

MARKET POWER AND GOVERNMENT CAPACITY

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Current concern, especially from those on the 'left', is that governments have been 'marketised'.

- "marketisation of government represents a form of cultural imperialism by a group of economists pushing a particular and false economic dogma"
- Globalisation is also often viewed as the culprit, with governments being dictated to by international financial markets
 - Hence the desire of the protestors to in some unspecified way limit the power of those markets

By contrast those on the 'right' are often critical that governments have not deregulated further

- For example, unemployment and the inequality associated with unemployment, are attributed to the lack of labour market flexibility, and especially to a failure of relative wages to adjust to shifts in supply and demand

Although they draw very different conclusions about the desirability of marketising government, both the left and the right tend to view markets as limiting the power of governments.

What I want to suggest today is that the shift to marketisation often represents an attempt by governments to enhance or restore their power. Why is this so? The starting point is that the power of governments is being limited by multiple causes, but particularly by the unwillingness of the electorate to allow governments to rule by fiat. Governments have lost respect, trust and authority. More and more governments have been finding that regulations have presented an invitation to avoidance or evasion; and/or that the perverse incentives that regulations create means that they are not achieving their intended purpose, or at least are not efficiently achieving that purpose.

The attractiveness of markets for governments is that they can often still be *managed* by governments, while at the same time markets will create desirable incentives for individual actors to pursue the government's objectives. Even globalisation, while it releases very powerful forces, can often be managed if the government changes its means, and there are considerable advantages for our society in remaining open to engagement with the rest of the world. In effect governments aim to manage markets so as to create a synergy between the objectives of the individual, or individual interest groups, and the broader collective objectives of society.

Of course such a synergy cannot always be established, but even where there is a clash of objectives between the individual and society, it does not always follow that the old-style regulation of individual behaviour is the best means to achieve society's objective. Often governments can be more effective if they take other compensating action through another related set of policies, rather than deliberately attempting to prevent the individual from pursuing his or her own self-interest.

In effect, my contention is that the marketisation of government is for the most part a pragmatic response to changing conditions. The means by which governments are seeking to achieve their objectives are changing, but the objectives and most importantly the values that underpin them are not changing radically.

Indeed the responsibilities of government are continuing to grow. Governments are taking on new responsibilities for protection of the environment. Assistance to families has been substantially extended – especially as women participate in the paid work force and are less available to care for the young and the elderly. And increasingly there is an expectation that the losers from change should be compensated by the rest of us. As a result, the level of government expenditure and revenue relative to GDP has not declined significantly from the peak achieved in the mid-1980s, and the

volume of social and environmental regulation has continued to increase, while the *nature* of economic regulation has changed rather than the amount.

In sum, the marketisation of government should be seen as a pragmatic response by government, involving a change in the means of government intervention rather than in the amount or the intent.

I will illustrate this thesis by referring to the changes that have been occurring in three areas of policy:

- Macroeconomic policy
- Microeconomic policy
- Service delivery

The questions we need to focus on are:

1. Where have governments made greater use of markets
2. Why
3. Has the marketisation of government increased or reduced their capacity to set and achieve their policy goals

Because of limitations of time I will not cover where markets do not work and/or where complementary government intervention is needed. These instances are significant, but it does not necessarily follow that re-regulation is the best remedy. As I mentioned, a better alternative may be to use complementary fiscal action to assist those who are disadvantaged by change.

Macroeconomic Policy

Objectives of macroeconomic policy have not changed:

- Rising living standards
- Low inflation
- Low unemployment

Scale of fiscal intervention has not changed.

- The scale of government fiscal intervention in the last two recessions has been as large or larger than ever before (see Table). Keynesian fiscal policy is being actively pursued.
- Levels of taxation and government expenditure have not declined, and social expenditure has increased by 2 per cent of GDP during the Labor years (see Chart)
- Structure of income tax is not very different, and if allow for base broadening it is roughly as progressive (see table)
- Large differences in expenditure and taxation can be tolerated even within an integrated economy
 - See differences between countries and within the USA
 - The notion of a race to the bottom is a fig-leaf to cover the traditional interests of high income earners in low taxation
 - Issue is how the money is spent and that is why people still move from Mississippi to Massachusetts

What has changed is the focus of monetary policy and some aspects of its conduct.

The major change was the floating of the exchange rate, and this was forced by the globalisation of capital markets. However, the Australian financial system has never been immune to international financial disturbances.

Globalisation has not altered the fundamental choice: monetary policy can be used to regulate the domestic economy or to regulate the exchange rate, but it cannot successfully accomplish both goals at once.

What globalisation has taught us is that we are better off focussing on domestic demand and inflation than on the exchange rate. As a result monetary policy is now more independent. International financial 'shocks' may now present a greater threat, but the floating exchange rate also offers greater protection against them. With a fixed exchange rate monetary policy had to target the exchange rate and that meant that it largely reflected the

monetary policy of the targeted country (the USA). By adopting a floating exchange rate Australia now has for the first time the scope to conduct an independent monetary policy that can be directed towards stabilising domestic demand. Thus in response to the East Asian economic crisis, Australia clearly adopted an independent monetary policy and let the exchange rate depreciate. This depreciation allowed Australia to avoid the worst of that crisis and trade through it.

One worry is that while the floating exchange rate provides governments with the capacity to run an independent monetary policy, are international financial markets now so powerful that governments are unwilling to use that independent capacity? Would they rather please the markets than the voters, because of the capacity of the markets to destabilise governments?

In considering this issue, we need to remember that a critical feature of economic policy – perhaps of all policy determination – is uncertainty. Accordingly when governments and markets disagree, the question of who should prevail, really comes down to who is more likely to be right? In some instances, at least with the benefit of hindsight, it would seem that the markets were right and that they provided a useful early warning to government that corrective action was needed to enable the government to achieve its own objectives. In such instances governments would have been better off to bow to markets early and take corrective action in their own interests. On other occasions, however, experience suggests that financial markets can be capricious and over-react. Financial markets may also have a conservative bias that can lead them to underestimate the economy's potential for non-inflationary growth.

Where there are good reasons for governments to believe that their economic policies are sound, it is arguable that they should take advantage of their capacity to conduct an independent monetary policy, and treat movements in the exchange rate with benign neglect. Although the increase in the scale of international financial flows makes it more difficult to face down markets than it used to be, it is also less painful. A fall in the exchange rate is less

damaging politically than the increases in interest rates that were sometimes necessary to preserve the former fixed exchange rate regime. And a decline in the exchange rate is of much less concern now that there is strong domestic competition and the economy is less inflation prone. If the authorities are right and the economic fundamentals are sound, any such fall in the exchange rate will reverse itself before there is much impact on inflation.

I would argue that we have been living in this situation for the last year or so, and that the authorities have been prepared to live with an over-depreciated exchange rate rather than raise interest rates in an attempt to defend a higher exchange rate. The exchange rate depreciation has helped us maintain employment and economic growth in the face of international pressures. And the transmission of monetary policy stimulus through the exchange markets has been more effective than if we had relied on domestic markets alone.

In addition, there are a number of other institutional changes that could reduce the chances of destabilising market speculation. The best known has been to give the central bank a substantial measure of independence. The government still has the fundamental responsibility for setting the inflation target that the Reserve Bank must try to achieve, but because of the Bank's independence it is seen as less likely to be motivated by short-term political goals and it has more economic credibility. As a result markets are more likely to respond positively to a change in monetary policy initiated by the Bank.

Microeconomic Policy

The main thrust of microeconomic policy over the last 15 years has been to improve the competitive efficiency of markets. The intention has been that markets should become more flexible and better able to adjust to change. More efficient and flexible markets can then help improve the efficacy of government policy, and this is essential if governments are going to rely more on markets to achieve their policy objectives.

The initiation of microeconomic reform was itself a response to a number of pressures:

- The decline of resource based rents and the cost-price squeeze these resource industries have been facing
 - Miners and farmers led the agitation for lower manufacturing protection and then competition in the non-traded goods part of the economy
- Recognition that changes in the exchange rate were much more significant than variations in border protection
- Desire to improve the rate of economic growth, and particularly productivity growth, especially as real wages stagnated under the Accord
 - Public utilities were especially relevant in this context as they were a long way from best practice, and this could not be ascribed to their community service obligations
 - Example of Australia Post
 - ACTU led the way in moving to forms of productivity-based wage bargaining with the enterprise as the bargaining unit
 - Main difference from the Reith/Howard approach to IR has been the role of unions in the bargaining process
 - Also the unions were not looking to shift relative wages, but to improve the organisation of work and thus improve the productivity of labour
 - Many employers would agree with the unions, hence their preference for 'pattern bargaining' where the transaction cost are much lower

Note the success achieved in terms of the government's overall objectives:

- Economy is much less inflation prone, and Australia is therefore better placed to adjust to overseas shocks
 - Independent capacity of the government has been increased through improvements to markets
- Rate of economic growth and productivity growth has been increased, with rising living standards and taxation revenue making the government's job of providing services somewhat easier

The outstanding concern is equity – in particular, unemployment is too high – and I will come back to this issue of equity later.

Service Delivery

The main change has been the privatisation of some service provision which is still publicly funded, and as a result the beneficiaries now have some choice of service provider. The outstanding example is employment services, but education – within public as well as private – child care and aged care, telecommunications and to a lesser extent postal services are others. Governments are also looking to develop *managed* markets in an attempt to improve the price incentives to adopt best practice with less reliance on regulation of the *quantity* of service offered, and which all too often ends up in politically unsustainable queuing. With managed markets governments still set the standards to be achieved, control rights of access and eligibility, and often the amounts of service to be provided. But the providers have some incentive to maximise the value for money and the clients have some choice, which in turn can help to improve the quality and responsiveness of the service provided.

The background is that criticism of public services was not limited to conservatives

- ACTU and politicians were critical of service delivery in the early 1980s
- So were many customers, although they often lacked channels to express their dissatisfaction

Choice is not all that new. It has always been available for publicly funded medical services.

An early direction for reform was devolution of service provision. This reflected a reaction to the previous philosophy that one size fits all in favour of giving the individual public service provider greater discretion to tailor the assistance to the needs of the particular client. This devolution was only possible if it were feasible to set out the results expected of the service

provider. But if it were feasible to do this for public service providers then it was often also possible to spell out in the form of a contract what was required of private providers who wished to tender for the work.

Another important concern has been the need to improve the coordination of services. Often people who are disadvantaged experience a number of interrelated needs. Poor education, poor health, poor housing and poor job prospects tend to go together. Many attempts have been made to improve interdepartmental and inter-government cooperation, but without conspicuous success. An alternative approach is to put the purchasing power in the hands of the beneficiary and/or their agent and allow them to purchase the array of services that best meets their particular needs from within a fixed budget. Often the purchasing agent, armed with the power of the purse, is then able to achieve the necessary coordination of services in much the same way as the builder is able to coordinate the services of the various sub-contractors who at different stages contribute to building a house. The purchaser is then also well placed to assess and insist on value for money, while the government continues to set the various standards for the various services that it is ultimately funding.

For example, trials have been proceeding for the coordination of health services to those people who have chronic health conditions requiring a variety of services. The carer's agent is provided with a fixed budget that is based on an assessment of the average cost of caring for someone with the particular condition, but the carer and the patient then control the actual mix of services purchased. They have an incentive to economise on individual services as they can then use the money saved to purchase better services. Where averaging is allowed across the carer's case-load, or a group of carers' case-loads, then money saved on one patient can be used to provide extra services to the most needy patients.

Having outlined the case for this new approach to service delivery based on managed markets, I do not want to suggest that it is universally superior. It

works better in some situations and not in others. Typically where it works best:

- there is considerable trust in the judgement of the service provider and/or the customer's agent (medical services)
- it is possible to specify in advance what is required of the service provider and performance can be monitored satisfactorily
- an accountability regime can be established designating who is responsible for what and the risks/consequences of failure for the government are not too great.
- any judicial aspects of service provision, such as determining eligibility for the service or an entitlement, can be separated and remain the direct responsibility of the government, especially when decisions are subject to appeal.
 - E.g. the role of Centrelink, but note the role of doctors and also aged care assessment teams as gate keepers to relevant services

I want to suggest that these issues of whether a service should be contracted out or not should be judged case by case on its merits, and that we should be neither for nor against this approach to the marketisation of government service delivery in principle. Where this approach works it has the advantage that it does assist the government to achieve its real objectives in an area where there has been much criticism of performance in the recent past – from the left as well as the right.

Criticisms of the Marketisation of Government

Have markets changed our values. Two particular areas of concern:

1. Less concern for equity – the pursuit of market-based solutions has led to greater inequality
2. Markets have increased the focus on individuals, but at the expense of collective needs. Moreover individuals only realise themselves and gain self-esteem by interacting with other members of the society they live in.

Equality

- The distribution of earnings has become more unequal, but the distribution of disposable incomes did not become more unequal over the life of the Labor Government (not sure what has happened since)
- The increased inequality of earnings could reflect shifts in relative rates of pay, or it could reflect shifts in the distribution of jobs
 - Not absolutely sure which is the explanation but think it is more likely to be a shift in the distribution of jobs
 - In any event it is unlikely to reflect changes in wage determination as the widening in the distribution of earnings started in the 1970s and continued at the same pace during the period of the Accord
 - Most likely explanation is changing technology, not the removal of trade barriers
 - The evidence relating to the pattern of job creation and destruction, the shift in relative prices among traded goods, and the relative wages of different skill groups, all suggest that the opening up of international trade has not been responsible for much unemployment
 - Essentially trade creates jobs as well as destroying them, and in Australia 'the fall in employment associated with low wages was outweighed by the increase in jobs associated with greater exports (Murtough *et al*, 1998:xi)
 - The changes in skill composition have been within industries rather than between industries, which again is consistent with technological change having the main impact.

In these circumstances, with relative rates of pay not obviously changing much, it is not clear that government attempts to re-regulate pay determination would – even if successful – lead to much greater equality. Instead government intervention would seem to better directed to improving the education and skill base of those who are least competitive in the job market, and/or supplementing their incomes in other ways.

Collective Values

Quite likely that a focus on cash assistance to the individual could lead to down-playing of collective values. But not so much an issue of markets versus government as an issue of whether assistance should be targeted at individuals or directed towards some social purpose (eg education, health), and/or provided to community groups as a means of building social capital. Easy to argue that more assistance should be passed through community groups, but need to recognise at the outset that this will raise difficult, but not insuperable, issues of accountability.

Conclusion

I do not think the process of marketising government has yet finished. More can yet be done to advance:

- Competition policy – although not the labour market in my opinion
- Education – see Karmel and Latham's ideas
- Health – see Scotton's proposals

The speed and extent of further marketisation of government may depend, however, on governments also taking countervailing action to preserve equity and enhance communities and social capital. In many instances the development of policy packages along these lines is likely to enhance the independent capacity of governments to set and achieve their desired policy objectives. In particular, this approach to marketisation is often likely to be more effective than further command and control legislation that creates its own incentives for evasion.

Budget Balance and Fiscal Impact

Year	Constant employment balance \$m	Real structural balance \$m
1950-51	12	967
1951-52	257	417
1952-53	138	688
1953-54	188	299
1960-61	-25	75
1961-62	-172	-131
1970-71	-256	-50
1975-76	-2450	-1482
1981-82	1083	2928
1983-84	-4749	-3134
1988-89	6437	10708
1990-91	3491	4562
1992-93	-8217	-7630

Table 7: Average Rates of Income Tax (%)

	1961–62	1970–71	1982–83	1987–88	1993–94	1996–97	2000–01
Multiple of full-time average weekly earnings							
0.25 AWE*	3	5	0	4	7	9	8
0.50 AWE*	7	10	15	14	14	14	13
1.00 AWE	13	18	23	24	23	24	22
1.50 AWE	18	24	30	30	29	31	28
2.00 AWE	22	28	34	35	34	35	32
2.50 AWE	26	32	39	38	36	37	35
3.00 AWE	29	36	43	39	38	39	37

Source: Authors' estimates

*These estimates do not allow for the rebates that pensioners on these incomes would receive. These rebates have increased relative to incomes over time.