

## **Microeconomic reform in Australia – An introduction**

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**July, 2001**

\* I am grateful for very helpful comments from John Freebairn and Ian McDonald.

## 1. Introduction

A set of government policy changes implemented in the past 20 years – commonly referred to as ‘microeconomic reform’ – have dramatically altered the structure and operation of the Australian economy. The specific policies that have constituted microeconomic reform are diverse but share a common underpinning – an attempt to “...change incentives facing private and public sector producers with the aim of inducing higher levels of productivity to support higher living standards” (Freebairn, 1998, p.49). The origins of microeconomic reform in Australia are probably most reasonably dated to the commencement of deregulation of financial markets in 1983 since it is after that time that government policy has consistently been directed to achieving this type of reform, and that the scope of reform has affected a significant fraction of the economy (Quiggin, 1996, p.1).

This article provides a brief introduction to microeconomic reform in Australia. It has three main objectives:

- To describe the main types of policy changes implemented through the process of microeconomic reform;
- To describe the main rationale for undertaking microeconomic reform; and
- To discuss the main outcomes from microeconomic reform in Australia.

## 2. What is microeconomic reform?

The process of microeconomic reform in Australia has encompassed a wide variety of changes to government policy (see Productivity Commission, 1996, and Industry Commission, 1998):

- Changes to regulation of the government sector. (i) Many government business enterprises have been corporatised or partially/fully privatized. Corporatisation involves the introduction of market-type objectives for managers. Privatization is the sale of assets of the government business to private owners. Examples of businesses that have undergone corporatisation are Australia Post, and Melbourne Water Corporation (formerly MMBW). Examples of businesses that have been privatized are the Commonwealth Bank, Qantas, Commonwealth Serum Laboratory, and electricity generation facilities in Victoria. (ii) Entry to markets in which government businesses operate has been deregulated. For example, new entrants have been allowed to compete with Telstra in telecommunications markets such as the mobile phone market. (iii) The right to supply a variety of government services has been contracted out to private sector providers. Examples are the provision of prison services in Victoria, provision of legal services to Commonwealth and state government departments, and provision of labour market training for job seekers.
- Reform of protection against international trade. Trade related reforms have primarily involved reductions in tariffs imposed on manufactured and agricultural import goods. This process began with a 25% across-the-board tariff cut in 1973, and was followed by further reductions in January 1977 and November 1996, as well as phased reductions introduced in 1988 and 1991. Whereas the average effective rate of

protection in the manufacturing industry had been over 35 per cent in the late 1960s, by the mid 1990s this had fallen to about 5 per cent. (Sectors where tariff rates remained higher were the textile, clothing and footwear sector, and the passenger motor vehicle sector.)

- Reform of product markets. Entry barriers to a variety of product markets have been removed, and regulation of the operations of businesses in those markets has been reformed. For example, in the finance market in 1985 entry restrictions in foreign banks were partially lifted, and the interest rate ceiling for new home loans was removed. In the aviation industry in 1987 controls on airfares were removed, and in 1990 restrictions on entry to the domestic aviation market were lifted. Restrictions on competition from 'parallel imports' have been removed in the market for sound recordings, and partially in the market for books.

- Reform of agricultural markets. Agricultural markets have been affected by reductions in tariffs on imported goods, and by the reform of market structures. Tariffs on goods such as sugar, citrus products and dried vine fruits have been progressively reduced over the past 20 years. Examples of reforms of market structures have been the removal of controls on egg production and pricing, and abolition of the Minimum Reserve Price Scheme for the wool industry.

- Changes to regulation of labour markets. (i) Changes to the role of the third-party arbitration authority in wage-setting. The role of the Industrial Relations Commission in setting wages and conditions for workers has been reduced – most fundamentally after the passage of the Workplace Relations Act 1996 that has restricted its role to adjudicating on safety net wage adjustments. (ii) Changes to the 'locus' of wage bargaining. Between the early 1980s and late 1990s the locus of wage bargaining has shifted from being exclusively undertaken at the national level to being undertaken predominantly at the enterprise level between individual unions and employers. This change has been mainly due to reform of Commonwealth and State industrial relations legislation to require that agreements over wages and conditions between workers and employers must be at the enterprise level in order to receive legal protection. (iii) Changes to regulation of trade unions. Reform of State legislation from the late 1980s onwards, and the passage of the Commonwealth Workplace Relations Act 1996, have significantly reduced the extent of compulsory union membership (for example, abolition of closed shop arrangements), and have restricted the scope of allowable strike action that can be taken by trade unions. (iv) Changes to entry barriers to providing labour services. An example is the process of award restructuring in the late 1980s and early 1990s that removed demarcations that limited the range of tasks that could be undertaken by some groups of workers. (The labour market for professionals is however an area where there has been very little progress in removal of entry barriers.)

- Reform of the tax and welfare systems. Tax systems for business and individuals have undergone several types of reform. Probably the most notable change has been the introduction of a Goods and Services tax in July 2000. Other reforms have included significant reductions in the rate of company tax, and introduction of capital gains tax. Reform to the welfare system – that encompasses payments to unemployed persons, older aged Australians, and low-income families – has included changes to eligibility conditions for payments and requirements on payment recipients. For

example, in the second half of the 1990s the activity test for unemployed welfare payment recipients has been significantly changed with the introduction of the Jobseeker diary, and Mutual obligation.

### **3. Why undertake microeconomic reform?**

The objective of microeconomic reform is to improve the efficiency of operation of the economy. Efficiency is generally interpreted in terms of productivity – the value of output that is produced with a given quantity of inputs. Microeconomic reform will result in an increase in productivity where:

- It raises the quality of inputs being applied in production; or
- It improves the allocation of inputs between production activities.

Where either of these conditions holds there may be a one-off increase in the level of productivity, or an increase in the rate of growth of productivity in the economy.

#### How might microeconomic reform raise the quality of inputs used in production?

Increases in the quality of inputs may occur through a rise in the productive capacity of those inputs, or an increase in the intensity with which the inputs are applied. As an illustration consider the case of labour inputs supplied by workers. The value of output produced by an hour of labour from a worker will be increasing with the skill of that worker (productive capacity), and with the effort of the worker (intensity of application). Workers may have an incentive to undertake more training to increase their skills where, for example, microeconomic reform removes demarcation barriers and hence increases the range of tasks that workers are allowed to perform.

#### How might microeconomic reform improve allocation of inputs to production activities?

- By implementing policies to correct for ‘market failure’.

Market failure refers to situations where the operation of a competitive market without government intervention would lead to an inefficient allocation of resources. One example is where production activities by a firm cause pollution. That pollution will lower the welfare of other members of society, which can be thought of as a cost of the production activity, but it is not a cost that is borne by the firm emitting the pollution. Hence the amount of resources devoted to the production activity by the firm causing pollution will be more than the efficient level. Government regulation could improve efficiency by reducing the level of output of the firm emitting the pollution. This might be done by taxing the output of that firm, or directly regulating the total amount of output that the firm is allowed to produce.

- By removing policies that distort the operation of the economy.

Policies that distort the operation of the economy are forms of government intervention that affect the allocation of resources in the economy through price regulation or entry barriers, or government ownership and service provision, and where the policies are not intended to solve a market failure problem.

An example of distortionary price regulation would be the imposition of tariffs on imported goods. Tariffs on imports raise the maximum price that can be charged for

the same good by Australian producers. This increases the profitability of production of import-competing goods in Australia compared to production of other types of goods. Hence more resources are devoted to production of import-competing goods than would otherwise be the case. But the Australian firms that are only profitable because of the tariff are less efficient than international firms that produce the same good. Hence efficiency would be improved by the removal of the tariff. Resources used by the Australian firms that would become unprofitable after removal of the tariff can be diverted to producing other types of goods. There is an efficiency gain per unit of output equal to the difference between the cost of producing the import-competing good in Australia and buying it from international producers.

Entry barriers that restrict the number of competitors in a market can have two effects on resource allocation. First, firms in such a market will have some degree of price-setting power, and are likely to use that power to increase prices above what would prevail in a competitive market. The corollary of higher prices is that output in that market will be lower than in a competitive market. In other words, the amount of resources devoted to production of output in the market is less than the efficient level. Second, firms that do not face a high level of competition may not have incentives to minimize the cost of production. (This is sometimes referred to as X-inefficiency.) The removal of barriers to entry to a market are likely to improve resource allocation by reducing the scope for firms to raise prices above competitive levels, and by providing stronger incentives for cost minimization.

Reform of government activity by privatization or corporatisation of government enterprises, or by contracting-out of service provision, is likely to affect resource allocation through a change the objectives of decision-makers. For example, a privatized business will have the objective of profit maximization, whereas the same business under government ownership is likely instead to have an objective that is an amalgam of efficiency and political considerations. The effect of political considerations on the operation of a government enterprise may mean that allocation of resources in that business will not be efficient. Examples would be where, for political reasons, a government enterprise may hire more workers than is necessary, or where it maintains a service to a region that has a higher cost than its value to residents in the region. In such circumstances where a change in ownership of a business removes political considerations as an objective for decision-makers, it should cause an increase in efficiency.

- By reducing incentives for expenditure of resources of rent-seeking activities. Rent-seeking activities are expenditures by business or individuals who seek to influence government policy in a way that will improve their own welfare. Examples would be businesses lobbying for subsidies or tax reductions targeted at their industry, or for restrictions on entry to their industry. Resources allocated to rent-seeking do not produce output. Hence transferring those resources to other production activities would increase output. Where microeconomic reform creates an environment where businesses and individuals believe that governments will not implement policies that lower efficiency, it may discourage rent-seeking and thereby improve resource allocation.

Descriptions of the ways in which microeconomic reform can increase productivity constitute the 'case for reform'. It is also important to be aware that there is a 'case

against reform'. That case rests on arguments that microeconomic reform may not improve efficiency, and that it may have adverse effects on objectives other than efficiency.

One situation where microeconomic reform may not have an overall positive effect on productivity is where there are significant adjustment costs associated with reform. One way to think about the effects of microeconomic reform is to imagine two paths for productivity - a 'no reform' path; and a 'post reform' path that exists after the implementation of microeconomic reform assuming that no other changes occur to affect productivity. The net benefit of reform is measured by the difference in the value of output between the no reform and post reform paths.

Suppose the ultimate effect of reform is to permanently raise the level of productivity in the economy. Where that effect occurs immediately at the date of reform then there is an unambiguous net benefit for the economy. However, what is more likely is that there will be a delay after reform is implemented before the economy achieves the new higher level of productivity. This is because reform causes a process of adjustment that does not occur instantaneously. For example, following a decrease in tariffs there are likely to be some workers whose jobs are destroyed who do not immediately find re-employment, and it will take time for entrepreneurs to see that there are new opportunities for profitable production in other industries created by the tariff reduction. In calculating the overall efficiency effects of microeconomic reform it will now be necessary to take account of the transition period during which the economy is shifting towards (but has not reached) the post-reform path.

Figure 1 illustrates some alternative transition paths in productivity that might be possible following the implementation of microeconomic reform. The path 'Reform - Case A' shows how productivity would shift following the implementation of microeconomic reform where adjustment to reform is instantaneous. The other path 'Reform - Case B' shows a case where adjustment to the post-reform productivity level does not occur instantly. In fact, in this case it is assumed that productivity initially falls below the level that would exist in the absence of reform, before increasing to the post-reform productivity path. Depending on the size of the decrease in productivity, and the duration of the adjustment period, it is possible that in the 'Reform - Case B' it will not be optimal on efficiency grounds to implement the microeconomic reform.

In some circumstances microeconomic reform may require the introduction of a new regulatory regime. Whether reform improves productivity will then depend on the efficacy of that regulation. One example would be contracting out of provision of government services to private sector suppliers. The effect on welfare of taxpayers of those services is likely to depend on price and quality. Hence contracts between governments and private sector suppliers need to be able to specify price and quality standards. In some cases it seems that this can be done quite successfully - such as for provision of garbage collection services. But for other cases - such as supply of prison services - it seems that it has been very difficult to achieve desired quality standards. In this situation the loss in welfare from service quality reduction may outweigh any benefit from reductions in the cost of the service, and hence microeconomic reform may have a net negative effect on productivity. As King (1998, p.70) notes "Many microeconomic reforms are desirable in certain situations

but are undesirable in others. If policy makers treat microeconomic reform as a simple recipe for economic growth and social efficiency, then society as a whole is likely to suffer.”

All of the discussion of the rationale for microeconomic reform up until now has been about effects on efficiency. But generally economists think of there being two main objectives of economic policy – efficiency and equity. It is not necessarily the case that an improvement in efficiency will also improve equity. In fact, it may not even make all members of society better off. Bodies who support microeconomic reform – such as the Productivity Commission – argue that with appropriate use of the tax and welfare systems it is possible to redistribute efficiency gains from that reform in a way that equity objectives are achieved. Whether this happens in practice is an important issue in judging the overall effects of microeconomic reform on the welfare of Australian society.

#### **4. What have been the effects of microeconomic reform?**

A serious assessment of the effects of microeconomic reform would need to consider its effects on efficiency and equity. Thus far there has been some research on the effects on efficiency, but there has not been any research to address equity consequences.

One reason for the limited amount of empirical research on the effects of microeconomic reform is the difficulty of measuring those effects. First, many factors apart from microeconomic reform have affected productivity in the past 20 years, and it is difficult to separate between the effects of those factors. Second, microeconomic reform has been a continuing process over the past 20 years, and therefore, only the effects of increases or decreases in the rate of reform should be evident in data on productivity. Third, the coverage of microeconomic reform – although extensive – has not extended to all sectors of the economy, and hence it may be difficult to find effects of microeconomic reform in aggregate data on productivity.

Empirical analysis of the efficiency consequences of microeconomic reform has been of three main types: (i) Analysis of aggregate data on productivity; (ii) Analysis of industry-level data on productivity for sectors where microeconomic reform has been implemented; and (iii) Studies of adjustment costs.

##### *Aggregate evidence*

One generation of studies of the effects of microeconomic reform has applied ‘general equilibrium’ models of the Australian economy to simulate the effects of that reform. (General equilibrium models study the effect of a policy change through the whole economy. The alternative approach – known as partial equilibrium – only study changes in the market where the policy change has its direct effect.) These general equilibrium studies generally find quite large effects of microeconomic reform. For example, the Industry Commission (1995) estimated that implementation of the ‘Hilmer report reforms’ had improved productivity by about 5.5 per cent of GDP. Studies using the general equilibrium approach have however been criticized for the assumptions made about the size of productivity gains from microeconomic reform, and for failing to properly incorporate and value effects of reform on consumption

(Quiggin, 1996, pp.208-211, and 1997, and Gruen, 1997, pp.201-203). For example, Quiggin (1997) adjusts the Industry Commission estimates of the Hilmer report reform benefits by assuming smaller direct effects on productivity from reforms, and incorporating adjustment costs, and concludes that those reforms only raised productivity by about 0.7 per cent of GDP.

More recently, analysis of the effects of microeconomic reform has focused on data that show an upsurge in productivity growth in Australia from the mid 1990s onwards. Over the period from 1964-65 to 1993-94 multi-factor productivity growth was 1.2 per cent per annum, but from 1993-94 to 1997-98 the rate of growth was 2.4 per cent. (Multi-factor productivity growth can be thought of as a measure of growth in output that adjusts for increases in labour and capital used in production.) Figure 2 shows this data in more detail.

The Productivity Commission (1999a) has argued that the upsurge in productivity growth can be attributed to the effects of microeconomic reform. This is mainly an argument that is made by ruling out alternative possible explanations. (This approach recalls the statement by Raymond Chandler's detective Philip Marlowe in 'Playback': "There are things that are facts, in a statistical sense, on paper...And there are things that are facts because they have to be facts, because nothing makes any sense otherwise."- Chandler quote). Other explanations that are considered are the role of the business cycle, the introduction of new technology, and changes in the distribution of labour income between wages and employment. Each of these explanations is rejected. For example, it is argued that since the introduction of new technologies has been common to all industrialized economies, but the productivity surge has been (almost) unique to Australia, therefore this cannot be the whole explanation. Wooden (2001) goes further in analyzing the causes of the productivity surge, and argues that the timing of the improvement in productivity suggests that it is reform of labour market regulation that is almost exclusively responsible for that outcome. That is, the timing of the improvement, from the mid-1990s onwards, follows quite closely after the beginning of the shift to enterprise bargaining around 1993.

The main criticism of this empirical approach is that it does not provide direct evidence of a link between microeconomic reform and productivity growth. It seems to require some explanation why a series of policy reforms implemented throughout the 1980s and 1990s should suddenly begin to affect productivity from the mid-1990s onwards. A related point is that the aggregate data do not provide any insights into the precise ways in which microeconomic reform has affected productivity.

#### *Industry-level evidence*

The Productivity Commission (1999b) has undertaken a series of detailed industry-level case studies in order to attempt to find direct evidence of a link between microeconomic reform and improvements in productivity. One example is the study of the whitegoods industry. The removal of import quotas for whitegoods in 1978, and tariff cuts on whitegoods between 1978 and 1982, have been the main reforms in that industry. It is estimated that annual labour productivity growth in the industry increased from 5.3 per cent in the 1970s to 8.3 per cent in the 1980s. On the basis of the similarity in timing of the increase in productivity and microeconomic reform, that reform is argued to have been the significant causal factor for the improvement in

productivity. Although this type of industry-level evidence does potentially provide some more direct evidence on the effects of microeconomic reform, and overcomes difficulties in separating effects of reform from other policy changes in aggregate productivity data, it also has shortcomings. For example, in the absence of a comparison with a similar industry where microeconomic reform did not occur, it is difficult to argue that the only factor that could have caused an increase in productivity growth in the whitegoods industry between the 1970s and 1980s was that reform.

### *Adjustment costs*

There has been little direct analysis of the magnitude of adjustment costs from microeconomic reform. The main work - on modeling adjustment costs of tariff reform - has been undertaken by the Productivity Commission (2000). In that study a general equilibrium simulation analysis of the effects of removing all remaining tariffs on imports to Australia is undertaken. It is estimated that the long-run benefit of that cessation of tariffs would be \$480million (1999-2000 dollars) per annum. Labour market adjustment costs are treated as the costs of retraining workers who need to switch jobs, and costs of time spent out of employment for workers retrenched following the tariff cuts. These costs are estimated to be about \$70 to \$90million over the first 10 years after implementation of the tariff cuts. Hence, adjustment costs are substantial, but are outweighed by the gains in productivity and output.

Other more general evidence on adjustment costs does exist. A range of studies have examined the consequences of retrenchment from a job for employment and wages of those workers (see Borland, 1998). These studies generally find that retrenched workers have a difficult time in the labour market. For example, a study undertaken by the ABS in July 1997 of persons who had a job between 1 July 1994 and 30 June 1997, and who had been retrenched from that job, found that those workers had a much lower probability of being employed in July 1997 than for the general population. Hence, to the extent that microeconomic reform has increased the incidence of worker retrenchment, it is likely to have imposed significant adjustment costs. Of course, the question of whether microeconomic reform has affected the incidence of retrenchment is a separate issue. There is some evidence that the incidence of retrenchment was higher by a significant amount in the first half of the 1990s than in other comparable periods in the 1980s. One explanation would be the effects of microeconomic reform. However, there are alternative explanations (such as more rapid technological change), and the rise in retrenchment does not seem to have persisted beyond the mid-1990s.

### *Summary*

Several conclusions can be drawn from the available empirical evidence on effects of microeconomic reform:

1. Microeconomic reform does not seem to have had a negative effect on productivity in the economy. Even commentators who are skeptical about the need for reform accept that it has probably had a small positive effect on productivity. For example, Quiggin, 1996, p.222 argues that "...it is difficult to sustain the view...that microeconomic reform has caused large reductions in social welfare".

2. There remains great uncertainty about the size of any positive effect from microeconomic reform on productivity. The difficulty of obtaining direct estimates of the effect of reform on the economy means that this is likely to remain the case.
3. Substantial adjustment costs in the economy are likely to have resulted from microeconomic reform. The fact that adjustment costs are borne by a small proportion of workers suggests that reform is likely to have had some adverse effect on equity in Australia.

## **Readings**

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