to firms facing unforeseen adjustment pressures.

The IC has readily acknowledged that there will be circumstances where specific adjustment measures or programs are warranted on efficiency or equity grounds. Thus, it has typically recommended phased rather than abrupt tariff reductions.

But, as the IC (1996c) found in relation to rural adjustment, it would be crucial that any specific measures were set up in a way that encouraged rather than delayed adjustment. For example, there is the risk that 'transitional' programs will become permanent. The retention of 'temporary' quotas on car imports from 1974 to 1988 illustrates this point. More generally, the provision of adjustment assistance to particular industries may encourage other industries to seek similar assistance as part of any reform proposals. Subsequent 'horse trading' over the level of support may act to delay necessary microeconomic reform.

For these sorts of reasons, the Commission (PC, 1996) has argued that the social welfare system and generally available retraining programs are usually better than specific measures as a way of assisting producers or employees adversely affected by change.

Several existing 'business competitiveness' programs aim to 'compensate' industries for the adverse effects of other government policies. For example:

- The Factor f scheme exists partially to offset the effects on the domestic pharmaceutical industry of drug price suppression under the Pharmaceutical Benefits Scheme.
- The Diesel Fuel Rebate Scheme offsets an inefficient impost on petroleum products used by farmers and miners. The excise on diesel fuel would otherwise distort production choices.
- Various tariff concession and import duty rebate schemes reduce the impact of tariffs on the cost of imported inputs.

As the Mortimer Review (p. 167) recognises, if 'problem' policies cannot be altered, compensating support may improve overall resource allocation.

However, designing compensatory policies is informationally demanding and this can lead to targeting difficulties. In this context, the IC's recent report on the pharmaceutical industry (IC, 1996a) concluded that the Factor f scheme had over-compensated some firms and under-compensated others.

More broadly, compensating for the adverse effects of other policies can reduce the pressure to reform those policies. As the Mortimer Review (pp. 168-71) acknowledges, compensating assistance is very much a second-best option. General taxation reform could remove the need for the Diesel Fuel Rebate Scheme. And further tariff reform would render tariff concessions on imports redundant.

Sustainable resource management. The IC's submission to the Mortimer Review did not address resource management programs in any detail. Nevertheless, it is clear that significant market failures can occur in this area. For example:

- Poor land management can lead to erosion and water run-off which reduce the quality of adjacent water supplies to downstream users.
- Community demands for conservation of biodiversity and other environmental attributes are often not reflected in decisions about resource use.
- Property rights to certain natural resources are inadequately specified, or there may be constraints on trade in these rights.
- There may be insufficient information on, or ignorance of, the effects of natural resource use.

Addressing these problems will often require better and more flexible property rights and regulatory regimes rather than business programs. For example, the IC's recent draft report on land management (IC, 1997b) proposes recasting the regulatory regime to ensure that resource owners and managers take into account the environmental impacts of their decisions. It also proposes measures to create or im-

prove the markets for key natural resources and to encourage conservation on private land. In a similar vein, the Mortimer Review (p. 182) proposes the introduction of tradable quotas for all Commonwealth fisheries. However, the review also endorses business programs aimed at gathering and disseminating information on the consequences of poor land management and at encouraging energy efficiency. In the presence of such information market failures as those noted above, these programs may be useful. But the same caveats apply. For example, governments should be careful not to crowd out private markets: note the increased use of private consulting services which accompanied the partial withdrawal of State government extension services for agriculture (IC, 1996c).

Some Practical Considerations

Even when there is a good case for government business programs, there are invariably costs and constraints which can reduce the benefits or lead to negative outcomes.

Costs of intervention. Raising taxes to pay for business programs has efficiency costs. For instance, the efficiency cost of income tax could amount to more than 20 cents for each additional dollar raised (PC, 1996). And as well as the direct budgetary costs, there are the administrative costs for government and business alike.

Information problems. Proper assessment of proposed programs must take account of the nature and magnitude of the underlying problem and the impacts of alternative policies to deal with the problem (including doing nothing). Obtaining the information to make such assessments can be costly or even impossible. Moreover, information on the benefits of program support will typically be more comprehensive than that on the costs to the wider community. This increases the risk of programs being based on what is good for particular firms or industries rather than for the community as a whole.

Promotion of rent seeking. Government support for industry, even for good reasons, inevitably encourages lobbying for financial favours. From a national perspective, this is unproductive.

Incentives for program administrators. Administrators of business programs can face incentives that conflict with the goal of obtaining the best result for the community. For example, the performance of program administrators is likely to be judged on how well they have served the users of a program. This can lead to 'regulatory capture'. In addition, to avoid the appearance of failure, governments can be tempted to provide extra assistance to 'at risk' activities that have previously benefited from public support.

International obligations. Australia is a signatory to international trade agreements that limit the forms of government support to business. For example, World Trade

Organisation provisions prohibit any export subsidy outside agriculture. As the recent challenge to the import credits scheme for the textile industry highlights (IC, 1997c), Australian governments cannot ignore those commitments with impunity.

These problems do not condemn all business programs to failure. For example, as already noted, the IC (1995) found that tax concessions for R&D have benefited Australia, despite the difficulty of precisely estimating the extent of market failure in this area.

But the problems do highlight the need for proper assessment of the potential benefits and costs of intervention. Thus, the Mortimer Review (p. 72) recommends a threshold test for all business programs. This would require a formal assessment of whether a program would provide a net economic benefit, would address a market imperfection and would not breach Australia's international obligations. It would follow an assessment of whether the program was preferable to other approaches, such as changes to regulations or taxation measures. In many respects, this recommendation is in line with similar proposals in the IC's submission to the review.

However, as is apparent from the preceding discussion, the Mortimer Review's views on the circumstances in which net economic benefits are likely to arise go well beyond conventional views and those of the IC.

Good Program Design

Where business programs can improve community welfare, policy should focus on obtaining the maximum benefit for the funding involved. In its submission to the Mortimer Review, the IC (1997a:29-37) highlighted the key aspects of good program design.

Effective targeting. Programs should focus support on new activity rather than activity that would have occurred anyway. They should also target market failures generally rather than particular firms or industries. Thus, generally available support for activities such as R&D is preferable to firm-specific subsidies. And programs should be open to all firms rather than limited to (say) firms of a particular size.

Transparent support. Transparency facilitates monitoring and reporting on the outcome of programs. It requires clear eligibility criteria that limit administrative discretion in the allocation of funding to firms. An important finding emerging from the IC's inquiry (1996b) into State government assistance to industry is that secrecy in process and outcomes can lead to public suspicion that 'deals are being done', even when this is not the case.

Maintaining market incentives. Programs should retain the incentive for firms to operate efficiently and should not alter relative prices any more than is necessary to address the underlying problem.

Avoiding unnecessary compliance costs. Keeping programs simple, seeking industry input to program design, and relating the stringency of compliance requirements to the amount of support provided to individual firms can help to contain compliance costs. However, there will often be trade-offs between reducing compliance costs and meeting other objectives, such as targeting support. Hence, compliance costs must be assessed in conjunction with other benefits and costs.

Avoiding program duplication. Coordinating related programs and addressing duplication will reduce compliance costs. It will also diminish confusion for firms about what support is available. To help avoid duplication, program support at one level of government should take account of similar support at other levels.

Effective monitoring and public reporting. All business programs should be monitored regularly to assess their performance against underlying objectives. Public reporting of outlays and outcomes is important to allay suspicion that business programs are simply 'business welfare'.

Periodic review by independent bodies. There is a need for periodic and independent review to consider whether programs remain relevant in the light of changes in the wider market and policy environment. This should be formalised through the imposition of sunset clauses in business programs.

Separation of policy from delivery. Responsibility for policy formulation should be separate from responsibility for program delivery.

Contestability in service provision. Where a program involves a service to industry — for example, extension advice — delivery should be open to the private sector and/or other government agencies.

User contributions to the cost of services. Market failures are rarely, if ever, significant enough to justify full public funding of business service programs. User contributions also help to avoid unnecessary use of programs and maintain pressure on providers to deliver services efficiently.

Of the recent industry policy reports, only the Mortimer Review looks at these issues in any detail. Its recommendations are, for the most part, identical to or consistent with the checklist in the IC's submission. The main difference is that the Mortimer Review (p. 82) recommends annual performance reports and periodic evaluations against agreed objectives and performance indicators, with broader reviews only in exceptional circumstances. This would be less rigorous than the IC's proposal for periodic *independent* reviews triggered by legislated sunset provisions.

Concluding Remarks

The over-riding objective of government business programs must be to improve community welfare. The focus of business programs cannot be simply on

'promoting industry' or particular sectors. The development and growth of particular industries or sectors is an outcome of industry policy, but should not be its objective.

The Mortimer Review explicitly recognises that business programs must address market imperfections and provide net economic benefits. Its proposals for assessing business programs are also consistent with most of the IC's; the other recent reports do not properly consider these issues.

Yet despite the Mortimer Review's greater rigour, there is a significant tension between its criticisms of the ad hoc nature and poorly specified objectives of many existing programs and its finding that the current level of expenditure on business programs is appropriate. More importantly, the review's proposals carry a significant risk because they are based on a very broad interpretation of market failure and the circumstances in which governments should intervene.

The adoption of investment incentives would represent a significant shift towards a more interventionist industry policy. The practical difficulties of identifying and quantifying any external benefits from new investments supported by incentives raise considerable doubts about the merits of such an approach. Certainly experience at the State level with investment attraction is far from encouraging.

More generally, with any proposals for business programs, it is imperative to ensure that the extent of market failures, and the capacity of governments to address them effectively, are not overstated. But where programs are implemented, the importance of good program design, including periodic independent reviews triggered by legislated sunset provisions, cannot be overstated.

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