



AgEcon SEARCH
RESEARCH IN AGRICULTURAL & APPLIED ECONOMICS

The World's Largest Open Access Agricultural & Applied Economics Digital Library

This document is discoverable and free to researchers across the globe due to the work of AgEcon Search.

Help ensure our sustainability.

Give to AgEcon Search

AgEcon Search

<http://ageconsearch.umn.edu>

aesearch@umn.edu

*Papers downloaded from **AgEcon Search** may be used for non-commercial purposes and personal study only. No other use, including posting to another Internet site, is permitted without permission from the copyright owner (not AgEcon Search), or as allowed under the provisions of Fair Use, U.S. Copyright Act, Title 17 U.S.C.*

1/19/97

Micro gains from micro reform

John Quiggin

Department of Economics

James Cook University

Communications to John Quiggin at

EMAIL John.Quiggin@jcu.edu.au

FAX + 61 77 814149

Phone + 61 77 81 4798

+ 61 77 251269

I would like to thank Nancy Wallace for helpful comments and criticism.

Abstract

Large estimates of the benefits of microeconomic reform have been put forward in official studies. By contrast, Quiggin (1996a) concludes that benefits of microeconomic reforms have been modest. A key area of disagreement relates to the claim that increased competition leads to increases in technical efficiency. In the present paper, this issue is addressed. Possible sources of efficiency gains including scale economies, technological innovations, X-efficiency gains and the removal of satisficing behavior are considered. It is concluded that although ideas such as X-efficiency and satisficing suggest that competition may in some cases improve efficiency they do not imply that free market policies will maximise welfare. Overstated claims about the benefits of microeconomic reform have distorted Australia's economic priorities and encouraged an uncritical acceptance of economically unsound policies proposed in the name of competition.

Micro gains from micro reform

Macroeconomic policy dominated the economic policy debate from World War II to the mid-1980s, but governments' capacity to control macroeconomic variables declined sharply from the early 1970s onwards. The term 'microeconomic reform' initially reflected a conscious rejection of the focus on macroeconomic variables such as aggregate demand and average real wages, and a belief that a return to the high rates of growth of the postwar period could be achieved through a comprehensive assault on the distortions and rigidities that had built up in the Australian economy since Federation.

The case for comprehensive microeconomic reform in Australia was first put forward in *Australia at the Crossroads* by Kasper et al. (1980). This book also began a tradition of making quantitative estimates of the benefits of microeconomic reform. Kasper et al. estimated that microeconomic reform would yield a cumulative gain of 77 per cent by the year 2000 relative to the base scenario of no reform. More modest, but still large, estimates of the benefits of microeconomic reform have been put forward by the Industry Commission (1990, 1995), the Bureau of Industry Economics (1990), the Business Council of Australia (1994), Dao and Jowett (1994) and Filmer and Dao (1994). By contrast, Quiggin (1996a) concludes that the benefits of past microeconomic reforms have been modest, and that the benefits of remaining reforms, such as further reductions in tariff rates, are likely to be very small.

□ A number of issues arise here. There is plenty of room for debate about the appropriateness of particular partial equilibrium estimates of the benefits and costs of individual policies of microeconomic reform. Also, there is the question of whether general equilibrium effects will systematically amplify the benefits of microeconomic reform. However, the critical issue in the debate over microeconomic reform is the belief, widely held but rarely clearly articulated, that increased competition will generate a long term increase in technical, as opposed to allocative, efficiency. This claim is frequently expressed in terms of putative 'dynamic gains' from microeconomic reform, and may therefore be referred to as the dynamic gains hypothesis. This main object of the present paper is to examine this hypothesis.

The paper is divided into three parts. In the first section, some background issues are discussed. Central results of neoclassical welfare analysis relevant to the assessment of microeconomic reform are presented. In addition, some issues arising from the ambiguity surrounding the terms 'efficiency' and 'competition' are discussed. The second section deals with the dynamic gains hypothesis. Issues discussed are the static trade-off between competition

and scale economies, the relationship between monopoly competition and innovation, X-efficiency and satisficing. The final section deals with the policy implications of the analysis. It is argued that overstatement of the potential benefits of reform has resulted in an inappropriate set of policy priorities and has encouraged the adoption of some welfare-reducing policies. Alternative policy directions are suggested.

Background

A neoclassical analysis of microeconomic reform in Australia

The most significant single example of microeconomic reform was the reduction in tariffs that commenced in 1973. A vital result derived from neoclassical welfare theory, largely ignored by both advocates and critics of tariff reform is that welfare losses from a distorting tax are approximately quadratic in the size of the distortion. This yields the following results:

- (i) In a process of reducing tariffs uniformly towards zero, most welfare gains will be achieved in the early part of the process; and
- (ii) the variance of tariff rates will typically be at least as important as the average level of tariffs in determining welfare losses.

It follows from a neoclassical analysis that about 50 per cent of the total welfare gain from tariff reform in Australia was generated by the 25 per cent across-the-board cut of 1973. In Quiggin (1996a) the total welfare cost of the tariff structure prevailing in 1971 is estimated at between 1 and 2.5 per cent of GDP. It also follows that, the benefits of reducing a 5 per cent tariff to zero are trivially small. For a 5 per cent tariff, the estimated welfare loss is equal to 0.025 per cent of GDP. If some import-competing industries, such as the motor vehicle industry, continue to enjoy higher rates of protection, eliminating tariffs for the rest of the import-competing sector will probably reduce welfare.

These estimates are consistent with the results commonly derived from general equilibrium models in Australia and overseas. The Industry Commission has reported higher estimates of the benefits of reform Derived from modelling exercises based on versions of the ORANI model. However, these estimates are not derived from welfare theory, but from estimated changes in GDP. Quiggin (1996b) argues that the choice of closure assumption for the ORANI model leads to an overestimate of the impact of parameter changes on the main economic variables of interest. Further, as observed by Forsyth (1992), when capital stocks are variable, estimated changes in the level of GDP do not provide an appropriate basis for considering the effects of microeconomic reform on social welfare.

Most Industry Commission analysis suggests that microeconomic reform will make the economy more capital intensive, so that depreciation and payments to foreign owners of capital will make up a greater share of GDP. Hence, economically relevant variables such as national income and consumption will grow more slowly than will GDP. In addition, to the extent that the new capital stock is domestically owned, consumption must be foregone to finance investment, and this cost is excluded from consideration by the Industry Commission.

Quiggin (1996a,b) also criticises the Industry Commission's estimates of the benefits to be obtained from the large class of initiatives referred to as 'Hilmer and related reforms'. In addition to the point about ORANI closure, it is argued that:

(i) the misuse of world best practice estimates, an inappropriate choice of counterfactuals, and the use of upper bounds as estimates have led to over-optimistic estimates of the productivity gains likely to result from microeconomic reform;

(ii) in a number of cases, the Commission has mistakenly treated income transfers between groups in society as net welfare benefits; and

(iii) the final benefits of reform are likely to be less than the direct benefits because many of the reforms under consideration involve reductions in employment which will lead some workers to withdraw from the labour force. Quiggin estimates the benefits from Hilmer and related reforms at around 0.5 per cent of GDP.

In a response to Quiggin (1996b), Dee (1996) takes issue with a number of points of detail which will not be addressed here. A key point in Dee's response is that microeconomic reform will push firms and workers to 'work smarter, rather than harder'. More generally both Dee (1996) and the Industry Commission (1995) assume that competitive pressure will generate improvements in technical efficiency.

Some terminological issues

At least in part, the belief that competition enhances technical efficiency reflects confusions arising from ambiguous use of the terms 'efficiency' and 'competitiveness'. In ordinary usage, the term 'efficiency' is used to correspond to what economists call 'technical efficiency'. The term 'efficiency' is used in economics in a way which is rarely precisely defined, but, broadly speaking, corresponds to the achievement of potential Pareto-improvements. Efficiency gains may arise either from improvements in technical efficiency or from improvements in allocative efficiency. A standard neoclassical economic analysis shows that a shift from monopoly to competition yields an improvement in allocative efficiency.

The term 'competitiveness' is not widely used in mainstream economics, but is very commonly used in business. In oligopolistic settings, a firm is 'competitive' if it can set a price which is both profitable and sustainable, in that no competing firm can profitably set a price sufficiently low to capture market share. A firm which is not competitive in this sense will ultimately go bankrupt. An increase in technical efficiency is equivalent to an increase in competitiveness in this sense

In discussions of international trade, it is frequently, but incorrectly assumed that this concept of competitiveness can be applied to countries supplying goods to world markets. In fact, the consequences of low productivity in traded goods industries are precisely the same as the consequences of low productivity in non-traded goods industry, namely a reduction in factor returns. The use of the term 'competitiveness' as a shorthand for the inverse of the real exchange rate is related to this invalid analysis. As Krugman (1994) observes, a good test of an economist with a sound training in trade theory is that they should wince whenever the term 'competitiveness' is used.

Thus the claim that 'greater competitiveness equals greater efficiency' derives support from the ambiguous interpretation of the terms 'competitiveness' and 'efficiency'. In what follows, I will be concerned with the question of whether policies aimed at promoting competitive markets (that is, markets characterised by freedom of entry, non-collusive pricing behaviour and the absence of price-distorting interventions) will generate improvements in technical efficiency.

Competition and technical efficiency

Neoclassical economics is normally based on the assumption that firms minimise costs. Hence, if all firms have access to the same technology, changes in cost can arise only from changes in the scale and scope of output. In a neoclassical analysis of microeconomic reform, attention is therefore focused on the comparative statics of equilibrium output choices, and on resulting changes in economic welfare.

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 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.

The dynamic gains hypothesis, in one form or another, has been incorporated by assumption in most recent estimates of the benefits of microeconomic reform, including those of the Bureau of Industry Economics (1990), the Business Council of Australia (1994), Dao and Jowett (1994) and Filmer and Dao (1994). The Industry Commission has not presented quantitative estimates of dynamic gains. However, much of its analysis of the productivity benefits of microeconomic reform relies on the implicit assumption of the dynamic gains hypothesis. Moreover, it has been argued that the Industry Commission's estimates of the benefits of microeconomic reform, based on neoclassical economic analysis, are lower bound estimates because dynamic gains are excluded from consideration.

The dynamic gains hypothesis does not have a well-developed theoretical basis. The main object of this section is to consider whether ideas such as X-efficiency and satisficing can be used to support the dynamic gains hypothesis. The section begins, however, with a review of the standard neoclassical analysis of the relationship between competition and technical efficiency.

Static issues and the trade-off between competition and scale economies

Until recently, most analysis of competition policies was based on the presumption that there existed a trade-off between technical efficiency and competitive markets, at least where these were the result of active pro-competition policies. This is because many industries are characterised by economies of scale. The trade-off arises because technical efficiency is enhanced when the number of firms is small, while competition is enhanced when the number of firms is large. In the extreme case, that of natural monopoly, technical efficiency is maximised when the market is served by a single firm.'

In recent Australian policy discussions, the tension between market competition and the achievement of scale economies has been played down or ignored. It is frequently asserted that technological changes have led to the breakdown of natural monopolies. At the same time, the concepts of contestable monopoly and potential competition have led to greater tolerance of private oligopolies and monopolies.

Much of the policy discussion appears to be based on wishful thinking rather than hard analysis. Technological change has broken down old distinctions between industries such as telecommunications, mass media and computing. In the process, old natural monopolies are being broken down, but new ones are being created, for example, in markets for the 'content' to

be provided for pay-TV services. There is no reason to suppose that the trade-off between competition and technical efficiency is going to disappear.

Telecommunications provides glaring examples of policy failure arising from wishful thinking about competition. The provision of cable and local telephone services to the residential 'local loop' is a natural monopoly. Indeed, once the service is provided by a single firm, there is zero benefit from the provision of the service by a second firm. Yet Australian telecommunications consumers are paying for the construction of duplicate cable networks.

Over-optimistic assumptions about the competitiveness of private oligopolies have been evident in policies towards the banking industry. Analysis of bank margins gives clear evidence of oligopolistic pricing policies (Milbourne and Cumberworth 1992), but the rapid decline in the number of firms in the industry is not regarded by advocates of microeconomic reform as a cause for concern.

Competition, monopoly and innovation

In neoclassical economic analysis, it is assumed that technology is exogenously given and that, in the absence of regulation requiring the use of inefficient techniques, competitive, monopolistic and regulated firms will all operate on the production possibility frontier.¹ The first important challenge to this view came from Schumpeter (1961), who argued that monopoly was more conducive to innovation than competition, since monopolists can capture the benefits of innovation. The alternative view, that competition encourages innovation, is widely held, but has rarely been argued at length.

It is possible to develop the argument further in the context of regulation of a perfectly contestable industry. Suppose that regulation consists of prohibiting entry to the industry and setting a price vector based, on rate of return regulation. Neoclassical analysis suggests that allocative inefficiency will be created to the extent that the regulated price vector differs from the optimal Ramsey price vector. Further, there may be a distortion in relative factor intensity arising from the incentive for excessive capital intensity noted by Averch and Johnson (1962). But there has been relatively little analysis of whether such regulation will promote or retard innovation. The answer appears to depend on the nature of the innovations.

Consider first the case of firm-specific innovations, such as new methods of internal organisation. By preventing entry to the industry, regulation means that the only firm-specific

¹ Regulation may distort factor input choices, as in the Averch-Johnson (1962) effect. This is a form of allocative rather than technical inefficiency.

innovations will be those available to incumbent firms. Potential entrants with access to firm-specific innovations that would make them more efficient than the incumbent firms cannot exploit those innovations. Thus, to the extent that firm-specific innovations are important, regulation may reduce the rate of innovation.

On the other hand, consider the case where innovations are costly but cannot be patented. In this case, classic Schumpeterian effects will dominate. An incumbent firm with regulatory protection from entry will capture the benefits of innovation. However, neither the incumbent firm in an unregulated and perfectly contestable monopoly, nor potential entrants to that industry, will gain any benefits from deregulation. Once the innovation was developed, it would be available to incumbent firms and entrants alike.

In summary, the textbook presumption that competitive and monopolistic firms are equally efficient may be inappropriate in particular cases, but there is no basis in economic theory for an assumption that competition promotes technical progress. Empirical evidence on this issue is limited.

It has been widely claimed, for example, that banking deregulation has promoted innovation (Australian Bankers Association 1990). However, this claim is based simply on the presentation of a list of innovations that took place during the 1980s. Some of these innovations, such as the introduction of automatic teller machines, would have happened whether or not deregulation took place. Furthermore, no attempt was made to compare the rate of innovation before and after deregulation. For example, the Australian Bankers Association's list of innovations includes a number of minor changes in credit card services, but credit cards themselves were introduced well before deregulation.

X-efficiency and labour intensity

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. Liebenstein refers to the productivity gains arising from this process as improvements in 'X-efficiency'.

X-efficiency is necessarily related to labour productivity. The prospect of scrappage cannot make an engine work more efficiently or a tonne of iron ore yield more steel, but the prospect of losing a job can force workers to change their ways of doing things. Hence, if the X-efficiency hypothesis is to be made explicit, it must represent a claim that labour will be more

productive when markets are competitive. Pressure for X-efficiency improvements may come either directly through labour markets or indirectly through product markets.

Workers face direct competitive pressure through labour markets when services previously supplied by employees of governments and large private firms are subjected to competitive tendering and contracting. A number of studies have shown that competitive tendering and contracting reduces in the cost of service provision. The 20 per cent average reduction in cost estimated by Domberger, Meadowcroft and Thompson (1986, 1987) has been widely cited. Cubbin, Domberger and Meadowcroft (1987) argue that much of this gain arises from an improvement in technical efficiency. Similarly, it is frequently claimed that reductions in tariff protection have forced firms and their employees to become more efficient, for example through technical innovations and the elimination of rigidities in firm organisation.

Despite the frequency with which such claims are made, mechanisms by which an X-efficiency gain might be achieved are rarely described. One possible explanation is that, if there are multiple equilibria, an external shock might lead to a jump from a Pareto inferior to a Pareto superior equilibrium, corresponding to a gain in X-efficiency.

To pursue this idea a little further, suppose that there are two possible contractual structures, one of which involves considerable dissipation of resources in the process of dividing the rent associated with the existence of a given firm, and one of which does not. In a situation of limited competition and high profits, both contracts are consistent with the continued existence of the firm. When competition becomes more stringent, the second contract is sustainable but the first is not. The X-efficiency argument might then be restated as an argument about the existence of multiple equilibria in the contracting problem.

A more fundamental difficulty with the X-efficiency argument is that there is no reason to preclude the possibility that an external shock might lead to a jump in the other direction, from a Pareto superior to a Pareto inferior equilibrium. The fact that most of the anecdotal evidence concerns favourable shifts tells us little — enterprises that experience both adverse external shocks and Pareto inferior internal changes are unlikely to survive, so there will be no one left to tell the tale. Against the success stories in the manufacturing sector we must set the many firms that have disappeared altogether. It may be that among these firms there are many that could have survived but for adverse internal responses to competitive stress.

Even if increasing competition tends on average to generate improvements in X-efficiency, analysis based on the idea of X-efficiency does not yield a case for the optimality of free market policies. Suppose, for example, we accept, for the sake of argument, the claims that protection made Australian firms inward looking and complacent; that competition from imports is making

firms 'lean, mean and efficient'; and that an outward-looking, export-oriented economy will yield dynamic benefits associated with the growth of the Asian region. The argument about the benefits of competition from imports appears to imply that even better results would be obtained if tariffs were replaced by import subsidies. Similarly, a belief in the virtues of an 'outward looking' orientation appears to suggest a strong case for subsidising exports. More generally, it seems likely that any explicit X-efficiency argument is likely to generate a case for optimal government intervention.

The idea of X-efficiency has been criticised by neoclassical 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 labour 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). More generally, over the period since 1986 there has been a significant increase in working hours for full-time employees, particularly in the form of unpaid overtime (Australian Bureau of Statistics 1996, Low 1996). These observations suggest a general increase in work intensity associated with microeconomic reform.

Increases in work intensity would be desirable if the institutions prevailing before reform led to excessive on-the-job leisure, in the sense that workers would be willing to work harder in return for wage increases less than or equal to the additional output resulting from greater effort. In the period before reform, it was widely believed that such conditions prevailed in much of the public sector and on the waterfront. Microeconomic reform has been highly effective in eliminating areas of inadequate work intensity. Employment in the railway and waterfront industries has been reduced by 50 per cent or more, and government business enterprises such as Telstra have greatly reduced staff numbers. In the public service, the steady application of staff ceilings and 'productivity dividends' has maintained continuous pressure to reduce staff numbers.

Despite general increases in work intensity, growth in output per capita during the period of microeconomic reform has been slower than in the 1950s and 1960s and no faster than in the turbulent decade from 1973 to 1983. In large measure, this may be explained by the observation that economic policy has been directed at solving the wrong problems. In a situation of chronically high unemployment, the net social payoff from identifying and eliminating areas of suboptimal work intensity will in general, be considerably less than the direct saving to the employer, particularly if the workers involved are unskilled or are old enough to make attractive

the option of permanent withdrawal from the labor force. In the case of government business enterprise reform, even the direct savings to employers have not been all that great. Most government business enterprises are fairly capital intensive, so that even large proportional reductions in labour inputs yield only small savings in total costs.

One of the most unfortunate effects of the X-efficiency debate has been to keep alive the fallacious idea that increases in working hours or work intensity represent a costless method of increasing output, an idea which has always had a strong appeal for employers, if not for employees. The popularity of the X-efficiency idea also induced a relatively uncritical reception for arguments suggesting that competition will yield benefits over and above those suggested by standard microeconomic theory, namely that prices will be forced down towards marginal costs.

Satisficing and 'working smarter'

The idea that competitive reform will push firms and workers to 'work smarter' is a key element in much advocacy of microeconomic reform (Dee 1996), but has rarely been the subject of close analysis. An assertion that people can be induced to 'work smarter' would appear to rely on an underlying assumption that individuals normally satisfice rather than optimise. That is, having reached a situation they regard as satisfactory, individuals do not devote effort to searching for improvements, even if such effort would yield benefits in excess of the costs. The idea of satisficing is intuitively appealing, and responds to one of the most widespread criticisms of neoclassical economics, namely the claim that *homo economicus* is simply too rational to be believable. It is somewhat ironic therefore, to find such an idea at the basis of arguments for policies based on the simplest version of neoclassical analysis. The frequency with which arguments about 'working smarter' are heard suggests that very few of those frequently referred to as 'economic rationalists' actually believe in rationality.

Even more than X-efficiency arguments, the claim that individuals are satisficers will in general imply support for intervention rather than for free markets. Two possibilities arise. First, if governments can discover productivity improvements that satisficing individuals fail to adopt, there is a case for 'command and control' measures directing individuals to move to 'best practice'. Although direct government imposition of such directives has not been common, the managerial style of the last ten years in institutions such as universities has clearly been influenced by this kind of thinking.

Satisficing also appears to provide a case for active government policy aimed at destabilising the economy as a whole or individual sectors of the economy. If the removal of

tariff protection will induce individuals to 'lift their game', so presumably will large fluctuations in interest rates or public sector demand.

Labour market reform

For advocates of microeconomic reform, labour market reform represents the last great hope for substantial and visible benefits from reform. It is frequently argued that the disappointing results of tariff reform and other microeconomic reforms reflect the fact that labour markets are too rigid to allow firms to take advantage of new opportunities.²

This claim would be more plausible if labour market institutions had remained more or less unchanged. In fact, nearly all the features of the Australian labour market that were considered major obstacles to economic progress in the 1970s have already disappeared. Strikes are uncommon and demarcation disputes almost unheard of. Narrow job classifications have been replaced by broadbanding. Restrictive work practices and union opposition to new technology have virtually disappeared. The level of real unit labour costs is below that prevailing in the 1960s. These outcomes represent a considerably more radical shift than was considered possible in the 1970s, even by Kasper et al. (1980).

The labour market reform policies of the Hawke-Keating government involved an attempt to maximise the flexibility of wage-setting institutions while preserving a substantial role for unions and a 'safety-net' role for the award system. The reforms introduced by the Howard government are designed to minimise the role of unions and awards, but have been constrained by the need to make compromises to ensure the passage of legislation through the Senate and by concerns about electoral support. A full scale program of labour market reform would involve the elimination of minimum conditions, and a system of individual contracts based on the general presumption of employment at will. Broadly speaking, the labour market institutions of New Zealand and the United States correspond to the outcomes that would be achieved by such a program.

The experience of New Zealand and the United States suggests that reductions in minimum wages, if accompanied by reductions in the level and availability of unemployment benefits, will lead to some net expansion of employment and reduction in unemployment. However, the increased probability of employment is unlikely to be sufficient to offset the loss of

² This is reminiscent of the 'sequencing' debate over the appropriate path of transition from Communism. There appears to be little agreement on whether labour market reforms should precede or follow capital market and product market reforms.

income from wages and benefits. Hence such a combination of measures is likely to result in unskilled workers receiving less income, even though they supply more labour.

The employment effects of radical labour market reform appear to be modest. One way of evaluating them is to consider estimates of the non-accelerating inflation rate of unemployment (NAIRU) also referred to as the natural rate. Recent Australian experience suggests a NAIRU of 8 per cent, compared to about 6 per cent in the United States and New Zealand. However, the unemployment rate for the United States is understated because many of the unemployed are engaged in criminal activity, which is the only source of income in the United States for unemployed males without dependants or access to the very limited system of unemployment insurance. At any time more than one million males (more than 1 per cent of the male labour force) are imprisoned. It is likely that those engaged in crime are either omitted from labour force surveys or misreport their status. In the case of New Zealand, it is necessary to take account of the large numbers of unemployed New Zealanders who have migrated to Australia.

In summary, the effects of labour market reform on aggregate labour market outcomes are likely to be modest. The central issue is the claim by advocates of reform that the working arrangements associated with labour market reform will permit the achievement of productivity gains that were previously precluded by restrictive conditions of employment.

Consideration of general labour market trends, the outcome of enterprise agreements to date and the analysis above suggests an alternative view. The process of labour market reform is likely to result in longer working hours and greater work intensity. Employer proposals in enterprise bargaining have frequently involved the elimination of overtime payments and shift restrictions, giving employers increased flexibility in the determination of working hours. This increase in flexibility is achieved at the expense of a reduction in the flexibility with which workers can manage their own time. In a sense, such changes represent a transfer of the 'just-in-time' concept from physical inventories to labour time. Increased work intensity will produce gains in measured productivity, but such gains will in reality be transfers from employees. Transfers of this kind do not constitute net increases in social welfare.

Policy implications

The debate over the magnitude and nature of benefits of microeconomic reform is significant only if it can provide a guide to policy. In this section, it is argued that misleading estimates of the benefits of microeconomic reform have led to inappropriate policy choices and

that alternative policy directions should be followed, with the central objective of reducing unemployment.

Does the overstatement of benefits matter?

In this paper, it has been argued that the benefits of microeconomic reform have been overstated in analyses such as those of the Industry Commission (1990, 1995). Does this kind of overstatement matter? It might be seen as harmless exaggeration in aid of a good cause. In this section, it is argued that overstated claims about the benefits of microeconomic reform have distorted Australia's economic priorities and encouraged an uncritical acceptance of economically unsound policies proposed in the name of competition.

Over-optimistic estimates of the benefits of the microeconomic reform program have encouraged an uncritical acceptance of any policy initiatives that can be represented as promoting competition. Telecommunications provides the clearest example. Overstated estimates of the benefits of competition in long distance telecommunications have encouraged the view that competition in the local loop would also be desirable. As a result, policy has encouraged the development of duplicate cable networks for pay-TV and advanced telephony, and of three separate digital mobile phone networks to replace the single analog network shared by Telstra and Optus. The result will be the waste of billions of dollars in the provision of an inferior level of service. Indeed it seems likely that the costs of inefficient provision of infrastructure are the main reason why ordinary consumers have seen very little benefit from the substantial restructuring of Telstra and the associated loss of thousands of jobs (Quiggin 1996a).

Attention to the costs of microeconomic distortions have also led governments to ignore the far higher costs associated with unemployment levels of over 8 per cent, which have now been sustained for most of the past fifteen years. The annual cost of high levels of unemployment is between \$40 billion and \$80 billion (Langmore and Quiggin 1994), far in excess of any realistic estimate of the benefits of microeconomic reform. But advocates of microeconomic reform, notably the Industry Commission, have resisted any serious attempt to do anything about unemployment for fear that it would put obstacles in the way of their reform agenda.

Finally, the era of microeconomic reform has been associated with an increasing focus on narrowly financial policy objectives¹, despite the fact that economic theory gives equal weight to

¹ As observed in Section 1, even in narrowly financial terms, GDP is not an appropriate measure of welfare.

non-monetary components of welfare. This has encouraged a 'mercantilist'⁴ viewpoint in which the production of goods particularly for export is seen as vitally important, while services such as health and education are seen as cost burdens on the economy.

The inflated expectations held for microeconomic reform in Australia have diverted attention from more significant issues. At the same time, the uncritical reverence for competition that pervades policy circles has helped to generate policy mistakes that have largely dissipated whatever benefits have been generated by economically sound reform policies. The fact that a decade of intensive microeconomic reform has produced no measurable improvement in economic performance is clear evidence that a new approach is needed.

Where to from here?

If further microeconomic reform will not yield substantial improvements in economic performance, where should economic policy be going? In developing alternative policies it is important to learn both positive and negative lessons from microeconomic reform. One positive lesson of microeconomic reform is that there are more ways of organising public enterprises and delivering public services than were considered in the past. In particular, the performance of firms like Telstra has shown the falsity of the assumption that government business enterprises are necessarily unprofitable or that public ownership necessarily entails particular employment conditions such as lifetime tenure.

The key negative lesson of microeconomic reform is that the gains from correcting distortions in price, are generally small in comparison to those generated by improvements in macroeconomic aggregates such as the level of employment and the effective stock of human and physical capital. Consideration of macroeconomic issues suggests that we face two main problems. The first is the high level of unemployment, and the associated waste of resources, inherent in current policy settings. The second is the need to expand human capital endowments through education and training. Current policy is not helpful in either respect. Unemployment is accorded a very low priority. Proposals for microeconomic reform in the education sector appear likely to increase efficiency as measured by such misleading indicators such as cost per student while reducing the effectiveness of the education system and hampering future economic growth.

Langmore and Quiggin (1994) proposed a program involving a substantial expansion of education and other community services, with the joint aims of achieving direct reductions in

⁴ Mercantilist ideas have also been evident in some of the opposition to microeconomic reform, most obviously in support of tariff protection.

employment, and growth in the stock of human capital. Such a program would require increases in income tax rates and thereby challenge one of the great shibboleths of Australian politics. It is often claimed that it is impossible to raise taxes. But the experience of microeconomic reform has shown that nothing is politically impossible if the case for it is argued strongly enough.

Concluding comments

A central, but rarely explicit, part of the case for microeconomic reform is the dynamic gains hypothesis, that is, the claim that free markets and competition will generate improvements in technical efficiency. In this paper, this claim has been assessed, and shown to be inconsistent with neoclassical economic theory, which suggests that all firms will minimise costs and that, in the presence of scale economies there is a trade-off between technical efficiency and competition. Although ideas such as X-efficiency and satisficing suggest that competition may in some cases improve efficiency they do not imply that free market policies will maximise welfare. In the absence of evidence to support the dynamic gains hypothesis, it must be concluded that the net benefits of microeconomic reform have been small, if indeed they have been positive.

In the history of economic policy in Australia, the era of microeconomic reform represents at best a detour and at worst a dead end. For more than a decade, attention has been focused on minor problems and the central issue of unemployment has received only peripheral attention. Over time, the policies advocated in the name of microeconomic reform have been driven more and more by ideological commitment, and have had less and less to do with rational analysis of economic problems.

References

- Australian Bureau of Statistics. (1996), *Labour Force, Australia*, AGPS, Canberra.
- Australian Bankers Association (1990), *Submission to the Parliamentary Inquiry into the Australian Banking Industry*, Melbourne.
- Averch, H. and Johnson, L. L. (1962), 'Behavior of the firm under regulatory constraint', *American Economic Review* 52, 1052-69.
- Bureau of Industry Economics (1990), *Microeconomic Reform*, BIE Discussion Paper 9, AGPS, Canberra.
- Business Council of Australia (1994), *Business Council Bulletin*, , Melbourne.

- Cubbin, J., Domberger, S. and Meadowcroft, S. (1987), 'Competitive tendering and refuse collection: Identifying the sources of efficiency gains', *Fiscal Studies* 8(3), 49-58.
- Dao, D., and Jowett, T. (1994), *Economic effects of microeconomic reform - supplementary paper*, , EPAC Working Paper.
- Dee, P. (1996). The implications of Hilmer and related reforms: A response to Quiggin, Industry Commission.
- Domberger, S., Meadowcroft, S. and Thompson, D. (1986), 'Competitive tendering and efficiency: The case of refuse collection', *Fiscal Studies* 7(4), 69-87.
- Domberger, S., Meadowcroft, S. and Thompson, D. (1987), 'The impact of competitive tendering on the costs of hospital domestic services', *Fiscal Studies* 8(4), 39-54.
- Filmer, R., and Dao, D. (1994), *Economic effects of microeconomic reform*, EPAC Background Paper no 38, AGPS.
- Forsyth, P. (1992). 'A perspective on microeconomic reform', in Forsyth, P. (ed.), *Microeconomic Reform in Australia*. Allen and Unwin, St. Leonards, NSW.
- Ganley, J. and Grahl, J. (1988), 'Competitive tendering and efficiency in refuse collection: A critical comment', *Fiscal Studies* 9(1), 86-9
- Industry Commission (1990), *Annual Report, 1989-90*, AGPS, Canberra.
- Industry Commission. (1995), *The growth and revenue implications of Hilmer and related reforms*, AGPS, Canberra.
- Kasper, W., Blandy, R., Freebairn, J., Hocking, D. and O'Neill, R. (1980), *Australia at the crossroads. Our choices to the year 2000*, Harcourt Brace Jovanovich, Sydney.
- Krugman, P. (1994), *Peddling prosperity: economic sense and nonsense in the age of diminished expectations*, W.W. Norton, New York.
- Langmore, J. and Quiggin, J. (1994). *Work for all: Full employment in the nineties*, Melbourne University Press, Carlton, Victoria.
- Leibenstein, H. (1966), 'Allocative efficiency vs X-efficiency', *American Economic Review* 56, 392-45.
- Low, J. (1996). The increase in working hours in Australia, Unpublished honours thesis, James Cook University.
- Milbourne, R., and Cumberworth, M. (1992), Australian banking performance in an era of deregulation, working paper University of New South Wales.
- Quiggin, J. (1992), 'Free lunches in the case for privatisation and deregulation', *Economic Analysis and Policy* 22(1), 67-84.
- Schumpeter, J. (1961), *The theory of economic development*, Oxford University Press, London.
- Simon, H. (1955), 'A behavioral model of rational choice', *Quarterly Journal of Economics* 69(1), 99-118.
- Simon, H. (1987), 'Satisficing', in Eatwell, J., Milgate, M. and Newman, P. (ed.), *The new Palgrave: A dictionary of economics*, MacMillan, London.
- Stigler, G. J. (1976), 'The Xistence of X-Efficiency', *American Economic Review* 66(1), 213-16.
- Winter, S. (1971), 'Satisficing, selection and the innovating remnant', *Quarterly Journal of Economics* 85(2), 237-61.