



**Shadow Treasurer
Bob McMullan**

**Productivity, Competition, Telstra
and the Budget**

**Speech to
Australian Business Economists**

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Too often discussion of both economic and political issues falls into the trap of focussing exclusively on short-term issues. The immediate tends to displace the important.

Of necessity, I will give some attention today to the short-term economic outlook. But I also want to talk today about Australia's longer-term prospects.

A new dialogue on the drivers of future economic growth is long overdue. Without further reform, there is the danger that the strong growth of recent years will peter out.

Sustainable growth agenda

One of my goals as Shadow Treasurer is to promote a sustainable growth agenda as a central aspect of our economic policy.

I want to kickstart the debate about Australia's economic future by spelling out Labor's vision of the essential building blocks for effective economic management:

Our *sustainable growth agenda* rests on four foundations: sound macroeconomic policy; improvements to productivity; a fair distribution of the benefits of growth; and making sure that growth is environmentally sustainable.

- The first foundation is **sound macroeconomic policy**. It underpins all of our other policies. Reinforcing Labor as a party of low, stable inflation and low interest rates is a critical goal. As part of this, we will maintain our commitment to the golden rule of balancing the Budget over the economic cycle.
- The second foundation is **improving productivity**. Labor must build on the productivity boost delivered by the Hawke-Keating reforms by taking advantage of the new productivity revolution, based on skills, innovation, and a new competition agenda. This is a field given far too little attention by the Howard-Costello government.
- The third foundation is ensuring **a fair distribution of the benefits of growth**. The Labor Party's goal is a strong economy for a just society. Economic growth needs to be inclusive, not just for its own sake, but also because a fairer distribution of the benefits of economic growth is important to maintain support for future economic reforms.
- The fourth foundation is ensuring that growth is **environmentally sustainable**, to ensure a healthy economy in the medium to long term, and by making sure that environmental impacts are factored into economic costs.

I want to say a little today about the first foundation – macroeconomic management – and then elaborate more on some of the key issues arising from the second foundation – improving productivity. In particular I want to discuss what should be one of the key issues in today's economic debate: the importance of a competitive telecommunications industry.

Economic outlook

I share the view of most commentators that the Australian economy will show healthy growth over the next 12 months. The long awaited recovery in business investment, and an expected strengthening of the international economy should ensure growth continues.

However it is important to note there are some risks to the economic outlook. I don't think I am the only one to harbour such views.

It is clear from recent Reserve Bank statements that it is concerned about inflationary pressures beyond the end of 2002. This pressure is being driven by rapid growth in demand and activity that will see the economy approach capacity constraints, putting upward pressure on wages and prices.

The Reserve Bank and the Treasury seem to disagree over the speed at which the economy is approaching such capacity constraints, but ultimately it is the Reserve Bank that controls the direction of interest rates.

Recent remarks by Governor Ian Macfarlane suggest that, barring unforeseen circumstances, we will be returning to what he considers to be a more neutral interest rate setting. Based on existing levels of inflation, this could see the official cash rate returning to a level of around 5.5 to 6.5 per cent over the next 12 to 18 months.

It is clear that one of the factors putting pressure on interest rates is the loosening of fiscal policy. The Government's deficit Budget this year, and wafer thin surpluses of the next two years, have come despite ten years of solid growth performance.

There has been some commentary recently that Labor's opposition to some Budget measures in the Senate will put further pressure on the Budget bottom line. In fact, as the table in today's Financial Review makes clear, the net impact of Labor's position is Budget neutral over the forward estimates.

Rising interest rates have important implications for the broader economy. In particular, the labour-intensive housing sector is highly sensitive to interest rate rises. Coupled with the cessation of the Additional First Home Owners Grant and an oversupply of units in some cities, higher interest rates are likely to lead to a marked downturn in dwelling investment.

The Budget papers predict a relatively moderate downturn in dwelling investment over 2002-03. The reasoning is that the decline in new dwelling investment will be partly offset by continued growth in alterations and additions. But this seems at odds with past experience that these two components of housing typically move together.

The expected increase in interest rates also raises risks for households, which, on average, have increased their level of indebtedness in recent years.

The Budget papers argue that household balance sheets remain sound. This is based on evidence that the ratio of assets to debt remains healthy and that households can comfortably service their debt.

However there are a number of factors that suggest we should not be so relaxed. The ratio of assets to debt can vary: assets can vary in value while debt remains fixed. A correction in the property market would undoubtedly have an impact on the debt to asset ratio. Furthermore, the debt to asset ratio is the average for the entire household sector. There is little information concerning the distribution of assets and debt.

The other indicator of household financial health is debt servicing as a percentage of income. Debt servicing remains low at the moment, but should interest rates return to what the Reserve Bank considers neutral levels then it is likely that households will face a greater financial burden than ever before.

Modelling by Deutsche Bank suggests that if official cash rate returns to around 6 per cent then interest payment obligations of Australian households will reach a higher proportion of household income than at any time in the past 15 years – and would almost certainly represent the highest proportion of income devoted to interest payments in Australia’s history.

Increasing interest rates would also be expected to slow the growth in consumer spending. A key ingredient in the Budget growth forecasts is that consumption growth remains strong and that the predicted rebound in business investment comes to pass. But consumption has outstripped growth in disposable income, showing the extent to which economic growth has been driven by borrowing.

The question should be asked whether this is sustainable, especially in the face of rising interest rates. Rising rates may also threaten the forecast rebound in investment.

Nevertheless, while there are significant risks which will require care and management, the overall outlook should remain positive for the Australian economy unless there are significant external shocks.

Productivity and competition

But it is important we don’t lose sight of the drivers of growth in the longer term.

A crucial ingredient in sustaining growth is that we continue to promote improvements in productivity. One way of doing this is to ensure markets are as competitive as possible.

The goal of promoting a strong and efficient economy is a key goal for Labor. I choose those words deliberately – promoting a healthy economy isn’t always the same thing as promoting health for every business. It is a distinction that my political opponents sometimes fail to make.

Sometimes they are too eager to help out particular businesses in ways that hinder, rather than help, the goal of promoting a healthy economy.

Competition

I am astonished at some of the recent comments by business leaders attacking Australian Competition and Consumer Commission chairman Allan Fels.

It is the job of the ACCC to rein in anti-competitive behaviour. Of course the businesses affected don't like it, but the ACCC has a vital role to play in ensuring markets remain as competitive as possible.

Even if this does not always benefit individual companies, it is in the interest of consumers and the economy as a whole, and in the long-run interest of every well-run company in Australia.

I have had my disagreements with Professor Fels in the past, but he and the ACCC play a crucial role in ensuring the economy operates in the interests of the whole community, not just the powerful.

Productivity

A country's ability to improve its standard of living over time depends primarily on its ability to raise its output per worker.

That is why improving Australia's productivity performance lies at the heart of Labor's economic agenda. Improved productivity is one of the keys to the modern social democratic economic approach: striving for sustainable economic growth to deliver lasting improvements in living standards.

Australia is still reaping the benefits of a productivity surge that began in the early 1990s, in response to the structural reform program of the Hawke and Keating governments.

I was interested to read the Business Council's commentary on the importance of improving productivity in its recent report *Aspire Australia*, particularly its comments on the reasons for the improvement in productivity growth over the 1990s.

The sources of the improved productivity growth over the past decade are generally accepted to have been associated with microeconomic reform which was undertaken from the mid-eighties.¹

The report stresses the importance of encouraging research and development as a key ingredient in boosting productivity, and notes Australia's expenditure on R& D has fallen 'a hefty 10 per cent in the last two years'.

This is the worst fall of 17 OECD countries, and an indictment of this government's performance.

As the report says:

A sound long-term solution needs to be found. Research and Development is a long term issue. R & D policy cannot be turned on and off by successive governments.²

¹ Peter Duncan and Rodney Maddock, eds., *Aspire Australia*, Business Council of Australia, p. 22.

² *Ibid.*, p. 122.

The Business Council report finds that even though Australia has been increasing its productivity faster than most leading countries, its productivity, measured by output per hour worked, is about 20 per cent below the level of best-practice countries. Perhaps most important of all, the report notes that the rate of productivity growth has slowed over the past 18 months.

Catching up with that leading group of countries and re-igniting productivity growth are among the most important economic challenges facing Australia.

The traditional foundations of strong productivity and rising living standards are as important as ever: stable interest rates; low inflation; disciplined budget policy; openness to international trade and investment; and competitive domestic markets.

But there are other ingredients in the mix of policies to boost productivity that are just as important, and these have also been badly neglected by Howard and Costello.

These are policies to boost the nation's stock of human and social capital – to ensure Australia has the best possible education and training, in order to promote research and innovation that are crucial ingredients in improving productivity.

A recent OECD report, *The New Economy: Beyond the Hype*, identifies the critical role of information technology in promoting economic growth. It argues governments should increase competition in telecommunications and technology, improve skills, and make electronic government a priority.

The report argues that other elements of a pro-productivity approach are to foster innovation, by giving greater priority to fundamental research, improving the effectiveness of public research and development funding, and promoting the flow of knowledge between science and industry. And governments should invest in human capital, by boosting education and training, and stimulate creation of new firms by improving access to high-risk finance.

Telstra

The twin debates about the importance of competition and of improving productivity come together over the issue of the future of Telstra.

The lesson from the economic debate about competition is that if a strong performance from an individual firm arises from the exercise of its dominance in the market, and in the extreme case by exercise of monopoly power, this strong performance comes at a cost to overall economic performance.

The central issue in the Telstra debate is whether, and if so to what extent, Telstra is able to exercise this kind of market power.

Peter Costello has been carping for years about the need to sell Telstra to eliminate the government's debt. This is a red herring in the debate about improving Australia's productivity and economic performance. Reducing debt doesn't help Australia's macroeconomic balance if it is achieved by selling assets.

And as evidence by Treasury officials to a Senate Estimates committee last week demonstrates, the government does not even intend to eliminate its stock of debt.

To the contrary, the officials said reducing debt to zero was not the government's policy. They revealed the government is considering setting up an investment fund worth \$50 billion in order to maintain enough debt to sustain a viable bond market. And the Budget papers project income of more than \$2 billion over the forward estimates period from a theoretical government assets portfolio.

This completely demolishes the argument that the goal of selling Telstra is to eliminate debt. The truth is the government simply wants to maximise revenue from the sale of Telstra to bolster the balance sheet of the Budget.

Because of the preoccupation with bolstering its Budget, the government has deliberately ignored a much more important issue: the economic consequences of the *structure* of Telstra. The key issue for Australia's telecommunications industry is not the ownership of Telstra but its structure.

The crucial insight offered by Lindsay Tanner's discussion paper, *Reforming Telstra*, is that there may be a substantial economic cost in retaining the present structure of Telstra.

One crucial point, which has been widely misunderstood, is that there may be a serious detriment to competition when a company such as Telstra dominates a crucial market such as telecommunications. The telecommunications market is especially critical because it may well be the single most important industry for generating improvements in productivity.

Hence the key issue in analysing Telstra is not whether to pursue its privatisation – an issue which will have negligible macroeconomic impact – but the impact of the structure of Telstra on competition in its markets, and through that on the prospects for the new productivity revolution Australia needs.

The 1993 Hilmer Report, *National Competition Policy*, without mentioning Telstra specifically, makes a general argument about the problems of vertically integrated industries.

Hilmer discusses industries in which some aspects of the industry have the characteristics of a natural monopoly. Examples include electricity transmission grids and rail tracks.

But he points out that in many cases these natural monopoly elements have been integrated with potentially competitive activities.³ Industry structures of this kind present opportunities for cross-subsidisation.

Monopoly returns made in the monopoly market may be used to finance otherwise unprofitable prices in the competitive market, potentially driving out

³ Frederick G. Hilmer, *National Competition Policy*, AGPS Canberra, 1993, p. 218.

*or disadvantaging competitors. Indeed, even the prospect of such conduct may deter competitive market entry unless appropriate safeguards are in place.*⁴

Hilmer says that there are two ways of addressing these concerns: structurally separating the monopoly element from the potentially competitive elements, or leaving the integrated structure intact, and relying instead on more intrusive regulatory controls to guard against cross-subsidisation and against the potential misuse of control over access to the natural monopoly element.

He concludes that ‘accounting’ separation, to make the financial relationships between the two parts of a business more transparent, may place some constraints on cross subsidisation. However:

*... it will not be sufficient to remove potential incentives to misuse control over access to a vertically integrated element. Full separation at the level of ownership or control is required.*⁵

Professor Fels took up some of these issues in a speech last December. He concluded:

The combination of vertical integration of carriage services with the ownership of strategic content provides Telstra with unparalleled market power in the domestic market. Clearly, this has significant implications for competition in both price and services... There is no doubt in my own mind that Telstra’s incumbency and strong degree of vertical integration gives it an unparalleled advantage in the Australian market.

An OECD report last November considered the merits of the two methods of dealing with this problem: through regulation and through separation of the monopoly and the competitive part of the enterprise. When the owner of what the OECD calls the ‘bottleneck facility’, or monopoly element, also competes in the competitive activity,

*... it often has a strong incentive to restrict competition in that activity ... and can do so by raising the price or restricting the quality or timeliness of the access that it grants to rivals to the bottleneck facility.*⁶

But in spite of the best efforts of regulators, controls aiming at preventing this ‘are seldom fully effective’. It concludes that separation of the two parts of the enterprise would remove the incentive on the owner of the monopoly element to discriminate against competitors, and allow competition to develop to a greater extent. The OECD argues that accounting separation has some merit, but ‘because they do not address the underlying incentive to deny access, are not likely to be as successful as true structural measures’.

These are powerful arguments, but of course, there are also difficulties posed by full structural separation, and as Lindsay Tanner argues, these may in the end be judged to outweigh the potential benefits.

⁴ *Ibid.*, p. 219.

⁵ *Ibid.*, p. 220.

⁶ OECD, *Structural separation in regulated industries*, Paris, 2001, p. 16.

Representatives of Telstra and others with interests in this issue have been discussing these issues with me, and others, in recent weeks. They have put their arguments, and they warrant serious consideration.

But the significance of this issue is that it should not be seen as a mere subset of a Budget balance sheet argument, nor as a mere argument about ownership structures.

It is an issue about efficiency and productivity in telecommunications, and therefore about input cost issues for all other downstream industries, and about prices and services for consumers.

Conclusion

Economic debate in Australia in recent years has been focused on the issues of the eighties and nineties.

We need to lift our eyes to the horizon and look at the issues which will make us successful in the next generation and beyond.

Some issues will always be central. We will always need to be rigorous in taking care of the taxpayers' money, and ensuring a low inflation and low interest rate environment will always be important.

But there are new issues for the 21st century. The Treasurer never discusses education or research and development. He doesn't stand up for Allan Fels and his drive to enforce competition rules. He doesn't discuss the new competition issues, e.g. in telecommunications.

It's time we moved on.