Microeconomic reform inquiry

Overview

11 April 2014

Economic Regulation Authority
WESTERN AUSTRALIA

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1 Introduction

The Western Australian economy has enjoyed high levels of growth in recent years recording an average annual growth rate of 4.6 per cent per annum between 1995/96 and 2012/13.[1]

Western Australia's growth in recent years has largely been driven by a massive increase in demand for Western Australia's resources driven by the urbanisation of China. This has also exposed Western Australia to a level of risk in the event of a downturn in the resources sector.

The outlook for the State's economy is still strong, despite a forecast decline in business investment, particularly in the resources sector.[2,3] However, slowing economic growth in the coming year is anticipated, both in Western Australia and across the country.[4,5]

As Western Australians and the Government confront some important structural adjustments to our economy, we will not necessarily be able to rely upon continuing strong economic growth from our natural wealth to raise our living standards. Instead, productivity growth will have to come from reforms that remove unnecessary burdens on businesses and consumers and address the hidden waste in our economy.

The overarching purpose of this Microeconomic Reform Inquiry is to identify a package of microeconomic reform measures[6] that the Western Australian Government could implement to improve the efficiency and performance and hence productivity of the Western Australian economy. The economic reforms recommended in the Draft Report are aimed at ensuring the Western Australian economy remains resilient in the face of national and global economic change.

Potential reform options have been a rich field of inquiry for the Authority: there are many reasons why the Western Australian economy is not performing as well as it could be. This perspective has been reinforced by the large number of public submissions to this Inquiry, which have indicated that:

- limited public funds for infrastructure have not been applied to the best uses;
- the cost of doing business in Western Australia needs to be reduced;
- there is a failure to price goods and services appropriately; and
- poorly designed regulations are disrupting competition in some markets.

1 Western Australian Treasury, 2013, *Mid-year Economic and Fiscal Outlook 2013-14*, p. 56.

2 Western Australian Treasury, 2013, *op. cit.* p. 3.

3 Growth in export volumes is expected to increase in coming years, with a move away from business investment towards exports due to the completion of a number of large resources projects. This will likely occur because of a general transition from the construction phases of major projects to the production and export phases.

4 Western Australian Treasury, 2013, *op. cit.* p. 3.

5 Reserve Bank of Australia, 2014, *Statement on Monetary Policy – February 2014*, p.60.

6 Microeconomic reform can be defined as government policies or initiatives aimed at improving the productivity of specific industries or sectors in the economy. Forsyth, P. (1992) 'A Perspective on Microeconomic Reform', in Forsyth, P. (ed) Microeconomic Reform in Australia, Allen and Unwin, Sydney.

The ERA has broadly grouped the issues that it has dealt with in this Inquiry as follows:

- **Infrastructure:** State funded infrastructure is a key driver of productivity and has the potential to have a significant impact on our future prosperity, but the State only has limited resources to fund infrastructure. The ERA examines how we can maximise the productivity of this important enabler of growth through better decision making; potentially divesting some public assets to the private sector; and providing incentives to use infrastructure efficiently through user charges.

- **Addressing disincentives:** Reducing unnecessary regulation will assist existing and new firms and industries to react to changes in demand and technology, allowing them to capitalise on these changes to become more productive. Ensuring taxes comply with the core principles of good tax design, which stipulate that taxes should be efficient, simple and equitable, will reduce behavioural distortions and lower the efficiency costs associated with State taxes.

- **Removing barriers to competition:** Such barriers to competition are now the exception rather than the norm. Many of the restrictions on competition were addressed through the National Competition Policy reforms of the 1990s. However, some of the issues considered in this chapter represent 'unfinished business' from the National Competition Policy reforms. In this section of the Draft Report the ERA examines: regulation of retail trading hours; regulation of the taxi industry; regulation of the market for potatoes; the domestic gas reservation policy; and Keystart home loans. Removal of barriers to competition in these areas will provide the incentives for new businesses to enter the market. An increase in suppliers is beneficial as it encourages innovation, efficiency and can drive growth in employment.

By necessity we have limited the scope of our Inquiry to areas that would have the largest potential benefits to society and could be examined in the timeframe available for this Inquiry. However, the Terms of Reference for the Inquiry requires the ERA to recommend a small number of specific key reforms or sectors that require further investigation by the ERA and/or policy development by the Government. Areas recommended for future inquiries are discussed in greater detail in section 5 and appendix 1 of this Overview.

2 Summary of recommendations

This report makes recommendations for reform across 19 different areas[7] of the Western Australian economy, each of which is expected to generate considerable benefits to Western Australians.

Quantifying the benefits of reform can be challenging: in many situations the ERA has not been able to source sufficient data or information to undertake a robust quantification. The ERA has quantified benefits for three of the areas of reform considered in this report: State taxes, the taxi industry; and the potato market. For these three areas alone, the benefits of

[7] The nineteen areas being: congestion charges; State taxes; the taxi industry; the potato market; Royalties for Regions; Government project evaluation; electricity time-of-use/cost-reflective charging; Government engagement in commercial activities; public/private partnerships; unsolicited proposals; divestment of Government assets; fit for purpose investment; non-asset solutions; innovative funding sources; State infrastructure strategy; reducing regulatory burden; retail trading hours; domestic gas policy; and Keystart.

reform could exceed $594 million per annum[8] or $234 per year for every Western Australian resident.[9]

The benefits from remaining reforms identified in the Draft Report have not been quantified. These benefits would be derived from better provisioning of infrastructure, more efficient use of existing infrastructure, reducing the cost of regulatory burden, deregulating retail trading hours, rescinding the domestic gas policy and abolishing Keystart Loans.

In addition, the recommended reforms will remove barriers to entry and growth in a number of areas. The ERA expects substantial benefits to be derived from growth in the retail trading sector, the taxi industry and the seed potato industry. The ERA also expects that the removal of regulatory burden on business will result in the entry of new businesses, greater competition, and growth in employment.

The full list of recommendation made in the Draft Report is provided in the box below.

Infrastructure

1. Apply project evaluation processes, including cost-benefit analysis, consistently and rigorously to all major infrastructure projects.

2. Subject all election commitments to rigorous project evaluation processes before being included in the State Budget.

3. Publish the outcomes of all major project evaluations.

4. Repeal the Royalties for Regions legislation, or restrict regional funding to an amount determined annually as part of the Budget process and guided by appropriate cost benefit analysis on a project-by-project basis.

5. Trial a congestion charge for entering the CBD during morning and afternoon peak periods. In order to implement this, further investigation will be required in order to determine the borders of the charging area, the fee structure, the charging and management system and the capacity of the public transport system to handle the likely increase in patronage.

6. Progress be made towards implementing fully cost-reflective electricity tariffs for households and small businesses.

7. Investigate the feasibility of introducing flexible electricity charging schemes such as time-of-use and critical peak pricing.

8. Expand the use and scope of PPP’s to procure public infrastructure, particularly in cases that will result in core services being delivered for better value for money.

9. Develop a process and guidelines for unsolicited infrastructure proposals from the private sector.

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[8] This is based on the estimated benefit of $580 million from reform of State taxes, $9 million from reform of the taxi industry and $5.5 million from the reform of the potato industry.

[9] The Australian Bureau of Statistics estimates the Western Australian residential population as being 2,535,701 as at September 2013 (ABS data set: 3101.0).

10. Conduct a full investigation into the divestment of assets that pass the threshold criteria for private ownership.

Reducing the cost of complying with regulation

11. Appoint a lead reform agency (either the Department of Premier and Cabinet, or alternatively the Department of Finance) to work closely with senior departmental staff across all areas of Government to develop regulatory reform targets and monitor, enforce and publish performance against the targets.

12. Set Key Performance Indicators for regulatory reform targets for senior departmental staff.

13. Establish an Information and Communications Technology (**ICT**) office within Government (the Department of Premier and Cabinet, or alternatively the Department of Finance) to:

    a. identify technology-based strategies to reduce regulatory burden in Western Australia;

    b. develop and implement a policy and implementation plan for ICT reform in the State; and

    c. provide ongoing support to the Western Australian public sector, in the areas of service delivery, strategic ICT policy and planning, public sector innovation, and information management, focusing on reducing the level of regulatory burden.

14. Update the Red Tape Reduction Group's 2009 assessment of regulatory burden in Western Australia, to measure current levels of regulatory burden in the State.

15. Require departments with a regulatory role to:

    a. establish a customer service charter with clear and measurable service standards;

    b. have this customer service charter reviewed by a lead reform agency responsible for the reform programme;

    c. publish this customer service charter online, and display it in areas where staff provide services to the public;

    d. include a report on actual performance against the service standards in the departmental Annual Report; and

    e. set Key Performance Indicators for service standards for senior departmental staff.

16. Where regulatory problems are particularly broad or complex, establish working groups that include public, private, and community-sector representatives to assist in developing solutions.

17. Replace the Regulatory Impact Assessment Guidelines for Western Australia with a statutory mandate establishing the Regulatory Impact Assessment process, and defining the roles and responsibilities of the Regulatory Gatekeeping Unit.

18. Establish a five-yearly recurring review of the implementation and effectiveness of the Regulatory Impact Assessment process, to be undertaken by the Office of the Auditor General.

19. Transfer responsibility for the central publication, but not preparation, of Regulatory Impact Assessment documentation to the Regulatory Gatekeeping Unit, including the timely publishing of:

    a. Preliminary Impact Assessments;
    b. Consultation and Decision Regulatory Impact Statements;
    c. Compliance Notices and advice of non-compliance;
    d. statements of the supporting rationale for any non-compliant proposals adopted by Government, to be provided to the Regulatory Gatekeeping Unit by the Government;
    e. notices of exemptions (including the supporting reasons for approval of the exemption);
    f. notices of any changes made between a Consultation Regulatory Impact Statement and the subsequent Decision Regulatory Impact Statement, to be included with the Decision Regulatory Impact Statement; and
    g. a current list of all proposals undergoing Regulatory Impact Assessment, including the status of each, with the exception of cases where Cabinet-in-Confidence restrictions apply.

20. Amend the Guidelines (or their legislated replacement) to:

    a. limit applications for exemptions, including Treasurer's exemptions, to the period immediately after the requirement for a Regulatory Impact Statement has been triggered;
    b. limit the granting of exemptions to exceptional circumstances (such as emergency situations) where a clear public interest can be demonstrated;
    c. remove the capacity for exemptions to be granted in the case of election commitments, except where exceptional circumstances apply; and
    d. require timely publication of the reasons for all exemptions granted.

21. Establish a training and resourcing initiative to ensure that all Government departments involved in the preparation of Regulatory Impact Statements and Preliminary Impact Assessments have the capacity to conduct key analytical work (such as cost benefit analysis) in-house.

22. Mandate a 30-day minimum consultation period for Regulatory Impact Assessments, where consultation is undertaken as a part of the Regulatory Impact Assessment process.

23. Empower the Regulatory Gatekeeping Unit to develop and conduct post-implementation reviews for all non-legislative proposals that have been subject to a Regulatory Impact Assessment.

24. Direct the Regulatory Gatekeeping Unit to perform an audit of legislation overdue for review, and set a schedule for the review of these Acts.

25. Establish a review policy to be applied to all new legislation, specifying:
    a. criteria triggering the mandatory inclusion of a Review of Act clause;
    b. criteria for identifying the most appropriate Government or external organisation to perform the review;
    c. criteria to guide legislators in identifying how frequently a review should be performed; and
    d. standard wording for the Review of Act clause.

State taxes

26. Consider options for reforming payroll tax, residential transfer duty and land tax:
    a. broadening the base and lowering the rate of all three taxes to increase their efficiency; or
    b. increasing reliance on efficient taxes (land tax and payroll tax) and reducing or abolishing the inefficient taxes (residential transfer duty).

Retail trading hours

27. Amend the *Retail Trading Hours Act 1987* such that retail trading hours in Western Australia are fully deregulated, with the exception of:
    a. Christmas Day (12:00am - 11:59pm);
    b. Good Friday (12:00am - 11:59pm); and
    c. the morning of ANZAC Day (12:00am – 12pm),

    during which time only retailers that employ ten (or fewer) staff may open.

Taxi industry

28. Consider options for reforming the taxi industry:
    a. full and immediate removal of quantity restrictions in the taxi industry; or
    b. staged removal of quantity restrictions in the taxi industry; or
    c. removal of the regulations that prevent small charter vehicles from competing with the taxi industry.

Potato marketing

29. Either:

    a. repeal the *Marketing of Potatoes Act 1946* and *Marketing of Potatoes Regulations 1989* immediately; or

    b. repeal the *Marketing of Potatoes Act 1946* and *Marketing of Potatoes Regulations 1989* with an adjustment period.

Domestic gas reservation policy

30. Rescind the domestic gas reservation policy as soon as possible.

Keystart

31. Abolish Keystart as soon as possible.

3 What we were asked to do

The Treasurer has requested that the ERA undertake an Inquiry into Microeconomic Reform in Western Australia.

As part of this Inquiry, the ERA is to develop a package of microeconomic reform measures to improve the efficiency and performance of the Western Australian economy. In particular, the Treasurer asked the ERA to focus on areas of reform that will:

- improve productivity and flexibility of the Western Australian economy;
- increase choice for consumers and business;
- increase opportunities for Western Australian businesses to compete nationally and internationally; and
- remove or reduce unnecessary regulation.

In developing its recommendations, the ERA is required to:

- assess the efficiency of the Western Australian economy compared to similar national and international economies;
- identify areas of the Western Australian economy whose contribution could be improved through reform;
- identify options for improving the economic efficiency of these key areas;
- prioritise reforms based upon their potential to improve economic efficiency and future growth; and

- recommend a small number of specific key reforms or sectors that require further investigation by the ERA and/or policy development by the Government.

4 The need for microeconomic reform

Productivity measures how effectively an economy uses resources (labour and capital) in order to deliver the goods and services demanded by consumers. An increase in productivity represents an increase in output created from a fixed set of inputs (that is, productivity is about working smarter rather than working harder).

Microeconomic reform directly impacts productivity by influencing the input/output relationships in the economy. For example, restricting production of a good by licensing producers can result in higher prices and fewer products available to consumers. A reform that removes licence restrictions, which do not have a public interest justification, can lead to lower prices and a greater supply of the product or service.

Microeconomic reform also results in indirect effects on productivity; these include an increase in competition and openness[10] of the economy. In order to compete, businesses will generally become more productive. The opening of the economy also allows greater access to technology, expertise, trade and investment, all of which result in higher standards of living for individuals.

Professor Fred Hilmer AO, the architect of the national competition policy reforms of the 1990s, has identified two broad categories of microeconomic reforms: enablers and incentives.[11]

Enablers increase the capabilities in the economy and are the foundations that support businesses and individuals in their work. Enablers include infrastructure, training and education and legal frameworks. For instance, the Government can encourage or facilitate the development of infrastructure at crucial times to enhance the productivity of labour and capital.

Incentives are mechanisms that encourage businesses and individuals to improve their performance. Incentives can improve the productivity of an economy by: reducing unnecessary regulation or regulatory barriers; ensuring taxes comply with the core principles of good tax design; and increasing competition as competitive markets will generally serve the interests of consumers and the wider community.

The ERA considers that both enablers and incentives are important to the productivity of the Western Australian economy and that the Government should not focus on one to the exclusion of the other. However, it is incentives that provide the impetus for economically efficient behaviour, productivity gains and innovation. In the absence of these incentives, the provision of additional enablers may not deliver productivity improvements.

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[10] Openness in economic terms refers to the ease with which goods, services, innovations, technologies and capital can flow between participants in an economy and the international community.

[11] Hilmer, F., 2014, Competition Policy from 1992 to 2014, Presentation to the Business Council of Australia on 13 February 2014, accessed from http://www.bca.com.au/docs/d9695dfb-9c05-49b5-b5a5-aeb96866c400/Fred_Hilmer_Competition_Policy_from_1992_to_2014_FINAL_21.3.2014.pdf on 25 March 2014.

Hilmer notes there has been a shift in focus since the reforms of the 1990s away from incentives and towards enablers.[12] One reason for this shift in focus is that changing incentives is often more politically difficult than changing enablers. Microeconomic reform often involves winners and losers and even though society overall might be better off as a result of a particular reform it is often the case that the losers are a very vocal minority – one person's barrier to entry can be another person's protection from competition. This makes reform politically challenging. Additionally, a focus on enablers (for example, more infrastructure, better education) is often a far easier political debate.

A final point from Hilmer is worth noting. If reducing unemployment is a key objective then the research suggests that the real driver of employment is the growth in new businesses. Hilmer considers that "what we should be doing is creating an environment where new businesses are encouraged to form".[13] This reinforces the need to focus on incentives as well as enablers, particularly by removing regulatory barriers to entry and letting the forces of competition drive innovation.

In this Inquiry, the ERA has given consideration to how the productivity of the Western Australia economy could be enhanced by addressing enablers, incentives and the interaction between enablers and incentives.

5 The process we went through

Because the terms of reference for the Inquiry are so broad, the Authority needed to be highly selective in determining the areas of reform that could be examined in this Inquiry.

The submissions that the Authority received in response to the Issues Paper and Discussion Paper were an invaluable source of information about the issues facing the Western Australian economy, as well as potential solutions. The Authority also held a number of valuable meetings with government departments and agencies.

A list of potential areas for consideration in this Inquiry was developed from these submissions, meetings and also from ideas generated within the ERA.

The ERA chose to prioritise reforms that it considered would have the largest potential benefits to society and that would be relatively easy to implement. Figure 1 provides an overview of the ERA's approach to prioritising possible reforms in terms of their potential benefit versus difficulties in implementation.

The ERA decided that it would only address reforms that the State Government could implement. As a result, reforms that may be extremely beneficial to the State, but that require Commonwealth Government approval or action, have not been considered.

The ERA has also identified a number of issues from which reforms could yield significant benefits that it decided not to address in this Inquiry. However, the Terms of Reference for the Inquiry requires the ERA to recommend a small number of specific key reforms or sectors that require further investigation by the ERA and/or policy development by the Government. The ERA has categorised these areas as follows.

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[12] Hilmer, F., 2014, Competition Policy from 1992 to 2014, Presentation to the Business Council of Australia on 13 February 2014, accessed from http://www.bca.com.au/docs/d9695dfb-9c05-49b5-b5a5-aeb96866c400/Fred_Hilmer_Competition_Policy_from_1992_to_2014_FINAL_21.3.2014.pdf on 25 March 2014.

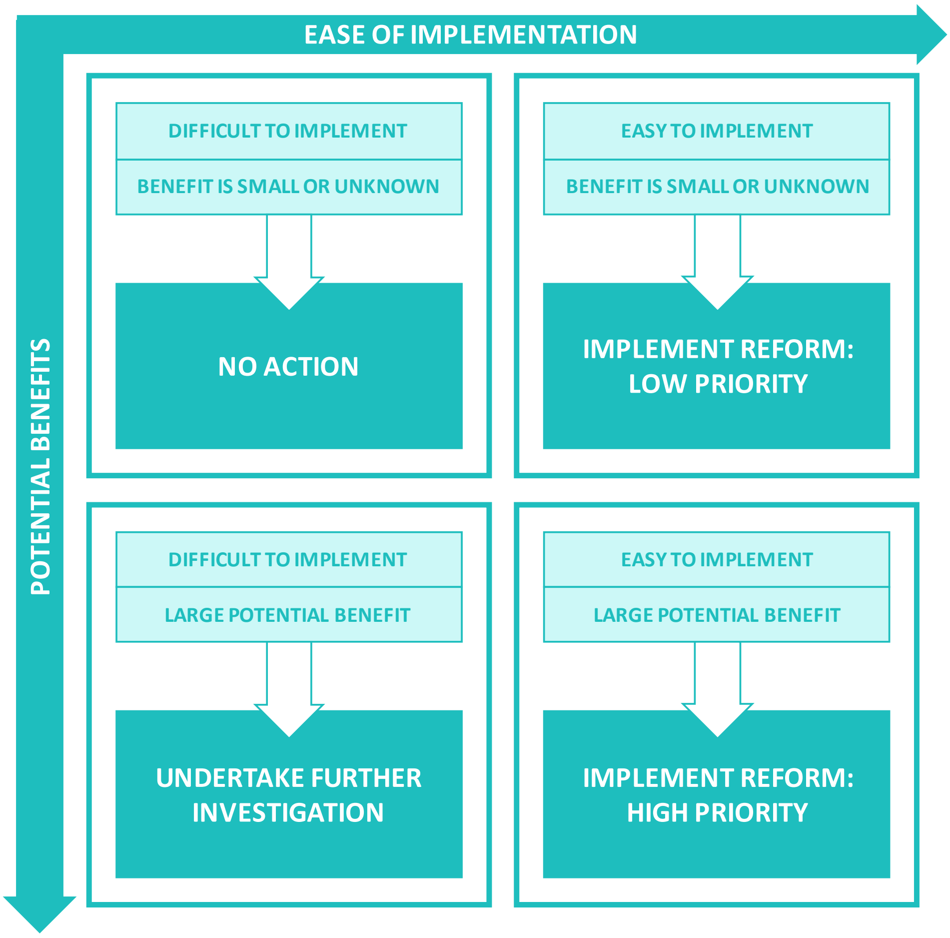
[13] Hilmer, F., 2014, Competition Policy from 1992 to 2014, Presentation to the Business Council of Australia on 13 February 2014, p. 8, accessed from http://www.bca.com.au/docs/d9695dfb-9c05-49b5-b5a5-aeb96866c400/Fred_Hilmer_Competition_Policy_from_1992_to_2014_FINAL_21.3.2014.pdf on 25 March 2014.

- Areas that were simply too large in scope to be considered as part of this Inquiry and would justify their own separate inquiry. These areas include: health; education; energy; procurement, IT and communications; occupational licensing; water and wastewater services; and public safety.

- Areas that were examined by the ERA as part of this Inquiry but which would warrant further examination in a separate inquiry. These areas include: reform of State taxes; restructuring electricity tariffs; road congestion charges; Government ownership of assets; and innovative sources of funding such as more extensive use of user charges and developer charges.

- Areas that were identified in the public submissions or during the course of the Inquiry that are worthwhile areas of examination, but were unable to be included in this Inquiry because of the need to prioritise areas with the greatest potential benefits, or because of time and resourcing constraints. These areas include: the forestry sector; bulk handling of grain; operations of Government; liquor licensing; waste management; government expenditures on safety; industrial relations; regional air routes.

Figure 1 ERA's Approach to Assessing Potential Reforms



6 Infrastructure

Strong relationships exist between infrastructure investment and productivity, which in turn is the major determinant of standards of living over the long term. This is because infrastructure is an enabler of productivity, it increases the capabilities of the economy and provides the support that businesses and individuals need in their work. Hence, a failure to deliver the right level and mix of infrastructure will lead to lower standards of living than would otherwise be the case.

Infrastructure expenditure in Western Australia is significantly higher on a per capita basis than other jurisdictions, reflecting not only higher economic activity, but also that the Government is more active in more sectors of the economy than is the case in other jurisdictions. This has been a contributing factor in the State's burgeoning net debt levels that led to a credit rating downgrade in September 2013.

The State's net debt levels and the Government's focus on the credit rating have forced the Government to place some form of constraint on infrastructure expenditure as it is simply unable to afford many of the projects that it would like to implement.

The ERA considers that a review of the way that the Government makes decisions on new infrastructure, the way it utilises existing infrastructure, and on the assets that Government owns, will deliver significant productivity benefits to Western Australia.

6.1 Improving decisions on infrastructure

The ERA has sought to identify ways to improve decision making around infrastructure to deliver greater benefits to the economy. Improved decision making and utilisation may in turn assist the Government to fund the infrastructure that consumers want, while placing less pressure on the State budget. The ERA has identified several areas in which infrastructure processes could be improved.

The Government already has good processes in place for infrastructure planning that are simply not applied. To facilitate effective decision making, the Government should provide stronger leadership in the consistent and rigorous application of proper process. The most effective way of ensuring that consistent quality information is supplied is to provide an appropriate incentive framework and structures for information sharing, to centralise some, but not all, expertise and to require that established processes are followed in all cases.

As part of effective project selection and evaluation, alternative projects may be identified that can provide some of the solution to the original problem for a fraction of the cost. Currently, due to budget pressures, infrastructure projects that cannot be afforded are delayed or cancelled entirely. A better way of approaching the situation may be to identify and implement alternative "fit-for-purpose" projects that could result in solutions being delivered earlier, more cost-effectively and in a way that better meets the needs of consumers.

Some areas of infrastructure expenditure are hypothecated and are not subject to the same scrutiny as that required of other projects. Royalties for Regions is one such program. The ERA considers that Royalties for Regions results in inefficient outcomes and should either be repealed or amended to restrict regional funding to an amount determined as part of the annual budget process. The Royalties for Regions scheme is setting aside excessively large amounts of funding for regional investment because of the interaction between increased royalty income and consequent reductions in GST revenue grants. This is placing the State budget under avoidable and unnecessary pressure and it is likely the funding could be better utilised elsewhere. If Royalties for Regions is to be retained, more stringent conditions should be developed for projects funded under the program.

The ERA considers that the development activities of the Department of Housing are largely commercial in nature and it is unclear whether or not they are addressing the policy objectives of Government. The ERA considers that these activities expose Government to unnecessary risk and should therefore be kept to a minimum. In the event that activities of this nature must be undertaken, the process should be transparent and priced appropriately given the risk.

There are a number of areas in which existing infrastructure could be better utilised. Before considering new infrastructure expenditure, the Government should investigate demand management tools that may obviate the need for such expenditure. For example, in many cases the more efficient use of existing infrastructure may delay or obviate the need for expensive capacity enhancement. In this review the ERA has considered time-of-use electricity charging and road congestion charging as measures that not only reduce the need for enhancement, but provide significant productivity gains as a result of changing the behaviour of consumers.

Currently, most Western Australians pay a flat rate tariff for electricity that is applicable at all times of the day. This pricing structure does not take into account the fact that the demand and the cost of supply for electricity can fluctuate significantly throughout the day, with clear peak periods in the afternoon when people return from work. Peaks are further exacerbated in extreme weather conditions (for example, during very high temperatures air conditioner use is dramatically higher) and, despite these peaks only occurring a few days each year, the generation and distribution network is built to accommodate it.

Accordingly, the ERA considers that a move to time of use charging (charging users more to use electricity in peak periods) could smooth demand for electricity by encouraging customers to consume less electricity during peak periods. This could reduce the peak capacity requirement of the network and therefore delay the need for expensive network enhancements.

Additionally, current electricity tariff structures do not fully recover the cost of providing electricity. The ERA considers that Western Australia should progress towards fully cost-reflective tariffs.

The inefficient use of infrastructure can impose considerable costs. The under-pricing of road use in Western Australia has resulted in rapidly increasing traffic congestion, with the cost of congestion in Perth expected to reach $1.6 billion by 2015.[14] This cost is composed of increased travel times, less reliable travel times, pollution costs and additional fuel costs.

Congestion in Perth is typically confined to morning and afternoon peak periods as people commute to and from work. In order to alleviate congestion, road users must be given incentive to either travel outside of peak periods or switch to public transport. Most urban economists agree that the best method for achieving this is some form of congestion charging scheme[15] that charges road users for using particular road facilities or for entering the confines of a restricted area. The ERA considers that a trial of a congestion charge

[14] Bureau of Infrastructure, Transport and Regional Economics, 2007, *Estimating urban traffic and congestion cost trends for Australian cities.*

[15] Small and Gomez-Ibanez, 1998, *Road pricing for congestion management: the transition from theory to policy.*

should be implemented for vehicles that enter the CBD during peak periods in the morning and afternoon.

Time of use pricing and congestion charges are designed to incentivise behaviour change in consumers, not raise funds for Government. However, there are situations where Government should implement charges to users purely as a means of funding infrastructure. Developing innovative sources of funding can ease budgetary pressures and allow the continued maintenance and provision of public infrastructure. The ERA has considered the potential for widening the use of developer charges and user charges.

The ERA supports the implementation of user charges to fund and maintain infrastructure in place of general Government funding as it enables a more equitable outcome by charging only the people who use that infrastructure. Additionally, the ERA considers that widening the base of developer charges could benefit Western Australia. It is reasonable that the developers who profit from infrastructure that support their developments should help to pay for the cost of providing that infrastructure

Finally, the ERA considered that the Government is not the only source of infrastructure investment proposals and in some cases not the best source. Developing a mechanism by which the private sector is encouraged to present unsolicited projects may result in a source of innovative solutions to infrastructure backlogs. Such a mechanism needs to balance the protection of private sector intellectual property with the over-riding requirement for value-for-money from government procurement.

6.2 Reviewing government ownership of assets and businesses

The Western Australian Government owns a large number of infrastructure assets and Government Trading Enterprises that are owned and operated by the private sector in other jurisdictions. Government ownership of assets and businesses has become a topical issue following the loss of the State’s AAA credit rating.

The State Government has announced that it is reforming its Business Model and Asset Investment Program with the aim of recovering the State’s AAA credit rating. The State Government will initially focus on a process to facilitate the sale of underutilised land holdings; discrete port assets; and certain electricity assets.

The ERA supports the Government’s review of its assets, but considers that the review should focus on sales that will improve the efficiency of the economy rather than focusing strictly on the budget bottom line.

Historically, to ensure that certain goods and services are delivered in a manner consistent with society’s interests, the Government has owned an asset or business to deliver those goods or services. These assets and businesses have been used as a way of achieving government policy objectives.

However, there are less invasive forms of intervention that the Government can undertake to ensure that goods and services are efficiently delivered to meet consumers’ needs and wants.

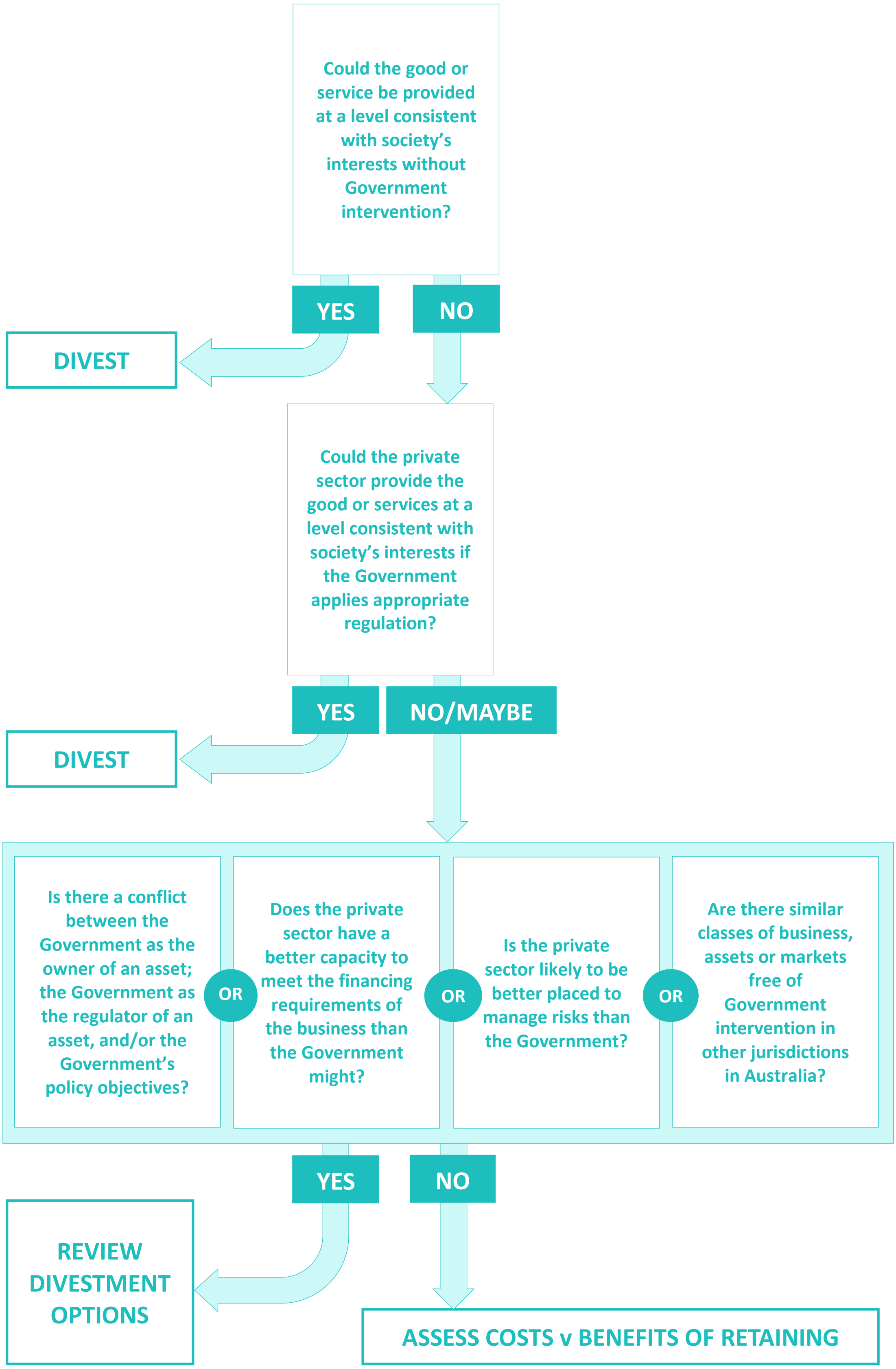
Divesting government assets, where appropriate, has the potential to increase the efficiency and productivity of the asset, which in turn may benefit consumers. It may also help to address conflicting objectives that arise from Government ownership (for example, trying to maximise profits from government business enterprises while also seeking to achieve social objectives). Greater private sector involvement in infrastructure also has the potential to reduce costs given that the private sector (with appropriate regulation) is able to operate more efficiently than government.

The ERA has developed a set of criteria for the Government to apply in reviewing the reasons for ownership of a business or asset. These criteria are summarised in Figure 2.

The ERA has applied the criteria to selected Government assets to assess their suitably for divestment (including Western Power, Synergy, the Water Corporation and the Port of Fremantle). This review is not considered to be comprehensive, but it does provide some preliminary guidance on how the criteria developed by the ERA could be applied.

A debate is needed about Government ownership of assets and businesses, informed by periodic reviews guided by a framework. Such debate should lead to decisions that resolve conflicting objectives, provide appropriate commercial incentives to maximise net benefits to the community, and, in the case of divestment, provide funds for retiring debt and/or investment in new infrastructure.

Figure 2 Criteria for Government ownership of a business



7 Addressing disincentives

7.1 Reducing regulatory burden

Well-designed regulation is one of the tools that allow governments to achieve policy objectives such as promoting efficient markets, encouraging public health and ensuring responsible development. Good regulation should have net benefits and the benefits should be greater than the benefits of other possible interventions.

However, regulation results in a burden on citizens and businesses when it is unnecessary, obsolete, or poorly designed. It imposes a net cost on society, can raise the price of goods and services, and discourages entrepreneurs from establishing new and innovative businesses and business practices.

The State Government has responded to public concerns about regulatory burden through a number of initiatives in recent years (including the Red Tape Reduction Group and Repeal Week). These initiatives have had a considerable impact, but there is still scope for reducing regulatory burden.

The ERA has made recommendations in the Draft Report that aim to further reduce existing regulatory burden and to prevent the introduction of poorly designed regulation in the future.

Addressing existing regulatory burden

To reduce the existing regulatory burden in Western Australia, the Government needs to improve co-operation between different Government agencies, make better use of technology to improve service delivery, and pinpoint the recurring problems faced by users of Government services.

The ERA considers that this can be done by establishing a State-wide regulatory reform programme to continue the good work that has already been done in this area. It also recommends that:

- the Government establish a division to assist departments in using technology to provide online services and information;
- Government departments be required to report publicly on how well they have met their customer service standards each year; and
- key performance indicators be applied to senior Government officials relating to their success in removing regulatory burden, and the degree to which their department has met its customer service standards.

The ERA also considers it essential that the Government frequently reports on the progress of the reform programme, and that it ensures that citizens and businesses are closely involved throughout the process.

Safeguards against future regulatory burden

The Government currently uses a process called Regulatory Impact Assessment to vet proposed new laws and policies and protect against the introduction of further regulatory burden. The process is a tool that helps Government make better decisions by considering the likely consequences of a proposal, and any practical alternatives.

Western Australia's Regulatory Impact Assessment guidelines are similar to those used internationally, and throughout Australia. Unfortunately, while the guidelines themselves are good, the State's process suffers from significant weaknesses in practice.

A major concern is that it is relatively easy for new regulations to escape scrutiny. Western Australia commonly grants exemptions for election commitments, and the Minister for Finance can also exempt any other regulation from scrutiny, at any point in the decision-making process. There is no requirement to advise the public of the reason for an exemption, or even that an exemption has been granted. The Government does not publish enough information to determine how often these options are used, but the fact that these exemptions are available reduces confidence in the ability of the process to provide genuine protection.

The role of public consultation in the process could also be significantly improved through better disclosure of information, and by ensuring stakeholders have sufficient time to comment. This would help ensure the Regulatory Impact Assessment process is used to genuinely improve policies rather than being used as a final 'ticking the boxes' exercise for decisions that have already been made.

The ERA considers that the best approach in preventing future regulatory burden is to retain the current process, but to take steps to strengthen it. This may include passing legislation to give legal force to the existing guidelines, significantly reducing the Government's ability to grant exemptions, substantially improving public disclosure of relevant documents and findings at all stages of the process, and directing the Office of the Auditor General to undertake a review of the implementation of the process.

It is also important to recognise that appropriate and effective regulation that has been scrutinised may still become inappropriate or obsolete over time. This can be done by establishing a set of guidelines to assist the Government in identifying new laws that require a periodic review.

7.2 Reform of State taxes

State taxes are an important source of revenue for the Western Australian Government, estimated to account for a third of the Government's revenue sources in 2013/14.[16]

However, State taxes impose significant efficiency costs on the Western Australian economy by distorting the decisions that taxpayers make because of those taxes. The efficiency costs arising from three of Western Australia's largest taxes (payroll tax, residential transfer duty and land tax) have been estimated to be in the order of $1 billion per annum.[17]

[16] Western Australian Treasury, 2013, 2013/14 Economic and Fiscal Outlook, p. 83, accessed from http://www.treasury.wa.gov.au/cms/uploadedFiles/State_Budget/Budget_2013_14/bp3.pdf

[17] Synergies Economic Consulting calculated this figure by applying KPMG's estimates of the pre-reform average efficiency costs to 2012/13 collections of payroll tax (22 cents), transfer duty (31 cents) and land tax (6 cents) as sourced from page 2 of Overview of State Taxes and Royalties to calculate the pre-reform efficiency cost. Source: KPMG Econtech, (2010), CGE Analysis of the Current Australian Tax System, p.2. Department of Treasury, 2014, *2013/14 Overview of State Taxes and Royalties*, p. 10 accessed from http://www.treasury.wa.gov.au/cms/uploadedFiles/_Treasury/Publications/2013-14_overview_of_state_taxes_and_royalties.pdf

In general, an efficient tax is one that minimises changes in behaviour (including to work, save, invest or consume).[18] The efficiency cost of taxes are reduced when the tax base is kept broad (that is, there are few concessions and exemptions), which in turn allows the tax rate to be kept low while still raising sufficient revenue. The combination of the broad base and the low rate reduces the incentives of taxpayers to change their behaviour in order to avoid taxes.

Businesses have the incentive and the opportunity to invest time and effort into activities to avoid or minimise the amount of tax they pay when a tax is applied at high rates with a large number of exempt activities. The following are examples of avenues that businesses have to reduce their payroll tax liabilities.

- Attempting to engage employees as independent contractors (because payments made to legitimate independent contractors are not subject to payroll tax) to reduce payroll tax and other payroll related liabilities (such as superannuation and workers' compensation).

- Sending parts of their operations off-shore, where wages and tax liabilities are lower. The CCI advise that some of its professional services members are hiring staff in South East Asian countries to complete work that could otherwise be done in Western Australia as a way of reducing staff numbers and not increasing their payroll tax obligations.

- Deciding not to employ additional staff to avoid exceeding the exemption threshold for payroll tax and finding alternative means to grow their businesses (such as greater use of capital) or simply not growing the business at all.

Such behaviour, as well as reducing State tax collections, impedes the growth of the State economy, by diverting activity to other jurisdictions, dampening overall activity and acting as a distraction to business owners (as the time and effort spent on minimising tax liabilities comes at a cost of other more productive activities, such as growing businesses).

Inefficient taxes also distort the behaviour of individuals. The most obvious implications for individuals arise from transfer duty on the sale of residences. Transfer duty is a significant impost with a maximum rate of 5.15 per cent[19] applied to the cost of buying a dwelling in Western Australia. Transfer duty may influence home-owners not to move house when it would be desirable for them to do so in the absence of transfer duty. This can have a number of negative effects on individuals, State tax collections and the economy more generally including:

- acting as an impediment to labour mobility – for example, an individual may choose not to relocate for work because of the cost of transfer duty associated with buying a new home; and

- inefficient use of housing stock – people may stay in particular dwellings when it no longer suits their needs and thereby prevent other people from accessing a dwelling of a suitable size. For example, empty-nesters may not downsize their homes and people with growing families may decide to extend their home rather than moving to an established dwelling of an appropriate size.

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[18] The main caveat to this being taxes that are deliberately designed to change behaviour (for example, when externalities are present).

[19] Department of Treasury, 2014, *2013/14 Overview of State Taxes and Royalties*, p. 10 accessed from http://www.treasury.wa.gov.au/cms/uploadedFiles/_Treasury/Publications/2013-14_overview_of_state_taxes_and_royalties.pdf

The ERA has examined two main options for reforming payroll tax, residential transfer duty and land tax in Western Australia in order to reduce the efficiency costs. Both reform options are revenue neutral for the State Government.

- **Broaden the base and lower the rate of all three taxes to increase their efficiency.** This option involves:
  - broadening the base of payroll tax, transfer duty and land tax by removing all concessions and exemptions identified by the Western Australian Treasury in its *Statement of Tax Expenditures*;[20] and
  - lowering the rate for payroll tax, transfer duty and land tax, such that the revenue raised by each tax stays the same.
- **Increase reliance on efficient taxes and reduce or abolish the inefficient taxes.** This option involves:
  - removing all concessions and exemptions on land tax and raising the rate (while retaining the progressive scale) and therefore significantly increasing the amount of revenue raised by land tax; and
  - removing all concessions and exemptions on payroll tax and lowering the rate such that the total net revenue raised by payroll tax remains the same; and
  - abolishing transfer duty on residential property.

A preliminary investigation indicates that the efficiency benefits of reforming state taxes are likely to be considerable. Broadening the bases and lowering rates will reduce the distortions to behaviour and have been estimated to have the potential to add $460 million to $580 million to the State economy. Reforming state taxes will also ensure that the State Government has access to a stable and growing source of revenue.

However, the ERA recognises that there are practical barriers to reforming State taxes, including the difficulties of convincing the business community and the general public of the need to forgo existing exemptions and concessions in State taxes for the broader public benefit of lower tax rates applied to broader bases.

Reforming State taxes will also do little to address the imbalance between the Western Australian and Federal Government in revenue raising capacities and expenditure obligations. Such reform can only be achieved through cooperation at a national level between the Federal Government and State and Territory Governments.

Nevertheless, the ERA considers that the two main tax reform options outlined in the Draft Report are worthy of more detailed consideration and seeks public comment on the merits of the two tax reform options.

8 Removing barriers to competition

Over the years, successive State Governments have put in place regulations that stop competition in various markets. These regulations result in situations whereby some groups are subsidising the incomes of other groups, and are ultimately costing society overall. Regulations also result in consumers having less choice (for example, choices about when

[20] Significantly reducing the payroll tax free threshold has similarities to the arrangements that applied when the States were granted the payroll tax base from the Commonwealth in 1971. The tax free threshold at that time was $20,800.

and where they can shop, choice about the variety of potatoes they can purchase) and higher prices (for example, higher taxi fares).

Such barriers to competition are now the exception rather than the norm, as many restrictions have been addressed. The Authority considers that there is a need to address the few remaining examples that have persisted.

8.1 Retail trading hours

Retail trading hours in Western Australia have been liberalised in recent years. However, Western Australia's retail trading hours are among the most restrictive in Australia.[21]

Governments have restricted retail trading hours in the past for various reasons. These have included the observance of the Sabbath, to protect different types of retail business (for example, large or small retail businesses) and for social purposes such as ensuring that employees in the retail sector can have family time on weekends.[22]

The ERA considers that these arguments in favour of restricting retail trading hours do not have the same weight as they did in the past, particularly given the considerable changes to society and technology since restrictions on trading hours were first introduced. Furthermore, there is no market failure that justifies the restriction on competition: a fact that has been consistently supported by independent reviews of retail trading hours.

Rather than being of benefit, regulation of trading hours creates considerable inconvenience by preventing people from shopping when and where they choose. Such constraints present considerable difficulties to time-poor individuals and households, particularly with the rise of dual-income and single parent households.

People, for various reasons, want to shop at times and places that are currently unavailable. In practice, there is no better demonstration of this than the number of people lined up outside their local supermarket just before 11:00 am on a Sunday morning, waiting to do their grocery shopping. Many people find it convenient to do their grocery shopping on a Sunday, but many would like to be able to shop earlier to free up the remainder of their Sunday for other activities.

The ERA considers that consumer choice, rather than Government regulation, should determine which shops open and when. Retailers will respond to consumer demand by opening when it is profitable for them to do so and remaining closed when it will not. Deregulation of retail trading hours will not result in shops being open 24 hours a day, seven days a week.

Regulation of retail trading hours disadvantages 'bricks and mortar' shops relative to on-line retailers, who are free to trade whenever they wish.

Deregulation of retail trading hours will disadvantage some retailers, particularly small retailers, who have enjoyed a degree of protection from competition. However, such retailers have already adapted to substantial liberalisation of trading hours in Western Australia, and the structural adjustments that would arise from full deregulation are not anticipated to be as significant.

[21] Productivity Commission (2011), *Economic Structure and Performance of the Australian Retail Industry*, Page 275.

[22] National Competition Council (2001), *Assessment of Governments' Progress in Implementing the National Competition Policy and Related* Reforms, page 21.1.

Reflecting these considerations, the ERA recommends that retail trading hours be deregulated in Western Australia with the exception of Christmas Day, ANZAC Day morning and Good Friday. This is similar to the models that have been implemented in Victoria and Tasmania.

8.2 The taxi industry

The taxi industry in Western Australia is highly regulated. Regulations administered by the Department of Transport determine: the number of taxis licensed to operate in Western Australia; the maximum price that may be charged for taxi services; and the quality and market conduct standards that must be met by taxi operators.

The ERA has concluded that quality and driver conduct regulations have a net benefit, while the quantity regulations have a clear net cost. Price regulation appears to be necessary to address the lack of competition in taxi markets with restricted entry. However, this lack of competition is largely caused by quantity regulation and if the quantity restriction was removed the reliance on price regulation would be expected to diminish.

The ERA could not identify a market failure in the market for taxi services that justifies the imposition of restrictions on the number of taxis that can operate. To the contrary, restrictions on the quantity of taxis have resulted in taxi services in Western Australia being expensive and under-supplied.

Taxi plates give the owner of the plate, or their agent, the right to operate a taxi.[23] The Department of Transport restricts the number of taxis permitted to operate in Western Australia by limiting the number of taxi license plates on issue. The practical outcome of this is that there are fewer taxis operating in Perth than there would be in the absence of this restriction.

The scarcity of taxi plates means that the value of taxi plates is maintained at an artificially high level. The value of taxi licence plates depends on the expected future stream of revenue that the owner of the plate will receive over the life of the plate. The current price for purchasing a taxi plate of around $300,000 signals that the current regulated lease rates provide significant profits to plate holders.

It is taxi passengers that ultimately pay for the higher than normal profits earned by owners of taxi license plates (who are not necessarily taxi drivers) through higher taxi fares. Deregulating the supply of taxis in Perth would reduce the prices paid for taxi services by customers and reduce or eliminate waiting times because taxis would have to compete with each other for customers, rather than the opposite which is regularly happening at present.

The ERA estimates that the benefit to taxi passengers of lower fares and reduced waiting time as a result of removing the restrictions on the quantity of taxis would be in the order of $39.2 million and $41.1 million per annum. Of this, $28 million would come at the expense of taxi plate owners in the form of income foregone.

Removal of the quantity restrictions would result in a small disadvantage for taxi drivers who lease their taxi plates directly from the Government. Taxi drivers who lease plates from the Government pay a lower price than those who lease their plates from private owners. Both groups of drivers receive the same regulated fare. Therefore, taxi drivers who lease their plates from the Government earn a slightly higher income after the value of the lease is

[23] It is not mandatory for owners of taxi plates to operate a taxi themselves. The legislation allows plate owners to lease their taxi plates to other parties, provided they meet the requirements to operate a taxi.

netted off. Removing quantity restrictions will eliminate this additional income assuming that the regulated fare is reduced by an amount that reflects the price of the private lease plate. This loss in additional income is estimated to be around $4.4 million per annum.

The ERA considers that there is a strong case for removing quantity restrictions in the taxi industry. The ERA presents three potential options for reforming the taxi industry in the Draft Report and seeks feedback on these. The options include:

- full and immediate removal of quantity restriction on the number of taxis that could operate in Western Australia; or
- staged removal of quantity restrictions, which could involve removing supply restrictions, but retain a material price for leasing taxi plates that will decrease over time; or
- removing restrictions on small charter vehicles to allow them to directly compete with taxis.

The removal of quantity restrictions in the taxi market is expected to cause a significant fall in taxi plate values and lease fees. For many taxi plate owners this could represent a significant loss in wealth and potentially income. The issue of whether taxi plate holders should be compensated for the loss of plate value is contentious, particularly as non-driving plate-holders have elected to invest in plates, rather than being required to invest in order to operate a taxi. The ERA welcomes submissions on the case for compensation.

8.3 The potato marketing industry

In Western Australia it is illegal to sell fresh potatoes grown in Western Australia for human consumption (ware potatoes) without a licence from the Potato Marketing Corporation, which is a statutory marketing organisation of the Western Australian Government.

The Western Australian ware potato industry was regulated after the Second World War in order to ensure supply and control price levels. Most other agricultural industries have since been deregulated, with the Western Australian ware potato market being one of only two regulated agricultural industries remaining in Australia.[24]

The Potato Marketing Corporation undertakes a number of functions under the Act that restrict competition in the market for ware potatoes. These functions (among others) include determining the quantity and the colour[25] of potatoes produced, issuing licences (Domestic Market Entitlements) to grow potatoes, setting the price that growers will receive, licencing wash packers and acting as the monopoly seller of potatoes to the wholesale market.

The Potato Marketing Corporation has some onerous regulatory powers under the Act, including powers to search premises where potatoes are grown, stop and search vehicles suspected of carrying more than 50 kilograms of potatoes, impound crops for evidence, and prosecute farmers.[26] The Potato Marketing Corporation can and has taken legal action against potato growers that have failed to comply with legislation.[27] The ERA considers it

[24] The New South Wales Rice Board being the other (Australian Bureau of Agricultural and Resource Sciences, 2014, Australian Agricultural Productivity Growth: Past Reforms and Future Opportunities, p30)

[25] Potato varieties are grouped into colours such as whites, blues, reds and yellows.

[26] Marketing of Potatoes Act 1946, http://www.austlii.edu.au/au/legis/wa/consol_act/mopa1946232/

[27] Countryman, 2013, http://au.news.yahoo.com/thewest/a/18042008/tony-galati-potato-charges-dropped/

to be unnecessary for a regulator to have such powers in relation to a crop that is not an illegal substance.

The ERA considers that there is no market failure in the potato industry that justifies such restrictions on competition. The Potato Marketing Corporation is not needed to predict and interpret trends in potato consumption: a free market is better able to respond to the changing needs of consumers.

The ERA also considers that a regulated system will always respond more slowly to consumer demand than will a deregulated market. For example, the Potato Marketing Corporation is planning to shift a large proportion of the State's production from white to yellow varieties over the next five years.[28] However, in eastern Australia yellow varieties have been a large share of production for some time.

The restrictions on potato marketing have raised the incomes of potato growers in Western Australia. However, this has been at the cost of Western Australian consumers, who pay higher prices than otherwise, have limited choices of potato varieties and endure poor product quality.[29] The restrictions have also limited productivity growth in the industry.

The ERA has found that the regulation of the ware potato market is hampering the development of a seed potato export industry in Western Australia. Western Australia has ideal conditions for growing seed potatoes; it has the right climate and is free from many of the diseases that are present in other potato growing areas. There is a significant opportunity for Western Australian growers to export seed potatoes to Asia, the Middle East and the Eastern States. Despite this, there has been a reluctance to invest because international exporters are prevented from selling seed tubers[30] that cannot be exported on the domestic ware potato market unless they have a Domestic Market Entitlement. This constraint reduces profitability and investment in the industry.

The ERA estimates that the restrictions on the Western Australian ware potato market have a net cost of $5.5 million per annum, or $101 per tonne of current production. This equates to a present value of $47.7 million over a 15-year period.

The ERA notes that a consultant engaged by the Potato Marketing Corporation (ACIL Allen) also found that the regulation of the potato industry imposes a net economic cost to Western Australia. ACIL Allen calculated a net cost of $66/tonne[31], or $3.6 million per annum based on production of 55,000 tonnes per annum.

The Authority believes that the existing regulations on the potato market have outlived their usefulness and are holding back the industry, as well as not serving the Western Australian public well. The ERA considers that the *Marketing of Potatoes Act 1946* and *Marketing of Potatoes Regulations 1989* should be repealed.

8.4 Keystart

Keystart provides home loans to Western Australians who are unable to obtain financing from the private sector. Keystart offers loans with deposit requirements that are significantly

[28] ACIL Allen Consulting (March 2014) Regulation and the potato industry in WA, p22.

[29] McKinna et al (2011), Strategic Analysis of the WA Ware Potato Supply Chain: Final Report. Batt, Peter, Western Potato Presentation, Claremont Showground 26th June 2007.

[30] The tuber is the part of the potato plant that is eaten.

[31] ACIL Allen Consulting (March 2014) Regulation and the potato industry in WA, p30.

lower than that of other lenders, allowing clients to purchase homes that they would not ordinarily be able to.

Keystart appears to be attempting to address a problem that is not a true market failure (that is, the inability of some potential homebuyers to access private finance because they do not have a sufficient deposit). There are alternative ways for ensuring that people have access to affordable housing that do not involve the Government providing loans, including public housing and rental subsidies.

Since its inception in 1989, Keystart has provided financing to more than 80,000 households and currently has a loan book consisting of over 16,000 loans with a value of almost $3.5 billion. It is unsurprising that Keystart has accumulated a large volume of loans considering the fact that the income cut-off is considerably higher than median income. Based solely on income criteria, 69 per cent of the Greater Perth region would be eligible for Keystart financing.[32] The ERA considers that if the program is designed to assist households on low incomes to access housing finance it should not be available to such a broad section of the public.

The lending activities of Keystart pose an unreasonable level of risk to Government finances, reflecting the size of the Keystart loan book and the fact that Keystart clients are at a higher risk of default because of their low deposit to loan ratios. Private lenders insure against default risk by requiring that clients with low deposit loans obtain Lenders Mortgage Insurance (LMI). However, one of the main attractions of Keystart financing to borrowers is that they are not required to purchase LMI, which would otherwise add thousands of dollars to the cost of purchasing a home.

The ERA is concerned that private borrowers are placed at a disadvantage relative to Keystart borrowers. Private borrowers have to have larger deposits than Keystart clients in order to obtain private finance. However, because LMI is so expensive, their deposit has to be even greater to pay for LMI or they will need to borrow more (with consequent higher repayments) to purchase the same home as a Keystart client.

In addition, the extra demand created by Keystart clients (who would not otherwise be able to purchase a home) may lead to private borrowers facing higher prices for housing, further reducing housing affordability.

The Department of Housing justifies Keystart's operation on the basis that it assists households into home ownership. However, it effectively increases demand for low-end housing, placing pressure on prices. It is likely that Keystart is offsetting the effects of the Department of Housing's other policy initiatives to some extent, reflecting that the majority of the activities of the Department of Housing focus on expanding the supply of affordable housing to ease pressure on the low-end section of the market.

The ERA recommends that Keystart be abolished due to the considerable financial risk that it imposes on Government and the negative impacts that it has on other buyers in the low-end housing market.

[32] Australian Bureau of Statistics, 2013, *2011 Census Community Profiles: Greater Perth Basic Community Profile.* Accessed from http://www.censusdata.abs.gov.au/census_services/getproduct/census/2011/communityprofile/5GPER?opendocument&navpos=220.

8.5 Domestic gas reservation policy

In October 2006, the Government of Western Australia adopted the WA Government Policy on Securing Gas Supplies. This policy requires a commitment from liquefied natural gas (**LNG**) proponents to reserve the equivalent of 15 per cent of the LNG production from each export project for the domestic (Western Australian) market.[33] This is known as the domestic gas reservation policy (**DGR policy**).

The rationale for the DGR policy is to "ensure secure, affordable domestic gas supply to meet Western Australia's long term energy needs and to sustain economic growth, development and value adding investment".[34]

The implementation of the DGR policy appears to have been the Western Australian Government's response to an adjustment by the market that involved a sharp spike in gas prices and tight supply of domestic gas. The ERA considers that there is no evidence of a market failure to justify the application of a DGR policy in Western Australia.

Historically low domestic gas prices were driven by legacy contracts (such as the *North West Gas Development (Woodside) Agreement Act 1979*). These long term contracts did not reflect the contemporary market conditions and prices, which have moved significantly from when the legacy contracts were signed. It was therefore inevitable that domestic customers would have to face a sharp increase in prices on the termination of the legacy contracts.

In turn, the low contract prices for domestic gas restrained investors from investment in new projects for the supply of domestic gas. This led to the balance between supply and demand for gas in the domestic market tightening.

It is economically efficient for the domestic prices of an internationally traded commodity, such as natural gas, to reflect international prices. The appropriate price attributed to the commodity is the price that it can attract internationally, adjusted for transportation and internal distribution costs (this adjustment is referred to as the net back price). Higher prices resulting from this principle are not indicative of market failure; indeed they demonstrate an effective functioning of an international market.

The ERA does not find any evidence of an on-going shortage of supply in the domestic gas market. A future gas supply shortfall is far from certain and is not an argument for government intervention in the domestic gas market.

The ERA believes that the DGR policy should be rescinded as soon as practicable. The costs that this policy imposes on the Western Australian economy far outweigh any benefits that it is believed to have. At the very least, it has the following negative consequences:

- It increases reliance on subsidised gas prices, leading to over consumption of the resource.
- It inhibits dynamic efficiency and technological innovation. For example, allowing domestic gas prices to reach higher net-back prices may encourage gas suppliers to find more cost-effective ways to explore for gas and encourage domestic gas users to invest in technologies to lower their gas consumption.

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33 The 15 per cent commitment can be met from offsets from sources other than the fields producing exports, although this has not occurred to date.

34 Department of Premier and Cabinet, *WA Government Policy on Securing Domestic Gas Supplies*, 2006

- It perpetuates the existence of industries that may not have a comparative advantage in WA at the expense of investment in other industries.
- It reduces the incentive for investors to invest in the gas industry in the longer term, reducing future levels of gas available for domestic or international use.

The ERA acknowledges that choosing to end the reservation policy may involve some structural adjustments in the domestic market. Gas will go to its highest-value use and, in the short-term, prices may have to rise beyond the 'export parity' levels, to correct for past market anomalies. Gas intensive industries will need to adjust, by being more efficient, switching fuels or passing on some costs. However, in the longer-term this will result in sustainable prices, more competition and greater security of supply.

9 Compensation

The ERA notes that, while the implementation of the recommendations contained in the Draft Report would be beneficial to the economy overall, in most instances the reforms would lead to winners and losers. Often, with reforms such as the ones recommended in this report, there are many winners and, while their individual gains are small, their number means a significant economy-wide benefit. In contrast, there are often only relatively few losers, but their losses may be individually significant.

The losers from reform are often those that have benefitted from a degree of protection by existing restrictions on competition and could experience a reduction in income or wealth as a consequence of the removal of those restrictions. As a general rule, the losers from reform can be expected to resist any reforms that will penalise them. This resistance will come in two main forms:

- trying to prevent the reforms from occurring by using any influence that is available to them and by attempting to discredit the analysis upon which the assessment of the relative benefits and costs of the reform are based upon; or

- should reform proceed, lobbying for compensation for lost income or wealth arising from implementation of the reforms.

Payment of compensation does not change the outcome of whether the removal of regulations is beneficial to the economy or not. It merely transfers money from one group to another on the basis that the receiving group is somehow more deserving of that money than those funding the compensation.

The ERA considers that there should not be any general rule on compensation and that groups or individuals need to explain why they deserve compensation on a case-by-case basis. There should not be an automatic presumption that individuals and businesses will be compensated for changes to government policies that have an adverse effect on them.

This is partly because different groups or individuals within groups can be affected differently by the same reform. For example, some holders of production licences[35] (such as taxi plates or potato licences) may have received those licences for free, while others may have purchased them for considerable cost. Licence holders may have held these licences for long periods of time and gained more than their initial investment in the form of

[35] Production licences only have value because of government regulations. The regulations provide value to the asset holder because of the additional income that is associated with the restrictions. In the absence of the regulations, there would be no substantial value associated with holding a licence.

high prices, or they may have recently purchased the asset and so have not had the chance to recoup their investment.

The ERA considers that investors should be aware of the risks associated with any investment they make. Licences have a value because of a potential future revenue stream that can be generated from owning the asset, arising from the government restriction. This revenue stream is the consequence of the above normal profits that can be generated while the restriction remains in place. Investors will be aware of the risk that the Government may remove the restriction at some point in the future and this risk will be incorporated into the value of the licence.[36] Investors would be 'double dipping' if they were to receive compensation from the removal of the restriction because they would already have been receiving above normal profits as a result of the restriction.

The counter argument to this is that the Government has effectively forced people to purchase the asset in order to enter the market or expand their operations, and therefore should compensate investors if reforms result in the value of the asset being eroded. However, investors or producers may have recouped the value of the asset through a higher income generated from being part of an artificially restricted group of sellers, and if this is the case there is no need to compensate for the loss of value of the asset.

The ERA notes that there are precedents for providing compensation for the removal of restrictions on competition. While there is no automatic right to compensation as a result of any policy change, the Government may consider that compensation is appropriate in particular circumstances.

10 Next steps

The Draft Report will be open to public comment until Friday 9 May 2014. After reviewing the responses received to this Draft Report, the ERA will prepare a Final Report, which will be presented to the Treasurer by 30 June 2014. The Treasurer will then have 28 days to table the Final Report in Parliament.

[36] Even if an investor is not aware of this risk, the risk should be reflected in the purchase price of the asset as long as there are enough buyers and sellers in the market for the asset.

Appendix 1 Potential areas of reform for further consideration

The Terms of Reference for the Inquiry into Microeconomic Reform requires the ERA to recommend a small number of specific key reforms or sectors that require further investigation by the ERA and/or policy development by the Government.

By necessity, the ERA had to limit the scope of its Inquiry into Microeconomic Reform to areas that would have the largest potential benefits to society and could be examined in the timeframe available for this Inquiry.

The ERA became aware of a number of areas of potential reform that could be of benefit to the Western Australian economy through public submissions, consultations with Government Departments and businesses, and through the analysis that the ERA has undertaken.

These areas were either not addressed in this Inquiry or were not fully examined, but may be the subject of future inquiries. The ERA has categorised these areas as follows:

- areas that were simply too large in scope to be considered as part of this Inquiry and would justify their own separate inquiry;

- areas that were examined by the ERA as part of this Inquiry but which would warrant further examination in a separate inquiry; and

- areas that were identified in the public submissions or during the course of the Inquiry that are worthwhile areas of examination, but were unable to be included in this report because of the need to prioritise the areas with the greatest potential benefits.

The topics in each of these three areas are elaborated upon in the subsequent sections.

Areas too large in scope to examine in this Inquiry

A number of potentially beneficial reform areas were identified, but excluded from the present Inquiry because they were too large in scope.

- ***Health Sector:*** The Western Australian health sector accounts for a significant proportion of Western Australia's State Government expenditure and thus provides a considerable opportunity for reform toward the efficient and effective use of health resources. Reform in the sector is currently driven by the 2011 National Health Reform Agreement that encompasses all States and Territories.

- ***Education:*** As is the case with the health sector, education accounts for a substantial proportion of Government expenditure. Additionally, education is a significant contributor to economic growth and productivity. Accordingly, the ERA considers that a review of the education sector could provide significant economic benefit to the State.

- ***Procurement, IT and Communications Reform:*** There may be potential benefits of well-designed models for collaboration and service sharing between Government Departments and agencies relating to Government procurement and service delivery.

- ***Occupational Licensing:*** The licensing of various trades and accredited occupations has been the subject of major federal review under National Occupational Licensing initiative since 2008. However, the progress under this initiative has slowed in recent times and may justify a higher level of priority.

- ***Energy:*** The Chamber of Commerce and Industry of Western Australia proposed that a detailed policy is needed for our State's energy sector over the long term, to provide direction with respect to management and development of energy resources, energy production, security and supply. In March 2014, the minister for Energy launched the State Government's Electricity Market Review to be undertaken by the Public Utilities Office.

Areas considered in this Inquiry that warrant further examination

Throughout its analysis the ERA identified reform areas that, while addressed in this Inquiry, could be the subject of extended investigation.

- ***Review of State Taxes:*** State tax reform could be subjected to a more thorough review. This could include Computable General Equilibrium modelling of the benefits of reform and a more thorough investigation of potential reform options.

- ***Flexible Electricity Pricing:*** A full cost benefit analysis of introducing smart metering and flexible pricing should be undertaken.

- ***Congestion Charging:*** Further investigation is required to determine the borders of a potential charging area, the fee structure, the management system and the capacity of the public transport system to handle increased peak patronage.

- ***Government Ownership:*** The ERA notes that the Asset Taskforce is undertaking a review of government ownership of specific assets. A review could be undertaken examining the divestment potential of assets and businesses not considered in this review, with a particular focus on recommending divestments that will result in significant efficiency gains.

- ***Innovative Sources of Funding:*** The potential for the wider use of user charges and developer charges was examined in this Inquiry. There exists many more potential funding sources that could be implemented or be more widely used. Investigation of these sources of funding could carry significant benefit to the economy.

Other issues that may warrant future consideration

A number of potential areas of investigation were identified in submissions or by the ERA during the course of the inquiry. While these areas are potentially beneficial, they were unable to be addressed in this Inquiry because of the need to prioritise the areas with the greatest potential benefits, or because of time and resourcing constraints.

- ***Forestry:*** Submissions requested that Government conduct a major review of the forestry sector on the basis that competition is being stifled by its current structure.

- ***Bulk Handling of Grain:*** The ERA received submissions requesting a review of the *Bulk Handling Act 1967* that governs the activities of Co-operative Bulk Handling. It was the view of the Pastoralists and Graziers Association that it has negative effects on the productivity and performance of the Western Australian grains industry.

- ***Operations of Government*****:** The Chamber of Commerce and Industry of Western Australia highlighted that Government spending has outpaced revenue for the past five years and there are now significant costs built in to the operational expenditure of the public sector. As a result, reform to the operation of Government could deliver significant economic benefits.

- ***Liquor Licensing*****:** Liquor licensing was addressed in submissions that referenced the significantly longer time taken to obtain a license in Western Australia than in the Eastern States.

- ***Waste management:*** The Chamber of Commerce and Industry of Western Australia believes that waste management demonstrates many of the natural monopoly characteristics of other utilities. Further analysis is warranted to consider the scope to implement initiatives that encourage greater competition, efficiency and innovation.

- ***Government expenditure on safety:*** In a previous inquiry,[37] the ERA recommended that the Government introduce a mechanism that more transparently and consistently prioritises capital expenditure on safety across government services. Such a mechanism would require all safety-related expenditures to be justified using common measurements (such as cost per statistical life saved and benefit cost ratios). To achieve this objective, government may need to establish greater institutional capability within either the Department of Treasury and Finance or a new body such as an Office of Public Safety.

- ***Industrial Relations:*** Industrial relations regulate the manner in which employers are able to manage and interact with their employees. Western Australia is the only state to retain its own industrial relations system. The Chamber of Commerce and Industry of Western Australia believes that there is no justification for Western Australia to retain its own industrial relations regime, and that the state should refer its industrial relations powers to the Commonwealth Government.

- ***Regional Air Routes:*** Western Australia's aviation market is subject to government regulation that grants individual airlines a monopoly over particular regional routes. The Chamber of Commerce and Industry of Western Australia proposed that the deregulation of intrastate air services, to encourage the competition that is needed to support the State's economic growth.

[37] Economic Regulation Authority, 2007, *Revised Final Report Inquiry on Harvey Water Bulk Water Pricing*.