



# Structural Adjustment — Key Policy Issues

Commission  
Research Paper

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# Foreword

Many countries, including Australia, have undertaken structural reforms over the last decade or so as a means of improving the productivity performance of their economies and the living standards of their citizens. At an aggregate level, Australia's economic reforms have yielded considerable benefits. However, concerns have been raised about the magnitude of the associated adjustment costs and distributional impacts. These concerns have loomed large in a resurgent public debate about the future course of microeconomic reform in general and National Competition Policy in particular.

From the Commission's perspective, two distinct sets of issues are central to this debate. The first is the adequacy of the processes and analytical framework used to evaluate reform proposals, particularly in relation to identifying the likely costs and distributional impacts. The second is the importance of effective design and implementation of policy reforms in securing sound outcomes. A continuing challenge for policy makers in this respect is to identify the circumstances in which the social safety net and other generally available measures may be insufficient or inappropriate, and the basis for choosing among additional measures.

This paper sets out the Commission's views on these important matters, drawing on its own research and experience over the course of many public inquiries, as well as input from leading policy analysts who participated in a Commission workshop. While some of the issues lend themselves to useful decision rules, many can only be resolved on a case-by-case basis — as part of the assessment process and implementation strategy for particular reforms.

Gary Banks  
Chairman

October 2001

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# Abbreviations

ABARE	Australian Bureau of Agricultural and Resource Economics
ABS	Australian Bureau of Statistics
ACOSS	Australian Council of Social Service
ADIC	Australian Dairy Industry Council
AIG	Australian Industry Group
ANTS	A New Tax System
BCA	Business Council of Australia
BIE	Bureau of Industry Economics
CIE	Centre for International Economics
CPI	consumer price index
EMTRs	effective marginal tax rates
EPAC	Economic Planning Advisory Commission
GDP	gross domestic product
GST	goods and services tax
IAC	Industries Assistance Commission
IC	Industry Commission
LAPs	Labour adjustment programs
NATSEM	National Centre for Social and Economic Modelling
NCC	National Competition Council
NCP	National Competition Policy
NILS	National Institute of Labour Studies
OECD	Organisation for Economic Co-operation and Development
ORR	Office of Regulation Review
PC	Productivity Commission
PMV	passenger motor vehicle

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QDLRC	Queensland Dairy Legislation Review Committee
TCF	textiles, clothing and footwear
WTO	World Trade Organization

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# Overview

In its first annual report, the Productivity Commission observed that it had been established at a time of vigorous debate about the future direction of microeconomic reform in Australia (PC 1998a, pp. 1-2):

Sections of the community are questioning whether the program of microeconomic reform undertaken in Australia over the last decade has achieved its supposed gains. Some say the gains are inherently small or do not justify the adjustment costs involved and express concern that those adversely affected have not been compensated adequately. There is scepticism about whether ordinary Australians are sharing equally with the ‘big end of town’ and dissatisfaction with how adjustment to change has been managed.

Concerns about reform and its effects, and about change more generally, are not new. More than twenty years ago, in the first of three discussion papers exploring structural change and its implications, the Industries Assistance Commission (IAC 1977, Preface) observed:

Individually and collectively we are continually having to adapt to structural changes of one sort or another, originating either from the interplay of market forces or from actions taken by governments.

... Almost all structural changes bring benefits to some people, industries or community groups, but impose costs on others. The benefits may take the form of increased incomes, better opportunities or enhanced security. Conversely, the costs may take the form of reduced incomes, security, or opportunities. Governments are often expected to resolve these conflicts of interest.

In the period bounded by these publications, the nature and pace of microeconomic reform in Australia has broadened and accelerated. Since the early 1980s, such reforms have extended beyond trade liberalisation and improvements in statutory marketing arrangements to encompass improvements in financial markets, the regulatory framework for government business enterprises, Australia’s tax system, the funding and delivery of education, health and community services, regulatory arrangements for businesses, natural resources and the environment, labour market and industrial relations regulations, and the development and partial implementation of National Competition Policy (NCP) reforms (IC 1998).

The continuing debate about the merits of microeconomic reform and, in particular, NCP, reaffirms the importance of policy choices being made on the best available

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information on the likely benefits and costs, including the adjustment and distributional consequences. It also underlines the need for careful consideration of how reforms are implemented and how the case for reform might be better articulated to the community.

## Key issues

The debate about the future direction of economic policy and reform in Australia highlights two challenging issues. The first relates to the *evaluative framework* used for assessing reform proposals and in particular:

- the way in which the benefits, costs and distributional effects of a proposed policy change are assessed when deciding whether a particular reform is in the interest of the community, and
- the approach taken to handling policy trade-offs — in particular, those which can arise between efficiency and distributional objectives.

The second relates to the development of *implementation strategies* to give effect to policy changes, namely:

- the circumstances in which there is a role for additional measures, beyond the social security and tax systems and other generally available adjustment measures, to support the implementation of policy changes, and
- the relative merits of each of the additional measures as aids to the implementation of policy changes.

This paper outlines the Commission's views on these issues. These have been shaped by its own experience (and that of its predecessor organisations) across a diverse range of public inquiries and research studies. The discussion also draws on insights from participants at a Commission workshop, *Structural Adjustment — Exploring the Policy Issues*, held in May 1999 (PC 1999g).

## The evaluation framework

Effective policy evaluation and implementation processes are fundamental to good policy outcomes. Decision makers need information and analysis to be able to demonstrate that a proposed policy change is in the community's interest having regard to its expected benefits, costs (including adjustment costs) and likely distributional consequences. Also, where appropriate, different implementation strategies need to be examined and the basis for particular policy choices made clear.

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The evaluation of reform proposals raises challenging issues. In the first instance, it can be difficult to separate the influence of proposed policy changes from the numerous other factors that interact to determine patterns of resource use, adjustment pressures and changes in the distribution of activity and income over time.

Further, the evaluation of reform proposals in advance of their implementation is constrained by available knowledge and inherent uncertainties about, for example, how firms, workers and consumers are likely to respond to changing incentives, as well as the impact of policy changes on the distribution of activity and income. Even in retrospect, one can never be sure of the counterfactual — that is, how the situation would have evolved without the policy change or with different policy settings.

In most cases, therefore, it is possible to provide only broad and qualified guidance as to the expected benefits, costs and distributional dimensions of reform proposals.

### *The benefits and costs of policy changes*

Policy changes, including microeconomic reforms, are initiated by governments because of the considerable benefits they can bring to the community.

For many policy changes, the benefits to the community arise from three main sources:

- by ensuring that prices promote an allocation of resources between different activities which yields the greatest return from available resources;
- by providing incentives for firms and service providers to keep their costs down; and
- by encouraging better and more innovative ways of producing goods and services as well as flexibility in adapting to changed circumstances.

The resultant benefits are reflected in higher levels of national income and job creation.

There are costs associated with realising the benefits of reform. For instance, it often takes time and resources for displaced workers to find alternative employment and for capital to be redeployed. Similarly, changes to the financing and delivery of social services are likely to require adjustments by recipients as well as by service providers. Understanding how workers, firms and consumers adapt to change is important in evaluating reform proposals. Indeed, information on the size and nature of the associated costs is required to determine whether, in aggregate, the expected

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benefits of a reform are likely to exceed the expected costs, including adjustment and redundancy costs. If this were not the case, a reform would not be worth pursuing. Also, such information can be used to assess the scope for reducing the costs when implementing a policy change.

In assessing the impact of a policy change, it is important to distinguish between economy-wide benefits and costs and transfers among individuals and firms.

People can experience various adverse impacts from policy change — temporary unemployment, redundancy, loss of value of assets, costs of moving, reduced opportunities. Other people benefit from change through improved employment opportunities, higher incomes, increased asset values and the like. These losses and gains are real and important to the affected groups. They give rise to distributional consequences that government may want to take into account for equity or fairness reasons.

At the broader community level, however, many of these gains and losses balance out — they are *transfers* among individuals and firms.

Change can also result in *economy-wide costs* that need to be included in the broader assessment of proposed policy changes. They can be broken down into direct and indirect costs.

*Direct* costs may include adjustment, redundancy and compliance/administrative costs. Adjustment costs often arise because resources are used by workers and firms to adapt to change within existing jobs or activities (for example, retraining or upgrading equipment) or in moving to a new job or activity (for example, job search and relocation expenses). Of course, where the resources used during the adjustment process produce benefits for workers and firms these need to be offset against the adjustment costs.

Redundancy costs arise where a policy change gives rise to unemployment or the underutilisation of labour or capital which is not offset by additional output or consumption elsewhere in the economy. However, microeconomic reforms are generally designed to increase consumption overall. Some policy changes may give rise to compliance and administrative costs — although, again, regulatory reforms are usually directed at lessening these costs to individuals, firms and administering agencies alike.

Costs which arise *indirectly* include those where the adjustment responses of firms and individuals affect in turn the operations of other firms or the labour market. For example, the closure of a number of firms within a region, in response to a policy change, can affect activity levels in other firms as well as the availability and

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accessibility of goods and services to consumers. However, it is necessary to compare these costs with any indirect benefits which may arise from a policy change, such as through lower input costs.

While these economy-wide costs can be significant and may extend over a considerable period, most are transitory. In contrast, the benefits of reform are typically ongoing. In many cases, therefore, the costs are likely to be small relative to the benefits, but this needs to be demonstrated rather than presumed. This raises the obvious question — just how much analysis is required to demonstrate that the longer-term benefits of a reform will outweigh its expected costs?

In the Commission's view, the extent of analysis needs to reflect the likely significance of the costs of making a policy change — that is, it needs to be pragmatically based and focused initially on a consideration of the nature of the reform proposal and its likely consequences, the characteristics of those likely to be affected, and the general state of the economy and local labour markets.

The costs of making a policy change may also be influenced by its timing and how quickly the change is introduced, requiring an assessment of the trade-off between delaying its implementation and receiving the benefits earlier. Beyond this, some policy changes, such as those to education and training systems and labour market regulations, can enhance the capacity of workers and firms to adjust to policy-induced or market-based changes.

Where the costs of a policy change are expected to be significant, further analysis is generally appropriate to:

- assess the extent to which an 'adjustment problem' may arise;
- identify whether government action is appropriate to address market and institutional impediments that increase the costs of change;
- ascertain the adequacy of existing government programs such as the social safety net and other generally available adjustment measures;
- assess whether the expected costs of making the policy change could be reduced (without unduly eroding the benefits) by modifying its form or implementation; and
- identify whether there is a case for including a review or monitoring arrangement as part of a reform proposal.

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### *The distributional impacts of policy changes*

Reforms can give rise to a wide range of distributional impacts. For example, a reform may induce changes in the cost of a good or service, changes in returns to firms and workers, or shifts in activity and employment opportunities. Some of these impacts will be transitional in nature while others will continue.

An assessment of the distribution of the benefits, costs and any transfers arising from policy changes is an important part of the evaluation of reform proposals. Governments and the community are not just interested in whether a reform is likely to yield net benefits but also which groups benefit and lose, and by how much. Identifying the most efficient and effective ways of pursuing specific distributional objectives is vital for securing ‘value for money’ outcomes. Information about the distributional effects of policy changes, although not always easy to obtain, can promote a better understanding of, and lessen resistance to, worthwhile reform. Furthermore, policy changes which are judged to be fair are more likely to be sustainable. Those that impose large costs on disadvantaged groups or give rise to large benefits for advantaged groups can be viewed as inherently inequitable or unfair.

Reforms involve changing existing policy settings which themselves favour some groups relative to others. Typically, there are more ‘winners’ than ‘losers’ from most reforms, but the individual gains for the ‘winners’ are often small and widespread whereas the losses for the ‘losers’ are often more significant, and concentrated. Concerns about losses accordingly tend to be expressed more strongly than support for gains.

An assessment of the distributional consequences of a proposed reform needs to consider the type of reform, its underlying objectives and whether the distributional impacts are likely to be substantial and uneven or uncertain. In practice, some reforms, such as changes to taxation arrangements and trade barriers, are more amenable to distributional assessments than others, such as the liberalisation of financial markets.

Assessments which consider only the first round or direct effects of policy changes may result in misleading conclusions. Indirect effects, which can be large but are typically less visible, often change the overall distributional outcome. For example, an Industry Commission analysis of price changes for electricity, water, sewerage and drainage services between 1990-91 and 1994-95 found that the direct effects had resulted in households at all points in the income distribution paying more for these services. However, for most households, the indirect effects on the prices of other goods and services (in the form of lower prices stemming from lower costs to business) more than offset the direct price increases. Thus, when both direct and

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indirect effects were considered, most households received some benefit from the overall price changes (IC 1996b).

Policy assessments should recognise that the existing distribution could itself be ‘unfair’, reflecting past government policies that have bestowed special privileges on some groups. Consequently, there is nothing sacrosanct about the existing distribution of income, wealth and resources, particularly where these reflect the outcomes of past policy decisions with questionable frameworks. Use of the existing distribution would imply an in-built bias in favour of the status quo. There are also costs associated with a ‘no reform option’. For example, some workers and firms would experience diminished opportunities for employment and growth if existing tariffs on certain goods and services were maintained rather than reduced.

While information gaps and uncertainty about the impact of policy changes frequently preclude detailed analysis of the distributional impacts of reform proposals, it is often possible to provide broad guidance. Neglecting or avoiding analysis of these impacts exposes the community to the risk that governments, in an attempt to deal with them on an ad hoc basis, will opt for inferior responses.

In many cases an initial assessment will reveal that the distributional impact of a reform proposal is likely to be minor or to yield relatively uniform impacts across groups. Further analysis would generally be appropriate where:

- the proposal encompasses specific distributional objectives; or
- the distributional impacts are expected to be substantial and uneven in nature, or to involve a large element of uncertainty.

### *Handling policy trade-offs*

Many reform proposals with beneficial efficiency effects involve relatively small changes to existing distribution patterns or may have impacts that would receive wide community endorsement. Examples include removing duplication of government programs, improving the effectiveness of general labour market programs and achieving more cost-effective ways of meeting social goals in areas like workers’ compensation, occupational health and safety and urban transport.

Nevertheless, conflicts between efficiency and distributional (as well as other) objectives do arise. In such cases, judgements are required about appropriate trade-offs. Examples include targeting welfare and tax expenditures to particular groups while attempting to avoid large unintended disincentive effects —such as ‘poverty traps’.

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The role of policy analysts in these circumstances is to help governments and the community to understand the consequences of different proposals and to facilitate informed decision making about appropriate trade-offs.

The conventional approach to this task sees the policy analyst's role as being to identify and, where possible, quantify the efficiency and distributional dimensions of reform proposals. Under this approach, benefits and costs (including any transfers) to individual groups are implicitly assigned equal weights — that is, a dollar of benefit, cost or a transfer for one person or group is treated as being of equivalent value for another person or group. Judgements about acceptable trade-offs (including whether alternative weightings should be used) are ultimately left for Parliaments to decide.

Some argue that this 'dollar is a dollar' approach is unsatisfactory, particularly where the distributional effects are likely to be significantly uneven. Various proposals for alternative weighting regimes have been put forward such as using weights inferred from existing or past policy decisions. Significant conceptual as well as practical difficulties arise in determining and applying these alternative weighting systems.

Consequently, only where a government makes an explicit public statement on the specific distributional weights to apply for a particular policy area would the Commission advocate departing from the conventional approach.

In general, where policy trade-offs arise, analysts can contribute to effective policy making by reporting on the efficiency and distributional dimensions and identifying options for handling or resolving any conflicts.

## **Implementation strategies**

The social safety net (that is, the social security and tax systems) and generally available adjustment measures (such as job search and training) will in principle usually be the most appropriate vehicles for assisting the process of adjustment and moderating any adverse distributional impacts from policy-induced or market-based change. They have several distinct advantages in performing these functions. They treat individuals in similar circumstances equally, target assistance to those in genuine need whatever the cause, address the net effects of the varying influences on the circumstances of individuals and families, and support individuals and families rather than a particular industry or activity. They are not without their weaknesses, however, and are capable of being improved. Even so, they cannot be designed to handle all contingencies.

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Consequently, questions arise as to the circumstances in which there is likely to be a role for additional measures such as direct compensation and reform modification, as part of an effective implementation strategy. Beyond this, there is also the issue of identifying the appropriate additional measure to use.

*A role for additional measures in support of policy changes*

Arguments commonly advanced for adopting additional measures are to promote equitable or fair processes and outcomes, to ‘buy-off’ opposition to policy changes and to improve the efficiency of the adjustment process.

Claims for additional measures on grounds of *equity or fairness* are often controversial and difficult to assess — these concepts are inherently subjective and perceptions about them vary. However, the case is likely to be strongest where a proposed policy change:

- imposes a clear and sizeable burden on a specific group in the community (particularly if the affected group is relatively disadvantaged);
- delivers benefits mainly to relatively advantaged groups in the community; and/or
- involves a largely unanticipated and material change to a well defined and defensible ‘property right’.

Assistance designed to ‘*buy-off*’ opposition to a policy change may appeal on pragmatic grounds. However, it is fraught with difficulties and carries considerable risks. For example, a decision to provide compensation to the opponents of a specific policy proposal is likely to encourage community groups to lobby against other proposed policy changes. Singling out particular groups for differential treatment also runs the risk of jeopardising fair process and is unlikely to yield consistent and equitable outcomes.

Opposition to proposed policy changes may arise, of course, because insufficient attention has been given to legitimate equity or fairness and efficiency considerations during the evaluation and design stages of their development. In that event, however, the appropriate course of action is not to seek to buy-off the opposition, but to improve the reform process.

The *efficiency* argument for additional measures is more straightforward. Where specific adjustment assistance or some other additional measure can reduce transitional costs attributable to market-based impediments (such as information gaps on alternative employment opportunities) and the expected benefits exceed the costs of intervention, there is a strong in-principle case to intervene. Similarly,

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where existing government policies or transitional measures accompanying a reform proposal seem likely to impede the adjustment process, there is a case for examining the possibility of modifying the relevant policy to remove or lessen the impediment. For example, the final report of the Reference Group on Welfare Reform (McClure 2000) identified a number of fundamental weaknesses in the current social support system which impair the efficiency of the adjustment process within Australia's labour market.

### *Comparing the relative merits of additional measures*

Additional measures are only likely to be appropriate where the social safety net and other generally available measures are ineffective or do not fully address relevant impediments. The range of possible additional measures include direct compensation, specific adjustment assistance and various forms of reform modification either prior to implementing a reform proposal (such as phasing, broad-based reform or reform dilution) or following the implementation of a reform.

Several issues that need to be addressed in identifying the additional measure(s) likely to be appropriate, and when, are set out in box 1.

#### **Box 1      Issues relevant to employing additional measures**

A number of matters need to be considered to identify whether there is a role for additional measures and, if so, what form they should take, including:

- the nature of the problem that provides an 'in principle' case for intervention;
- whether assistance available through the social safety net or other generally available adjustment measures is sufficient; and
- if not, whether the use of an additional measure (or combination of measures) would yield a better overall outcome.

To answer the last question, it is necessary to consider the relative merits of each additional measure in the context of the circumstances of particular policy proposals:

- Does the measure target the problem effectively (that is, provide assistance to the adversely affected group) and facilitate the process of change?
- Is the measure cost efficient in terms of its financing costs, administrative and access costs, likely behavioural costs and interactions with other programs/policies?
- Does the measure involve an equitable sharing of its financing costs?
- Is the measure transparent and subject to appropriate accountability mechanisms?

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Addressing these issues on a systematic basis is desirable in order to achieve consistent and equitable treatment of affected parties over time and to ensure that the measures are well targeted and cost-effective.

The need to apply additional measures will depend on the nature of the policy change and its associated adjustment and distributional impacts. Although a case-by-case approach generally will be required, it is possible to provide some broad guidance.

In principle, well designed *direct compensation* and *specific adjustment assistance* can be relatively effective where a policy change is likely to impose substantial and uneven losses, or result in large adjustment and redundancy costs, and the affected parties and the characteristics which make them vulnerable can be readily identified. These measures allow a reform to proceed without deferring the delivery of its benefits.

In practice, however, it is often difficult to identify the potential losers and the magnitude of their losses (or the impact of other influences on their financial circumstances), let alone the characteristics which accentuate their difficulties in adjusting to a policy change. Where it is likely that there will be markedly adverse distributional impacts or large adjustment and redundancy costs, reform proposals can be modified in advance of their implementation to ameliorate these impacts or costs or following their implementation to assist those actually adversely affected who may warrant additional assistance.

While *phasing* has its limitations — it delays receiving the benefits of a reform and may make a reform more susceptible to a policy reversal — it has distinct advantages where:

- the existing rules of the game are being changed and a ‘breathing space’ would facilitate a smooth transition to a new regime (the recent introduction of life-time community rating for private health insurance provides an example);
- existing institutional arrangements are being changed fundamentally and industry participants and regulators would benefit from having time to adapt (reforms to many of Australia’s infrastructure service industries have involved the sequential or staged introduction of important policy changes); and
- there is scope for ‘undue disruption’, but direct compensation and specific adjustment assistance are not feasible due, say, to limited information on the adjustment capacity of different groups of workers and firms (the phasing of tariff reductions for many industries is an example).

*Broad-based reform* — pursuing reform on a broader front — can provide an effective implementation strategy for advancing reform, although there are practical

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constraints on its use. By exploiting complementarities between a number of reforms, broad-based reform can lessen problems associated with adjustment to a series of piecemeal reforms and provide offsetting benefits to groups adversely affected by individual reforms. The shift from piecemeal to broadly based tariff reductions and the NCP framework provide examples of this approach. However, even broad-based reform may not effectively address the adverse effects of a large loss or cost imposts on disadvantaged groups.

*Reform dilution* — modifying the content of a proposed reform to improve its overall effectiveness — may represent an appropriate response. Some reform proposals may involve elements which are likely to impose large adjustment costs or cause markedly uneven distributional outcomes. Modifying these elements to promote better outcomes is likely to enhance the desirability of a reform proposal where alternative responses are not practical. It is important to target the problematic elements directly so as to minimise reductions to the potential benefits of proposals over the longer term. The application of the ‘no disadvantage’ test as part of the reforms to the industrial relations framework provides an example.

*Ex post modification* — considering the case for modifying a reform following its initial implementation — recognises that it is often difficult to deal fully with the adjustment and distributional consequences of a reform at the outset. Hence, it may be preferable to assess the case for modifying a reform as the implications of these consequences become clearer. This approach also enables policy makers to build a ‘learning by doing’ element into the reform process. The Commission inquiry into the *Impact of Competition Policy Reforms on Rural and Regional Australia* (PC 1999c) provides an example. The inquiry followed a request by a House of Representatives Standing Committee (Hawker Committee 1997) for a study of the extent to which the benefits of NCP were flowing to rural and regional Australia. The terms of reference for the inquiry stipulated that, amongst other things, the Commission should specifically report on any measures which should be taken to facilitate the flow of benefits (or to mitigate any transitional costs or negative impacts) arising from NCP reforms to residents and businesses in regional and rural Australia.

The successful implementation of reform may also be promoted by using a *combination of additional measures*. The introduction of the revised lifetime health premium arrangements covering private health insurance, for example, involved the provision of a nine month grace period, whereby people who joined private health schemes prior to July 2000 paid the base premium, regardless of their age. The grace period allowed people to assess the implications of the new arrangement and to respond accordingly. A grandfathering provision was also included to prevent any adverse impact on people aged 65 or over at the time of the policy change.

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# 1 About this paper

Structural change refers to compositional shifts in the economy — that is, changes in the relative size of industries, in the characteristics of the workforce and in the size and mix of activities within regions.

The sources of structural change are many and varied. They encompass market-related influences such as the introduction of new technologies and changes in consumers' tastes and lifestyles, as well as government-related influences such as changes in trade and investment barriers, reforms to infrastructure industries and changes to regulations affecting labour, finance and product markets (PC 1998b). Many of these government-related influences fall under the broad rubric of microeconomic reforms.

This paper focuses on policy issues arising from structural changes induced by microeconomic reforms.

Higher incomes, greater product choice and expanded employment opportunities are some of the benefits associated with microeconomic reform. Typically, many people share in these benefits. However, the changes induced by these reforms impose costs on some groups in the community (for example, job search and retraining, periods of unemployment and lifestyle changes).

Sections of the community are questioning whether microeconomic reforms have delivered their expected benefits. Some maintain that the benefits are small or insufficient in relation to the costs. Others are concerned that particular groups or specific regions are bearing a disproportionate burden.

Amongst the wide range of policy changes associated with Australia's program of microeconomic reform over the last 20 years or so, national competition policy (NCP) reforms have attracted particular attention. There are, for example, widely-held perceptions that these reforms have created social problems and accentuated inequalities in living standards between those living in the cities and those living in rural and regional Australia. These perceptions were communicated to the Commission during the extensive consultations associated with its inquiry into the *Impact of Competition Policy Reforms on Rural and Regional Australia*,

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culminating in the observation by the Commission (PC 1999c, p. xxiii):

Many people in country Australia see National Competition Policy (NCP) as an unprecedented outbreak of ‘economic rationalism’ which ignores important social issues and poses a threat to their way of life — adversely affecting their standard of living and the adequacy of services in country Australia.

Some inquiry participants argued that the process of NCP reform needed to be slowed or even halted. Others maintained that more needed to be done to assist or compensate those adversely affected by these reforms.

Following examination of submissions to the inquiry and its own analysis, the Commission found (PC 1999c, p. XLVI):

The effects on most, but not all, regions of the NCP reforms are likely to be less significant than those resulting from the broad economic forces which are continually reshaping economic and social conditions in Australia.

And:

Many people have a poor understanding of NCP and its effects. As a consequence, it has been blamed for adverse social and economic impacts resulting from a range of sources. This state of poor knowledge involves a risk that worthwhile reforms may be forgone and actions to overcome problems may be misdirected and ineffective.

Policy makers, economists, social scientists and others have for decades engaged in debate about the appropriate role for government in relation to structural adjustment, particularly where it is induced by policy changes. What is commonly agreed, however, is that in evaluating proposed policy changes, governments should take account of their overall benefits and costs, including the costs of adjustment, as well as their distributional impacts across different community groups and regions. However, beyond this, there is little consensus. Indeed, there are divergent views about how the costs of policy changes and distributional impacts should be reflected in policy design and implementation.

To explore these matters further, the Commission organised a workshop — *Structural adjustment – exploring the policy issues* (PC 1999g) — in Canberra in May 1999. The Commission asked five leading policy analysts — Fred Argy, Malcolm Gray, Wolfgang Kasper, Elizabeth Savage and Cliff Walsh — to address, amongst other matters, the question of how various adjustment and distribution issues should be most appropriately handled in evaluating the merits of proposed policy changes. The main thrust of their views is summarised in box 1.1.

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**Box 1.1 A summary of views on handling adjustment and distribution issues in evaluating proposed policy changes**

**Fred Argy** maintained that adjustment and distributional issues should be an integral part of the evaluation and design of reform proposals. He argued that the availability of a basic social safety net and the existence of favourable trickle down effects from growth-oriented reforms do not justify an 'efficiency only' approach to assessing reforms. Where ex ante identification of winners and losers is practical, it may be appropriate to provide direct compensation or modify a reform proposal prior to its implementation to enhance its effectiveness. He contended that, where such identification is not practical, the merits of ex post interventions to modify unacceptable distributional outcomes need to be considered.

**Malcolm Gray** recommended that adjustment and distributional issues be taken into account in any decision to adopt reform. He acknowledged that adjustment costs are difficult to estimate, but noted that comparative static modelling can generate estimates of some of the parameters of change, which can be combined with other information to indicate orders of magnitude. He argued that, where distribution effects are likely to be substantial, identification of their incidence and scale is an important first step in an iterative process of refining policy design.

**Wolfgang Kasper** considered that these issues should be treated with 'benign neglect' as there is simply no way of knowing all adjustment and distributional impacts in a complex and evolving economic organism. He argued that it is normally not feasible to differentiate in advance between different classes of adjustment costs and attribute them to specific policy measures. In his view, productivity-promoting reforms should not be hindered by inconclusive, drawn-out political debates about equity or regional impacts, most of which are unknowable and unprovable.

**Elizabeth Savage** maintained that adjustment and distributional issues should be incorporated directly into the assessment and design of reform proposals. She argued that policy makers should identify the welfare impacts of changes to the distribution of resources when policy reforms are designed. In her view, it is bad practice to introduce a policy change that may worsen efficiency or inequality, and then seek to address the adverse impacts after the event.

**Cliff Walsh** argued that the difficulties associated with evaluating the consequences of change, either for overall productivity and growth, or for distributional outcomes, are not a good reason for failing to evaluate them. In his view, policy decisions could be improved if more information were provided, especially about the distributional impacts of proposed changes.

*Source: PC 1999g.*

Underlying the varying views among these and other analysts, there were also differences of opinion about a range of related matters such as:

- how best to handle trade-offs between efficiency and distributional objectives, where they arise;
- the main rationales for government intervention in support of policy changes;

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- the relative merits of different approaches to policy implementation in terms of their ability to reduce the costs of change and/or moderate undesirable distributional impacts; and
  - the circumstances in which the social safety net and other generally available measures are likely to require supplementation.

This paper examines these and related policy issues. It draws on papers prepared for, and discussion at, the above mentioned workshop, together with the wider literature covering this challenging topic. The paper also draws on the Commission's experience in addressing these issues across a diverse range of public inquiries and research reports.

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## 2 The benefits and costs of policy changes

### Key points

- Much of the public debate about the merits or otherwise of policy reforms reflects community concerns about how their benefits and costs are evaluated. Common criticisms are that the costs are either ignored or given insufficient attention.
- Reforms are proposed by governments because of the considerable benefits they can bring to the community. Some of the benefits include lower prices, improved service quality and greater choice of goods and services. Reforms can also fuel improved economic growth, job creation and place communities in a better position to adapt to changing conditions.
- Often, however, there are costs associated with realising the benefits of reform. Adjustment induced by policy changes usually gives rise to a variety of costs including adjustment, redundancy and administration/compliance costs. There can also be indirect or flow-on costs on the activities of other firms or the labour market. Some of the impacts of policy changes — such as changes in asset values and incomes — give rise to offsetting gains and losses in the community; and as such are transfers rather than costs.
- A basic requirement for judging whether a proposed reform is worthwhile involves assessing whether, in aggregate, its expected benefits exceed its expected costs. With incomplete knowledge and inherent uncertainties about the impacts of policy changes, benefit/cost evaluations can be quite challenging.
- The costs of adjusting to a policy change are typically transitory in nature while the benefits of reform extend indefinitely into the future. In many cases, the costs of adjusting to a policy change are likely to be small relative to the benefits. This nevertheless needs to be demonstrated as part of the benefit/cost assessment.
- Where the costs of a policy change are likely to be significant, analysts should assess the potential for reducing them by, say, modifying the form of a proposed change and/or the process by which it is introduced.

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Policy changes, including microeconomic reforms, are initiated by governments because of the considerable benefits they can bring to the community. The benefits from reform arise as incentives and prices are changed to encourage Australians to make better use of their resources. Some of the benefits include lower prices, improved quality and greater choice of goods and services for households and businesses. Reforms can also fuel improved economic growth and job creation and place communities in a better position to adapt to changing conditions.

Realising the benefits of policy changes inevitably involves adjustment and this is not without cost. As the World Trade Organization (1997, p. 4) said:

Adjustment is at the core of a market system, and adjustment is not without cost. While economic policies may aim to improve the conditions for investment and growth — through infrastructural improvement, tax and tariff reform and prudent macroeconomic management — they can not reasonably guarantee prosperity without pain.

After many years of reform in Australia, there continues to be some scepticism within the community about the extent of the benefits and whether they are sufficient to offset the associated costs. Some claim that the benefits are inherently small, while others have suggested that the reform process has been ‘all pain and no gain’ for ordinary Australians. ACOSS (1999, p. 46), for example, in a report on reforms in community services, said:

... advocates of microeconomic reform and competition policy continue to argue that the benefits to date are substantial and that many more will flow. At times their faith in microeconomic reform and competition appear akin to blind faith ... The community is expected to trust that economic benefits will flow outwards and, ultimately if not immediately, be shared by everyone as improved living standards.

There are many in the community who are sceptical of these promises, particularly those whose quality of life has worsened over the past decade, for example, people facing long-term unemployment or experiencing the impacts of ‘structural adjustment’ in rural and regional Australia.

A common criticism is that, in some cases, the benefits from reform do not warrant the adjustment costs involved. For example, the Australian Industry Group in a Submission to the Productivity Commission’s *Review of Australia’s General Tariff Arrangements* (AIG 2000, p. 4), argued that:

...the overall allocative efficiency benefits stemming from an elimination of the general tariff are small and are likely to be outweighed by the associated adjustment costs.

Similarly, Webber (1997, p. 427), commenting on adjustment costs relating to reducing tariffs on passenger motor vehicles, said:

Even if the prospects of longer-term gains from cutting car tariffs seems to favour such a policy, the community may in fact be worse off due to the adjustment costs incurred. If these costs are high — as would be the case if displaced car workers are unable to

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find alternative employment — then the benefits of cutting car tariffs could well be outweighed by the costs incurred by those adversely affected by the policy. If that is the case, then it makes no sense to pursue a policy of further reducing car tariffs.

One of the dilemmas of reform is that the costs are often clearly visible, occur up-front and tend to be concentrated on particular identifiable groups, industries and regions whereas the benefits tend to be spread more widely (for example, through lower prices), and often take time to emerge. Also, where reforms threaten established privileges, it is not uncommon for affected groups to highlight the potential costs to them of losing such privileges. Not surprisingly, the debate about reform can become lopsided. As the Governor of the Reserve Bank recognised (Macfarlane 1998, p.2):

All too often, the debate is captured by those who lose from the process — and, as with any evolutionary change, there always are losers. Since these tend to be concentrated, vocal and well organised, and the beneficiaries dispersed across the population, debate can be one-sided.

But, despite this, various analysts and observers have suggested that when policy makers are evaluating reform proposals they ignore, or give insufficient attention to the cost side of the equation. For example, Quiggin (1998b, p. 9) commenting on a stylised framework used to assist in evaluating reform proposals, observed:

In the standard competitive model, the fact that firms may go bankrupt and employees lose their jobs as a result of the competitive process is not a cause for concern, since it is assumed that workers will immediately find new jobs elsewhere and firms' capital will be transferred into more productive uses. In reality, this is not the case. Workers displaced by competition may experience prolonged periods of unemployment.

If reforms that are in the interest of the community are to proceed, these concerns and criticisms need to be addressed. This involves explaining to the community what is at stake — that is, providing the best possible information and rigorous analysis of the expected benefits and costs and demonstrating that the reform is in the community's interest. Also, where appropriate, different implementation strategies should be examined and the basis for particular policy choices made clear.

Effective policy evaluation and implementation processes are fundamental to good policy outcomes. As the Chairman of the House of Representatives Standing Committee on Financial Institutions and Public Administration (Hawker Committee 1997, p. vi) said:

Society deals better with change when it: understands the rationale behind the decision making; can see a rigorous framework on which those decisions are based; is confident that those affected have been consulted; and believes all consequences have been considered.

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Against this backdrop, this chapter briefly reviews the main benefits from reform before looking at the costs of making policy changes. Reflecting community concerns about the adequacy of assessments of the costs of making policy changes, the focus of the chapter is on the cost side of the evaluation equation.

## 2.1 The benefits of making policy changes

Microeconomic reform is about improving living standards for Australians. Reforms achieve this by improving economic efficiency and productivity. There are three main components of economic efficiency — making the best use of our scarce resources, producing goods at least cost and adapting effectively to changing conditions so as to secure productivity gains over time (see box 2.1).

### Box 2.1 Components of economic efficiency

Economic efficiency is seen by economists as comprising three components.

*Allocative efficiency* is about ensuring that the community allocates scarce resources among different activities so as to get the greatest return (broadly defined). A nation's resources can be used in many different ways. An allocation of more resources to one activity will produce more output and income from that activity, but reduce output and income from other activities where the resources could have been used. Improvements in allocative efficiency bring about improvements in living standards as resources are used more effectively to generate more income and satisfy more needs and desires, but in ways that also reflect community wants.

*Technical efficiency* (sometimes called 'productive efficiency') refers to the extent to which the minimum required inputs of resources are used to produce goods and services, in accordance with economically-feasible technological and management standards. If waste is avoided in this way, improvements in technical efficiency can generate more income and bring improvements in living standards.

*Dynamic efficiency* refers to the capacity to generate the most from resources over time. This can mean not only finding better products, but also better ways of producing existing goods and services. Investments in education, research and innovation can be important in this regard. Dynamic efficiency can also refer to the ability to adapt quickly and at low cost to changed economic conditions and thereby maintain output and productivity performance in the face of economic 'shocks'. Improvements in dynamic efficiency are thus the key to achieving growth in living standards over time.

One way in which reforms can improve economic efficiency is by changing incentives and prices to encourage Australians to make better use of their scarce resources. Allocating resources so that the community receives the highest possible return brings improvements in living standards because resources are used to generate more income. Reforms which make producers and consumers conscious of

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‘true costs’ can also help to guide socially beneficial investments and provide price signals that prevent wasteful consumption of energy, water and other scarce natural and environmental resources.

Reforms can also encourage firms and service providers to be more productive. Many microeconomic reforms are about injecting more competition as a way of improving incentives or disciplines for firms and service providers to perform better. Firms may be induced, for example, to adopt more efficient work and management practices, to undertake research and development and to pay more attention to customer service. Productivity improvements effectively expand the nation’s resource base and its overall production potential. Benefits to consumers arise as prices are lowered and/or the quality of goods and services improves.

By generating higher levels of national income, reforms can fuel job creation and can place communities in a better position to adapt to changing conditions. The employment benefits from reform, however, tend to get overlooked — the community’s attention is usually on job losses associated with reform. As the National Competition Council in a report titled *National Competition Policy: Some Impacts on Society and the Economy* (NCC 1999b, pp. 58-9) said:

... a number of businesses newly exposed to reform are likely to shed jobs in the short term at least. This has been observed, for example, in regard to some electricity and telecommunications businesses.

However, there are likely to be employment gains, particularly in other industries. Competition helps to lift productivity, bringing cheaper prices for the products of newly exposed industries. This boosts the real incomes of Australian households, stimulating higher levels of consumer spending, in turn encouraging firms to increase production and employ more workers.

... It is not always easy for people to make the connection between competition reforms introduced several months ago in a particular industry and new jobs being created in unrelated industries, in some cases, thousands of kilometres away.

Despite some people being sceptical about the benefits, there is growing evidence of substantial gains from reform. While it is difficult to disentangle the separate contribution of reform from other changes observed in the economy, a number of analysts maintain that the sizeable improvements in Australia’s productivity, real income and employment growth in the 1990s reflects, at least in part, significant reforms over the last decade (see, for example, OECD 2001; Edwards 1999; Parham 1999; PC/ANU 1998; PC 1998a, 1999d; Reserve Bank of Australia 1999; Treasury 1999). For example, the OECD (2001, p. 77) in its latest economic survey for Australia observed:

Given the expected lags between the implementation of reforms and their impact on the behaviour of individuals and the reallocation of resources, the timing of the pick-up in

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multifactor productivity growth in recent years makes its interpretation as a response to the broad range of microeconomic reforms of the 1980s and the 1990s highly plausible.

While Edwards (1999, p. 1), commenting on the impressive performance of the Australian economy against the backdrop of the East Asian currency and banking crisis, maintained that:

... the economy's resilience largely stems from a transformation in its structure that is only now widely understood. The change — 15 years of vigorous economic reform in the making — has allowed Australia not only to withstand recession in the majority of its export markets, but to maintain one of the highest OECD growth rates through the nineties.

There is also considerable evidence across the economy of reforms benefiting both consumers and producers. For example, while the major reforms of government business enterprises have required considerable adjustment by managers and workers, in many areas there have been substantial reductions in prices to consumers and user industries and improvements in productivity (PC 1998a).

### **Assessing the potential benefits of policy changes**

The challenges facing analysts in assessing the potential benefits of reform proposals vary. In some instances, the benefits can be readily identified and are amenable to reasonably reliable quantification — for example, further reductions in tariffs and the commercialisation of publicly-owned enterprises. At the other end of the spectrum, the task can be much more involved. For example, in its report on the merits or otherwise of applying a ban to the production and sale of battery eggs in the ACT, the Commission (PC 1998c, p. 113) noted:

... there is little agreement about the effects on animal welfare of different egg production systems. However, based on the most authoritative studies in this field, the Commission considers it likely that a move away from battery cage systems towards alternative systems, such as barn-lay, would result in some improvement in hen welfare,... . Neither the extent of the improvement in hen welfare as a result of the ban nor the benefits derived by the community are amenable to reliable quantitative assessment.

The dynamic efficiency effects of reforms are the most difficult to measure, and the nature and significance of these effects have been contested. Some (such as Quiggin 1996, 1998a) have suggested that they are modest. Others (such as Corden 1974 and EPAC 1996a) argue that they are larger than the gains from improved allocation of resources. Analysis of the so-called 'cold shower' effects of competition-enhancing reforms and improvements in production and investment flexibility made possible by regulatory reforms suggest that dynamic gains can be quite important (see, for example, Winston 1993, OECD 1997 and PC 1999d). Commenting on this, in the

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context of the Commission's Review of Australia's General Tariff Arrangements, Professor Ross Garnaut (2000, submission D164, p. 1) observed:

The processes through which these additional gains are generated are subtle, and not amendable to precise measurement, but they are widely recognised by analysts of the process of economic development. ... Rather, there are additional gains that in their nature cannot be incorporated into quantitative economic models in a convincing way in the current state of art.

Reflecting these considerations, any evaluation of the potential benefits of a policy change will need to take account of the circumstances of specific proposals. In practice, a range of qualitative and quantitative measures need to be examined to build a picture of the likely benefits. Such assessments need to take into account changes in relative prices and likely responses to them, changes in service quality (such as wider product choices, improved reliability and timeliness), and any potential dynamic effects arising from changes to regulatory or institutional arrangements which could encourage improved productivity or cost savings.

As a general rule, it is also desirable to highlight areas where information is incomplete or the effects unclear. Also, since the benefits and costs of a policy change are likely to be distributed differently over time, it is often desirable to measure them in present value terms. This is because the community is unlikely to be indifferent between a policy change that yields benefits immediately and one that yields delayed benefits, particularly since the costs of making a policy change are usually incurred up-front.

## **2.2 The costs of making policy changes**

There are costs associated with realising the benefits of reform. The process of change induced by reform usually brings about some reshuffling of resources which can take time and involve some costs. For example, displaced workers are often not re-employed immediately, and it can take time to transfer equipment to other types of production. Similarly, changes to the financing and delivery of social services are likely to require adjustments by recipients as well as by service providers.

Many of the costs of policy change fall directly on individuals and firms. Displaced workers are likely to incur a loss of earnings while unemployed, and earnings when re-employed may be lower than if the worker had been able to remain in the previous job. Policy changes may also result in asset losses for firms. Many of these costs (using the term loosely) are, however, balanced out by gains to other individuals and firms within the community. For example, in commenting on the costs of trade liberalisation to workers and entrepreneurs, the World Bank (1997a,

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p. 58) noted:

Private costs of adjustment arise not only as a result of transitional unemployment but also when some workers and entrepreneurs — particularly those in once protected import-competing sectors — find their skills, talents and investments worth less after liberalisation than before because of permanent changes in returns to factors of production brought about by trade liberalisation. Specific groups of workers and firms also suffer from the destruction of rents they had previously shared in protected sectors. These private costs are virtually inevitable and can be large for the individual who bears them. The reverse side, of course, is that other workers and entrepreneurs— particularly those in export sectors — find their skills, talents, and investments worth more after reform.

Losses of income and wealth experienced by some workers and firms as a result of policy changes, while a cost to the affected parties, need not represent an economy-wide cost (that is, a net cost to the community). Where losses to one group are balanced out by gains to another, they are more accurately viewed as transfers from one group in the community to another. For example, deregulation of the dairy industry is expected to involve a transfer of income from dairy farmers to other groups, including consumers, in the form of lower milk prices. That is, while dairy farmers will incur a loss as their incomes decline, consumers will experience a gain from lower milk prices. From a national perspective, these transfers do not represent a cost to be offset against the efficiency-related benefits of deregulating the dairy industry.

The losses and gains associated with such transfers are real and important to the affected groups — that is, they have distributional consequences which governments may want to take into account for equity and fairness reasons. Governments may judge it appropriate to provide compensation to those who incur losses from policy changes that are in the interest of the wider community, particularly where they involve relatively large and unexpected changes (see chapter 3 and section 4.2).

### **What are the costs to the community of adjusting to policy changes?**

The economy-wide costs of adjusting to a policy change can be broken down into *direct* and *indirect* costs.

Costs *directly* borne by workers, firms and consumers during the process of adjusting to a policy change can include:

- Adjustment costs. These arise because a policy change requires workers, firms and consumers to engage in adjustment related activities. For example, workers may need to make changes within their existing jobs, seek new employment,

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retrain or move between regions. Firms will incur costs as they modify or dismantle existing plant and equipment and/or transport and refit it at a new location. Resources used during the adjustment process which produce benefits for workers, firms and consumers need to be offset against any adjustment costs.

- Redundancy costs — comprise output or consumption forgone where a policy change gives rise to unemployment or underemployment of labour and capital.<sup>1</sup> Again, any additional consumption or output induced by the same policy change elsewhere in economy would offset, to a larger or smaller degree, any output or consumption forgone.
- Compliance and administration costs. Examples of such costs include cases where changes to regulations and tax provisions often require individuals and firms to undertake various tasks to comply with their provisions. There are also associated costs for relevant government agencies. Often, however, reforms are directed at lessening these costs to individuals, firms and administering agencies alike.

*Indirect costs* associated with adjusting to a policy change can arise when the adjustment responses of individuals and firms affect the labour market and the operations of other firms. A large-scale lay-off of workers in a region that is already facing high levels of unemployment, for example, is likely to affect the employment prospects of existing unemployed workers in that region adversely. The most recently displaced workers will, in general, have better re-employment prospects and their presence can lengthen the duration of unemployment for the remaining unemployed.

Related to this, workers who experience prolonged periods of unemployment often suffer deterioration in their work skills and can find it increasingly difficult to return to work. To the extent that this effect is magnified by new additions to the unemployment pool, it represents a further potential indirect cost (see, for example, Bradbury et al. 1990 and Junankar and Kapuscinski 1991). Unemployment, particularly for long periods of time, can have adverse consequences for workers' health — for example, increased stress and loss of confidence. Some of these adverse effects flow on to the worker's family and society more generally and, in

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<sup>1</sup> Redundancy costs could be quantified by estimating the value of forgone consumption or output possibilities attributable to the under-use or unemployment of resources. Alternatively, it may be easier to derive an estimate of these costs by valuing the wages forgone by under employed or unemployed workers and/or the discounted value of the future stream of production available from the continuing employment of idle capital for its remaining life. This alternative approach was used by the Commission in its reports on battery eggs (PC 1998c) and review of Australia's tariff arrangements (PC 2000).

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the process, generate further indirect costs (see, for example, EPAC 1992, Junankar et al. 1992, National Health Strategy 1992 and McClland 1993).

At the firm/industry level, changes in the size of some activities can influence the viability of other activities. For example, the closure of a number of firms within a region in response to a policy change can affect the output of, and employment in, other firms as well as the availability and accessibility of goods and services to consumers.

These indirect costs represent costs to workers and firms and to the community as a whole and in principle need to be added to the direct costs to reflect the overall economy-wide cost of making a policy change. While in many cases, these costs may be relatively small, for some policy changes, they have the potential to be large, particularly in a regional context. Quantifying these costs is often a difficult task — many of the potentially relevant indirect costs are intangible in nature. While this does not lessen their importance and their contribution to the overall costs of change, it does point to the need for a pragmatic approach — namely, attempting a more detailed analysis only where they are likely to be significant.

### **Factors influencing the magnitude of the costs of making policy changes**

The magnitude of the costs associated with making policy changes and the ease with which adjustment occurs are shaped by three broad influences; the nature of the reform, the broad characteristics of the affected parties, and the general state of the economy and labour markets.

The *nature of a reform proposal* exerts an important influence over the associated adjustment process and the extent and pattern of related costs. Some reforms are limited in scope — affecting only a small part of firms' activities or only a few industries — and can be expected to produce relatively small pressures for change (for example, modifications to environment regulations involving a shift away from prescriptive 'command and control' regulations to an approach that allows greater flexibility in meeting regulatory standards). Other reforms — such as the implementation of the GST — involve relatively small changes across a wide range of industries, but entail larger changes for a few industries. And some reforms (such as in infrastructure services) involve extensive changes and, in consequence, require closer analysis of the magnitude of related costs and the possible need for transitional arrangements to facilitate the adjustment process.

The timing and pace with which reforms are introduced can also influence the costs arising from policy changes, in particular the extent of redundancy costs for labour

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and capital. As these factors also affect the flow of benefits, a careful assessment of the associated trade-off is required. Further, some reform proposals (such as improvements to the education and training system) involve changes which enhance the capacity of workers and firms to undertake adjustment in response to other policy changes and/or market-based pressures, thus reducing adjustment costs.

The magnitude of the costs associated with policy changes and the ease with which they are accommodated is also shaped by the *characteristics of the firms and workers affected*. Where firms can readily reduce their costs by improving the efficiency of their operations, exposure to increased competition is less likely to involve large and potentially disruptive changes such as plant closures. Such closures add a ‘lumpy’ dimension to the adjustment process, which is likely to involve significant costs in regions with limited alternative employment opportunities.

If large components of a firm’s capital resources (such as plant and equipment) are highly specialised, redundancy costs may be relatively high. Similarly, where the transitional provisions associated with a new regulatory standard involved an abrupt change, they may well induce premature scrapping of non-transferable, but otherwise productive, assets. In such a case, the consumption possibilities forgone (until the previously employed assets wear out) are an element of the overall cost of making a policy change.

The costs arising from change borne by employees are influenced by their characteristics. For example, where a policy change results in the displacement of workers who have highly specific firm or industry skills and/or are older, low skilled and have limited English, the overall costs of the change may be higher. Many labour market studies indicate that a substantial proportion of displaced workers are re-employed relatively quickly, but it is also common for a sizeable proportion to remain unemployed many months after being made redundant, while others withdraw from the workforce altogether (see box 2.4). This suggests that, in assessing labour market related costs associated with policy changes, consideration needs to be given to the likelihood of varying periods of unemployment for different groups of displaced workers.

Finally, where the *economy is experiencing relatively rapid growth*, capital and labour resources will, in general, be more readily absorbed by other industries than during periods of relatively slow growth or recession. Of course, *labour market conditions* vary across regions and, as a result, local conditions will be important. The adjustment and redundancy costs facing displaced workers are typically higher in regions characterised by narrow employment bases and rates of unemployment above the national average.

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An illustrative list of factors that can contribute to relatively ‘high’ adjustment and redundancy costs and can signal a ‘potential adjustment problem’ are presented in box 2.2.

**Box 2.2 Factors which may contribute to ‘high’ adjustment and redundancy costs and signal a ‘potential adjustment problem’**

In general, adjustment and redundancy costs are likely to be higher where:

- a proposed reform involves a relatively large shock, such as a large reduction in the expected profitability of an industry (for example, a large reduction in the price realised for an industry’s output);
- a sizeable proportion of firms within the affected industries are only marginally profitable, and hence have only a limited capacity to absorb a price reduction;
- the adjustment process involves a rate of job turnover much faster than usual;
- displaced workers are inexperienced, older and/or have highly specific skills that are not readily transferable to other industries;
- the economy is subject to high levels of unemployment and relatively slow or negative rates of demand growth; and
- adjustment is concentrated in regions characterised by narrow employment bases, slow or negative rates of demand/employment growth and relatively high levels of unemployment.

## **Incorporating the costs of policy changes in an evaluation**

Assessing the costs of making a policy change can be quite challenging, for a number of reasons.

Firstly, adjustments induced by policy changes do not occur in isolation from other changes, such as changes in technology and consumer tastes. A thorough assessment would require that the costs of making a policy change be separated from these other influences but, the contributions of many of the drivers of adjustment are largely unknowable in advance, particularly at the firm and industry level. And, historical rates of adjustment often do not provide a useful guide to the likely future rate of adjustment. Reflecting these considerations, Kasper (1999, p. 145), for example, observed that:

It is normally not feasible to differentiate ex-ante between different classes of adjustment costs and attribute them to specific measures.

Secondly, the adjustment responses of workers and firms (including the ease with which they undertake adjustment) tend to vary considerably. Inquiries by the

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Commission covering a wide range of industries attest to the diversity of the adjustment process and the difficulty of assessing in advance the magnitude of adjustment likely to accompany particular policy changes. The Industry Commission's 1997 textiles, clothing and footwear inquiry report (IC 1997c) included some comparisons which highlight this difficulty (see box 2.3).

**Box 2.3      The challenges of making a prior assessment of the effects of a policy change on an industry's output — an example**

In the 1986 Industries Assistance Commission (IAC) inquiry, the Textiles, Clothing and Footwear Council of Australia provided estimates of the likely response of the TCF industries to reductions in barrier assistance to a maximum tariff equivalent of 50 per cent over the seven years from 1988 to 1995. Under the Industry Plan actually implemented, the maximum TCF tariff in 1994-95 was 43 per cent and bounties and quotas were removed. That is, there were greater reductions in barrier assistance than those assumed by the industry in preparing its estimates.

The industry's stated expectations of the effects of reduced protection, compared to the actual outcomes over the period 1988-89 to 1994-95, are outlined below:

- the yarn sector would 'disappear' — in fact, gross product at factor cost in the wool, cotton and synthetic textile industries fell by less than 1 per cent;
- activity in hosiery would fall by 75 to 80 per cent — hosiery gross product at factor cost fell by 37 per cent;
- all manufacturers in 'other knitted goods' would cease production — 'other knitted goods' gross product at factor cost fell by 30 per cent;
- no domestic production of sleepwear would be viable — sleepwear gross product at factor cost fell by 14 per cent and sleepwear exports rose by 680 per cent; and
- footwear production would drop by 75 per cent — footwear gross product at factor cost fell by 37 per cent.

*Sources:* IAC 1986 and Commission estimates derived from unpublished ABS Manufacturing Industry data — see Appendix B (reported in IC 1997c, p. 6).

Thirdly, the adjustment process may not be linear in nature and may, therefore, be better represented as a series of 'trigger points' at which critical decisions are taken — for example, for firms, whether to continue or scale down production; and for workers, when to change employer, industry or locality. These 'trigger points' are influenced by a wide range of factors, of which a specific reform proposal is only one. This was recognised, for example, by the Industry Commission in its Automotive Industry report (IC 1997a, vol. 1, p. 338) where it observed:

... because of the nature of the industry's production processes, any significant disinvestment in the automotive industry is not likely to occur by a process of gradual

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attrition, but in a lumpy nature. This suggests that there are ‘trigger’ points at which decisions might be made to continue or to scale down production.

... To the extent that tariff levels are relevant to investment and adjustment decisions, it is difficult to claim that a reduction in tariff of 1 per cent, 2.5 per cent or even 5 per cent would provide the trigger.

A practical implication of this feature of the adjustment process is that various costs arising from policy changes may be postponed until a ‘trigger point’ is reached, at which time the costs may emerge in a lumpy manner.

Finally, as with other aspects of policy evaluation, an analysis of the costs of change is constrained by available knowledge and inherent uncertainties about key behavioural variables (such as the responsiveness of firms’ employment and investment decisions to changes in product or input prices).

Despite the difficulties, it is often feasible to provide a broad indication of the likely magnitude of the costs of making a policy change and the likelihood of an adjustment problem. Such analysis could assist policy makers to identify opportunities for reducing these costs as well as providing a counterbalance to the often exaggerated claims of vested interest groups. Several participants at a Commission workshop on *Structural adjustment — exploring the policy issues* (PC 1999g) and another workshop on labour market research (PC 1999a) observed that there is a need to develop better dynamic modelling frameworks to aid decision making in this area.

Several sources of information are available for assessing the likely adjustment impacts of proposed reforms, including consultations with affected parties, industry studies, surveys and data bases, and quantitative modelling work (see box 2.4).

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**Box 2.4      Assessing adjustment impacts of reforms — potential sources of information**

*Consultations with affected parties* — the Commission's public inquiry processes and the mechanisms associated with other reform reviews provide opportunities for the presentation and analysis of the views of the various interest groups. For example, the Queensland Dairy Legislation Review Committee, in seeking to determine whether restrictions on competition for the state's dairy industry should be retained, considered survey information provided by farmers on how they would respond to a decline in the farm gate price of milk of 10 cents or more. According to this information, 34 per cent of farmers in South-East and Central Queensland and 40 per cent of farmers in Northern Queensland claimed that they would leave the industry in response to a price decline of this order. In considering this information, the Committee sounded a note of caution (Queensland Dairy Legislation Review Committee 1998, p. 143):

Given the context of the survey, these estimates would probably be considered at the extreme end of what would happen. This is because individuals may recognise that their responses could influence the policy decisions and so they adjust their responses accordingly, potentially exaggerating likely impacts.

*Industry studies, surveys and data bases* — a number of ABS labour force surveys and specific studies covering the adjustment experiences of retrenched workers in different industries/regions are available to assist the analysis of adjustment in similar industries and/or regions (see, for example, surveys by Webber et al 1996, Borland 1997, Wooden 1988 and the BIE 1983, and articles by Webber et al. 1995, Curtain 1987, Borland et al. 2001, Le and Miller 1999, Stromback et al. 1998 and Murtough and Waite 2000). These surveys/studies emphasise the importance of examining general labour market conditions and specific worker characteristics, as well as the number of displaced workers relative to the size of the local labour market and overall employment growth. Where no relevant studies exist, specific studies can be commissioned to assess the likelihood and sources of any potential labour market adjustment problems and/or how firms might respond to reform proposals (see, for example, BIE 1996 a,b).

*Quantitative modelling work* — general equilibrium models, such as ORANI and MONASH, can be modified to enhance their suitability for analysing adjustment issues. For example, in its *Review of Australia's General Tariff Arrangements* the Commission used the labour input loss index developed by the Monash Centre of Policy Studies to undertake a more detailed assessment of labour adjustment costs associated with the removal of tariffs (PC 2000). While data limitations and inadequate knowledge of key behavioural variables inevitably limit the capacity of these models, they can nevertheless provide some guidance on broad orders of magnitude. Where there is uncertainty about the appropriate values of key variables, sensitivity analysis can be used to illustrate the significance of varying key assumptions.

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### *How much analysis?*

Given that most of the costs of accommodating policy changes tend to be transitional in nature while the benefits typically extend indefinitely into the future, it could be claimed that the costs can be largely ignored because they will be small compared to the benefits of a policy change. But, as Gray (1999, p. 106) argues:

Although an attractive simplification of the problem of policy design, commonsense and the practical realities of community decision-making suggest that this argument should be set aside.

The likelihood of the costs of policy changes being small relative to the benefits needs to be demonstrated, not simply asserted or presumed.

Further, it may be possible to reduce or avoid some of these costs through the design of appropriate policy responses. For example, weaknesses or failures in the market and institutional framework within which firms, workers and consumers operate may lengthen the process of adjustment and raise the costs associated with policy changes. Where these can be corrected by appropriate government action, the associated costs may be reduced or avoided (see section 4.4). In other cases, it may be feasible to reduce costs by directly modifying a reform proposal (for example, by phasing in a reform as opposed to introducing it immediately). Where the costs of making policy changes can be influenced in this way, it is appropriate to review both the costs and benefits of different ways of implementing a policy change (see chapter 5).

The key question is how much analysis is needed to allow policy makers to be confident, and to instil confidence in the community, that the long-term benefits from a reform will outweigh the expected costs of reform.

The need for detailed analysis, and the form of analysis will vary. For example, in its recent *Review of Australia's General Tariff Arrangements* (PC 2000) — which assessed the potential benefits and costs of a further reduction in general tariffs — the Commission devoted considerable attention to adjustment issues. The Commission concluded that further tariff reductions would involve a number of costs which, whilst potentially significant for some individuals and firms, would be slight overall and considerably less than those arising from other sources of change, such as advances in technology and exchange rate fluctuations. The Commission judged that the necessary adjustments were capable of being accommodated by the generally available social safety net and existing employment assistance programs, without the need for a prolonged phasing period.

Although labour market issues tend to be the focus of most adjustment analysis, the implications of reform for adjustment by firms and consumers are also relevant. For

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example, in its assessment of whether the benefits from banning the production and sale of battery eggs in the ACT were likely to exceed the costs, the Commission's analysis included an allowance for the premature redundancy of capital within the industry (as a proxy for foregone consumption possibilities) as well as for the higher price of eggs to ACT households (PC 1998c). Drawing on an independent valuation of the facility that would cease production in the event of the ban proceeding, the Commission estimated a social loss of no more than \$4.4 million (equal to an annual perpetuity of some \$290 000), from the premature scrapping of some existing battery cage production capital.<sup>2</sup> The annual cost to consumers of higher egg prices arising from the ban was estimated to be around \$650 000.

In general, the Commission considers that the extent of analysis needs to reflect the likely significance of the costs of making a policy change — that is, it needs to be pragmatically based and focused initially on three broad influences; the nature of the policy change, the broad characteristics of the affected parties and the general state of the economy and local labour markets.

Where the change related costs are likely to be small compared with the benefits of a reform, and can be readily accommodated, no further analysis would be required. However, where the costs of making a policy change are assessed as likely to be significant, further analysis would be appropriate to:

- assess the extent to which an 'adjustment problem' may arise and, where appropriate, highlight areas where the estimates of costs are sensitive to key assumptions;
- identify whether government action may be appropriate to address market and/or institutional impediments that increase the costs of making a policy change;
- ascertain the adequacy of existing government programs (such as the social safety net and other generally available adjustment measures) in providing assistance to those who are adversely affected;
- assess whether the expected costs of making the policy change may be reduced (without unduly eroding the benefits) by modifying its form or implementation; and
- identify whether there is a case for including a review or monitoring arrangement to facilitate subsequent refinements to the proposal following its

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<sup>2</sup> In discussing this issue, the Commission noted that, to the extent that this capital can be purchased and used elsewhere, there is no cost to society apart from the transaction costs involved (for example, the cost of dismantling the existing plant and arranging its transport and refitting at new locations). Estimating costs of this nature is particularly difficult. For a fuller discussion of the issues see PC 1998c (pp. 66-69).

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implementation. This is likely to be appropriate where the costs of a reform proposal are unclear, but have the potential to be large.

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## 3 The distributional impacts of policy changes

### Key points

- Policy changes inevitably have distributional implications.
- Governments and the community are interested not only in the aggregate net effects of a reform, but also about who broadly gains and loses.
- Public debate about the distributional impacts of policy changes often focuses on the short term or direct effects of reforms on individuals and households. But the indirect and longer term effects, while often less evident, are also important. Indeed, the multifaceted nature of distributional effects highlights the inherent dangers of attempting to assess them within a partial or static framework.
- While a variety of factors constrain the scope for analysts to assess distributional consequences, it is usually practical and desirable to provide indicative assessments of the main impacts to guide policy makers.
- If a proposed policy change encompasses an area with specific distributional objectives, the cost effectiveness of alternative measures for achieving these objectives should be assessed.
- If a proposed policy change is likely to give rise to substantial and uneven distributional consequences, the main impacts on different groups need to be identified, together with the desirability and feasibility of offsetting the more adverse impacts.
- While the potential for conflict between efficiency and distributional (as well as other) objectives underlying policy changes can be overstated, situations do arise where judgements about appropriate trade-offs between these objectives have to be made.
- In such cases, the associated trade-offs need to be identified and information provided to help policy makers appreciate the implications of different policy choices. Where an assessment of the different outcomes of a proposed policy change against its stated objectives yields an ambiguous result, it is still desirable to describe the nature and assess the implications of such ambiguity and to canvass options for handling the situation.

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Policy changes have distributional consequences. Reforms often involve changes in asset values as regulations governing the operation of different markets are altered. Also, moves towards more efficient pricing of infrastructure services (such as electricity, water and telecommunications) can have differing effects across user groups — some may face higher charges, others lower.

There are concerns within the community that the benefits of policy changes have not been evenly shared and that some groups are bearing a disproportionate share of the burden of change. For example, in its 1998 federal election statement, the Australian Council of Social Service (ACOSS 1998, p. 1) said:

The process of economic reform has certainly made the Australian economy more efficient and competitive, and boosted our collective wealth. But this increased wealth, to which all have contributed, has not been equally shared. We are in danger of forgetting that the purpose of an efficient economy is to improve people's lives.

Argy (1998, pp. 15–6) also argues that:

The role of an economy is not simply to deliver improvements in average material wellbeing. It is to improve social welfare (i.e. the overall wellbeing of Australians) and that is a much broader, tougher and complex performance test than average incomes per head. In particular, we need to take account of trends in: the availability of work for those who want it; the quality of life; and the distribution of welfare — both within and between generations.

While reforms are about bringing overall net benefits to the community, it is also the case that the benefits and costs, as well as transfers of income and wealth, are unlikely to fall evenly — some individuals, industries and regions will emerge as winners from reform, while others may lose, at least in the short term. Judging whether a policy change is worthwhile, therefore, requires consideration of its likely distributional consequences and their implications, having regard to relevant social welfare and equity objectives.

This chapter first briefly outlines why it is important to consider the distributional impacts of policy changes, before discussing the challenges associated with assessing them and why such assessments need to be adapted to the circumstances of particular reform proposals. It concludes with a discussion of ways in which advisers can assist policy makers to handle trade-offs between efficiency and distributional (and other) objectives where they arise.

### **3.1 Why distributional impacts matter**

Attempting to assess the distributional effects of policy changes should be integral to the evaluation of reform proposals. There are five main reasons for this.

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Firstly, policy evaluation needs to extend beyond consideration of whether a proposal increases the ‘size of the national pie’. Measures such as changes in GDP and the aggregate level of real consumption have limitations as measures of community welfare, quite apart from questions associated with distribution. They are deficient where potential reforms involve significant transfers of income or wealth between firms and individuals and disparate sharing of the benefits and costs. Typically, the concern of governments is not only about the aggregate net effects of a reform, but also about who benefits, who loses and by how much.

Indeed, while there are differing views about the implications of distributional considerations for the design and implementation of reform, most analysts agree that distributional consequences are an important consideration in the evaluation of policy options. For example, as Argy (1995, p. 68) states:

... public policy is about distribution just as much as efficiency, and economists who ignore distribution (because of a reluctance to indulge in inter-personal comparisons) are marginalising their contribution to policy; furthermore they run the risk that governments, in an attempt to deal with distributional effects, will adopt a third or fourth best reform option.

Much of the recent debate about the desirability and appropriate form of a goods and services tax (including the need, if any, for compensatory arrangements), for example, focused on the distributional impacts of the tax, including the likely effects on the most vulnerable groups in the community. Also, the recent inquiry into the *Impacts of Competition Policy Reforms on Rural and Regional Australia* (PC 1999c) was initiated in response to concerns about how the benefits and costs of such reforms were affecting those regions, and the government’s desire that the ‘benefits of increased competition in the economy flow to all Australians, including those living in rural and regional Australia’ (Costello 1998b).

Secondly, identifying the likely distributional consequences of different reform options can help to establish the most effective and efficient means of pursuing distributional objectives. The NCC (1999b, p. 64) considers that: ‘in addressing equity, it is important that the measures used achieve their objectives as efficiently as possible’. In practice, there is no costless way of achieving distributional aims — and the tax/transfer system may not always be the most cost effective (see, for example, Findlay and Jones 1982, Diewert and Lawrence 1994, Freebairn 1995, Quiggin 1996 and Stiglitz 2000). Consequently, the effects of different forms of redistribution need to be assessed in evaluating the merits of different policy options.

Thirdly, information on the potential distributional implications of a reform can assist policy makers in designing and implementing reforms so as to offset the more adverse impacts. Various strategies can be adopted to achieve this end, including

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phasing, broad-based reform or providing direct compensatory assistance (see chapter 5).

Fourthly, as recognised by the World Bank (1997b, p. 145), ‘... resistance to reform is often triggered by the potential redistribution of resources among different groups’. Consequently, providing information on the distributional consequences can play an important role in promoting community understanding about the likely impacts and, thereby, in obtaining a more balanced assessment of a reform proposal. For example, work demonstrating the regressive incidence of Australia’s import tariffs has been used to support the case for trade liberalisation (IAC 1980, CIE 1996).

Finally, distributional outcomes are important in underpinning efficiency and growth — reforms that are judged to be equitable or fair are more likely to be sustainable (Tanzi et al. 1999).

### **3.2 Assessing distributional impacts in practice**

Reforms can give rise to a wide range of distributional impacts, of which the incidence of the costs resulting from a policy change is only one dimension. Other dimensions, which vary according to the characteristics of particular reform proposals may include income and wealth transfers between different groups of workers, firms and consumers arising from changes in the relative prices of goods or services, changes in the distribution of activity and employment across industries and regions, and changes in the incidence of benefits and costs associated with government programs between different groups.

These effects are likely to vary depending on the time frame used (that is, whether the analysis is essentially ‘static’ in nature — related to a particular point in time — or ‘dynamic’, having regard to how the effects may change over time and between generations). The multifaceted nature of these dimensions points to the inherent dangers of limiting evaluations to a partial or static framework.

While the main income transfers and benefits and costs for some sub-groups of the population can often be broadly identified, for reasons outlined above, these provide, at best, only a first round approximation of the full distributional impacts of reform proposals. More detailed *ex ante* analysis is, however, far from straightforward.

Although reform proposals are intended to yield net benefits to the community they inevitably produce ‘winners’ as well as ‘losers’. This is because they entail changes to existing policy settings which themselves were often intended to favour some

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groups in the community relative to others. Typically, there are more ‘winners’ than ‘losers’, although the individual gains for the ‘winners’ are often small and widespread whereas the losses for the ‘losers’ are often more significant and concentrated. Concerns about losses tend to be expressed more strongly than support for gains. Policy makers need to be conscious of this imbalance.

In principle, the pre-reform distribution of income, wealth and resources is not sacrosanct. Indeed, it may be judged to be ‘unfair’ reflecting the outcomes of past policy decisions which bestowed questionable ‘privileges’ on particular groups. Accordingly, the distributional consequences of proposed policy changes need to be assessed on their own merits focussing on the specific effects attributable to the changes themselves. Questions relating to the equity or fairness of the overall distribution of income and wealth raise wider issues which extend beyond the evaluation of specific policy proposals.

A range of factors (both market and government-related) influence the distribution of income, wealth and activity at any time, and over time, making it difficult to identify the impacts of a reform proposal separately. In this context, it is important to use an appropriate point of comparison, or counterfactual, for assessing the distributional incidence of reform proposals. Simply using existing distributional outcomes as a benchmark may be inappropriate. If existing policy settings are flawed or capable of improvement there are opportunity costs associated with a ‘no reform option’ if the alternative (that is, reform) would improve distributional outcomes. One example could be where the quality of life of patients deteriorates in the absence of hospital reforms directed at meeting their needs. Where there are a number of reform options, these opportunity costs might reflect variations in the cost effectiveness of different approaches to achieving a desired policy goal.

Assessing the distributional impacts of changes in consumption patterns resulting from infrastructure price changes illustrates the complexity of ex ante assessments. Such reforms may mean that low income and low use households benefit under a user-pays regime, while others face larger infrastructure service bills. There may be behavioural changes in response to price changes which are difficult to assess in advance. The overall complexity of the task was captured by Argy (1999, p. 60):

The effects on regional or household distribution are not easily assessable and predictable in advance. Winners could be shareholders, consumers, particular groups of workers, etc, but it would be impossible to know in advance. The losers too are hard to pick specifically ex-ante, even though they may well be the more vulnerable workers in the community. This problem is compounded by lack of adequate data on how different reforms impact on particular households and how genuinely ‘poor’ some low income households are.

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Public debate about the distributional impacts of policy changes often focuses on the short term or direct adverse effects of reforms on individuals and households. Indirect and longer term effects are less evident, but are also important. Previous research by the Industry Commission into the effects of price changes for some utility services has revealed that even where the narrowing of cross-subsidies had seen prices to households rise, when the indirect effects through lower business costs were accounted for, most households benefited overall, including those on lower incomes (IC, 1996b). A number of commentators have noted that perceptions of distributional equity can be greatly affected by the time period under consideration (Stoeckel 1999, Moore 1999 and Saunders 1999). Saunders (1999, p. 258), for example, has called for improved longitudinal data to ‘provide better estimates of how policy changes affect individuals over time and how enduring those changes are’.

Finally, it may be appropriate to assess the impacts of individual reform proposals in a wider context which recognises that there can be offsetting effects where several reforms are occurring at the one time — that is, losers from one reform may be winners from another. For example, Industry Commission work (IC 1996b) on the combined effects of reforms on the distribution of income, in the areas of trade, electricity, telecommunications, competitive tendering and contracting of government services found that, collectively, these reforms increased the incomes of both low and high-income households, with the income gains being fairly evenly distributed.

Various techniques can be used to assess the distributional impacts of a proposed reform (see box 3.1) including:

- *Aggregate transfer measures* such as gross and net subsidy equivalents, taxes on materials and consumer tax equivalents, measure the income transfers to producers from final consumers, intermediate users and taxpayers (through higher prices for goods and services and higher taxes).
- *Hypothetical models* can be used to analyse the situation of, say, how a stylised representative individual or family, with assumed patterns of consumption and savings, is likely to be affected by a policy change.
- *Group or cameo models* divide the population into groups defined by particular characteristics (for example, by age, sex, labour force and marital status) to provide broad indications of the likely ‘average’ experience of group members.
- *Microsimulation models* use sample data to analyse the distributional impacts of a reform at high levels of disaggregation (typically tens of thousands of individuals). However, because they are limited to analysing the direct effects of a change on individuals and households, they are used mainly for analysing the distributional impacts of changes to the tax and transfer system.

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- *General equilibrium models* identify different industries/commodities and account for interdependencies that arise from the flow of goods, services and factors from suppliers and users. They capture an extensive range of adjustments across the economy that influence the distributional effects of a reform.

**Box 3.1      Assessing distributional impacts of reforms, some examples**

As part of the inquiry into Textiles, Clothing and Footwear (TCF), the Industry Commission (IC 1997c) calculated various **aggregate transfer measures** to illustrate the effect on broad groups of reducing TCF tariffs. It was shown that by reducing the 2000-01 TCF tariff to 5 per cent, the tariff tax burden on consumers (that is, the consumer tax equivalent) would be reduced by between \$547 and \$978 million (\$1996-97). This corresponded to between 0.22 and 0.39 per cent of household consumption expenditure.

The Australian Treasury used a **cameo (sub-group) approach** as part of its analysis of the overall impact of the various measures associated with the proposed ANTS (A New Tax System). The cameos covered various household types — single persons, dual income couples with and without dependent children, single income couples with dependent children, sole parents, age pensions and self-funded retirees (Costello 1998a).

The National Centre for Social and Economic Modelling (NATSEM) used a **microsimulation model** to assess the distributional impacts of the proposed ANTS package. This included, amongst other things, assessing the distributional impacts of removing food from the GST (with the loss of revenue financed in a number of different ways). The sensitivity of some of the key assumptions made by the Treasury in its modelling of the distributional impact of the package (such as whether the CPI was an adequate measure of likely price increases facing different types of households and the appropriate treatment of dissavings by households when calculating gains and losses) was also tested.

For the inquiry into the *Impact of Competition Policy Reforms on Rural and Regional Australia*, the Commission (PC 1999c) used a **general equilibrium model** with regional disaggregation (MONASH-RR) to illustrate the economy-wide effects as well as possible effects on metropolitan and country regions of National Competition Policy (NCP) reforms. The modelling work showed that there are likely to be significant gains to the Australian community, and for country Australia as a whole, from implementing NCP reforms. However, a wider dispersion was estimated among country regions than metropolitan areas in terms of output, employment and average income per person employed (see box 3.2).

Sources: IC 1997c, Costello 1998a, NATSEM 1999, PC 1999c

Each of these techniques relies on simplifying assumptions about the behaviour of individuals, households and industries, as well as the market structures within which they operate. They are essentially ‘static’ in nature. Their usefulness is also

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constrained by the availability of data, including the absence of information on the situation of those in the community who operate in the ‘black economy’. These limitations are, however, not unique to the analysis of distributional impacts of reform. Similar difficulties arise in assessing efficiency benefits and the costs associated with reform. Like any analysis, the techniques abstract from some of the complexities of the real world, but they can nevertheless provide useful insights.

### **3.3 Incorporating distributional considerations in an evaluation**

Some reforms lend themselves to detailed ex ante assessments of distributional impacts (for example, changes to taxation arrangements, such as the GST, and changes to trade barriers), while for others (such as financial deregulation) it is more difficult to identify winners and losers in advance, other than in broad terms. A decision to assess distributional impacts should take into account:

- the objectives underlying the reform, including whether they relate to specific distributional goals; and
- whether the distributional impacts are likely to be substantial, uneven or uncertain in their incidence.

Examples of the handling of distributional impacts in some past Commission reports are presented in box 3.2.

While there is usually a need for a preliminary assessment of the potential distributional effects of reform proposals, where the expected effects are minor (that is, they are likely to be relatively small and have uniform impacts across groups), no further analysis would generally be needed.

Where a proposal involves a policy area with specific distributional objectives (such as education, health, community services, labour market programs, the social security or tax systems), an evaluation would typically need to address the cost effectiveness of alternative measures to meet these objectives.<sup>1</sup> On occasions, it may also be desirable to review the appropriateness of specific distributional objectives to take account of changing priorities and assessments of the needs of different groups in the community.

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<sup>1</sup> Some examples of Commission inquiries where distributional issues have arisen in this context include: *Public Housing* (IC 1993b), *Urban Transport* (IC 1994), *Private Health Insurance* (IC 1997b) and *Nursing Home Subsidies* (PC 1999e).

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**Box 3.2 Handling distributional issues in evaluating proposed policy changes — some examples**

- As part of the **private health insurance** inquiry, the Industry Commission examined the implications of a number of different community rating schemes for the provision of voluntary private insurance (IC 1997b). The Commission found that the existing system had a number of major drawbacks. People with low health risks were increasingly exiting the funds or using them selectively in advance of foreseeable expenditures, leaving a residual of increasingly higher risk groups. These in turn faced rising premiums, which induced more departures, giving rise to a 'vicious circle'. Within the constraints imposed by the inquiry terms of reference, the Commission recommended a shift to a lifetime rating scheme, while maintaining the broad equity objectives of community rating. Under this scheme, following a grace period, people entering insurance late — for example, after the age of 30 — would pay higher premiums than those who entered earlier.

Distributional analysis suggested that the proposed scheme would not create inequities: no existing member of an insurance fund would be adversely affected (indeed, pressure on their premiums would be reduced); and the grace period would ensure that intending members were not disadvantaged. Further, to the extent that the proposed scheme encouraged early entry or deterred late entry by consumers, this would improve the risk profile of members, thereby lowering pressures on premiums and making insurance more affordable for the old and young alike. This was also considered to be fairer to longstanding members who would bear less of the burden of late entrants.

- The terms of reference for the **impact of competition policy reforms on rural and regional Australia** inquiry required the Commission, amongst other things, to report on possible differences in the economic and social impacts of these reforms between regional and metropolitan Australia (PC 1999c). As part of its response to this challenge, the Commission used the MONASH regional economic model to assess the long-term effects of NCP reforms on regional output, incomes and employment. While models such as this cannot depict policy-induced changes with precision, they can provide useful insights. Overall, only one of the 57 regions modelled was estimated not to benefit from NCP in terms of output. All regions were estimated to benefit in terms of average income per person employed. For most regions, NCP reforms were estimated either to increase employment or reduce it by an amount which would be absorbed by less than one year of recent employment growth. Metropolitan regions were estimated to experience increases in output close to the national average, better than average employment outcomes and below average increases in incomes per person employed. By each measure used, some country regions were estimated to gain more, and some less, from NCP reforms than metropolitan areas. In general, the Commission concluded that there is likely to be more variation in the incidence of benefits and costs of NCP among country regions than in metropolitan areas.

(Continued on next page)

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Box 3.2 (continued)

The Commission also found that the effects of NCP reforms on most, but not all, regions are likely to be less significant than those resulting from the broad economic forces continually reshaping economic and social conditions in Australia (such as the declining terms of trade for agriculture, changes in technology and in consumer tastes).

- As part of the inquiry into *Australia's gambling industries*, the Commission assessed the costs and benefits of gambling (PC 1999b). The benefits were largely derived from the entertainment value of gambling and were experienced by millions of Australians, with most receiving an estimated consumer benefit equivalent to some \$250 to \$400 each year. The costs — mainly relating to problem gambling — were felt by a much smaller group of around 290 000 Australians. The Commission estimated that the social costs — falling mainly on the problem gambler and their close family — were equivalent to some \$6100 to \$19 100 per problem gambler per year.

The Commission noted that this imbalance in the distribution of social costs and benefits was an area of legitimate social concern. This was particularly so because the usual remedy for distribution problems — some form of compensation — was unlikely to be feasible for two reasons. First, it is very hard to identify those who should be compensated and the appropriate compensation amount. This would involve huge transaction costs, and would raise moral hazard issues, as some people could feign problems to receive compensation or engage in risk-taking behaviour. Second, compensation of a problem gambler raises its own difficulties if they then gamble away any compensation. The Commission argued that the distribution of costs and benefits is a more salient issue when deciding gambling policy than in many other cases.

Concerns about the equity or fairness of reform proposals are likely to feature prominently where they impose large burdens on disadvantaged groups or give rise to large gains for advantaged groups (see section 4.2). Concerns may also arise where the distributional impacts of reform proposals involve a large element of uncertainty. In contrast, distributional impacts arising from losses of 'economic rent'<sup>2</sup> or value added to factor owners income or wealth as a result of the modification or removal of entry restrictions to markets, are less likely to attract community wide concern, although they often elicit strong opposition from the beneficiaries of these 'rents' (see section 4.2).

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<sup>2</sup> 'Economic rent' is defined as any payment over and above what is necessary to maintain a factor of production (that is labour or capital) in its current activity. As such, reductions in the size of these rents do not affect the quantity of a resource devoted to a given activity.

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Analyses of the impacts of reform proposals which are expected to involve substantial, uneven or uncertain consequences would involve:

- identifying the expected broad distribution of benefits and costs (including transfers) across relevant community groups;
- where appropriate, presenting a sensitivity analysis covering the distribution of these benefits, costs and transfers; and
- considering the desirability of options to offset adverse distributional impacts, either through modifications to the reform proposal prior to or following its implementation or the use of other measures, such as the provision of compensation.

In general, the benefits, costs and transfers associated with a reform proposal are treated as being of equal value across individuals or between sub-groups of the population (that is, a dollar of benefit or cost or transfer for one person or group is treated as being equivalent to a dollar of benefit or cost or transfer for another). However, there is some debate, addressed later in the next section, as to whether this is an appropriate approach when assessing distributional issues.

### **3.4 Handling policy trade-offs**

Judging whether a reform proposal is worthwhile usually involves answering two basic questions. First, as discussed in chapter 2, whether it is likely to yield a net benefit to the community. Second, as outlined in this chapter, whether the likely distributional outcome is ‘acceptable’.

Difficulties for policy advisers and decision makers alike arise where reform proposals do not clearly satisfy both the efficiency and distributional requirements. If, for example, a policy proposal is likely to yield a net benefit, but also a significant change in the distribution of income, a problem arises in assessing the ‘acceptability’ and importance of the distributional outcome relative to the efficiency gain. What trade-off is a government, on behalf of the community, prepared to make?

The potential for conflict between these objectives can be overstated. Indeed, they are often complementary rather than competing, particularly in the medium to longer term. For example, reforms aimed at improving productivity can encourage economic growth, improve job prospects for the unemployed and increase national income, yielding more funds to assist the disadvantaged. In such cases, efficiency-enhancing reforms have distributional outcomes which are more likely to have general support. The NCC (1999a, p. 15), for example, noted that:

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Competition helps to break down concentration of economic power by opening up markets. In this sense, it promotes greater equity by removing special protection and privileges traditionally conferred on particular businesses, thus removing discrimination between market participants.

Many reforms with beneficial efficiency effects increase national income while generating relatively small impacts on the existing distribution of income or producing distributional effects that would attract wide community endorsement. Examples include:

- removing regulations which give rise to anti-competitive practices such as restrictions on entry to banking and the professions;
- improving the effectiveness of general labour market programs (for example, job information and training services) and removing restrictive work practices;
- improving accountability regimes and removing duplication across Commonwealth/State and Territory programs; and
- providing more cost-effective means of meeting welfare and other social goals in areas such as workers' compensation, occupational health and safety, public housing, urban transport, and nursing homes.

Nevertheless, conflicts between efficiency and distributional (as well as other) objectives do arise, and in some cases, policy decisions involve complex and controversial choices between these objectives and even trade-offs between different distributional goals. Examples include reform proposals covering aspects of the tax and social security systems, the wider application of user charges for goods and services, the provision of health services, the regulation of private health insurance and financing the provision of higher education.

At the Commission's workshop on *Structural adjustment — exploring the policy issues* (PC 1999g) there was broad agreement with the conclusion of the House of Representatives Standing Committee on Financial Institutions and Public Administration (Hawker Committee 1997, p. 11) that:

The ultimate decisions on the weighing up of the costs and benefits are basically political ones, to be justified by the Parliament and in the final analysis by the electors.

The role of policy analysts was seen as being to help governments and the community understand better the nature and implications of opting for different trade-offs and thereby to facilitate well informed decision making. This still raises the question of how this can best be done.

The conventional approach is to identify, describe and where possible quantify the efficiency and distributional dimensions of a reform proposal, while leaving value

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judgements about acceptable trade-offs to Parliaments. Under this approach, analysts usually implicitly assign equal weights to the distribution of benefits, costs and transfers among groups (that is, the ‘dollar is a dollar’ approach).

Some argue that this approach is incomplete (see, for example, Dasgupta and Pearce 1972, pp. 65-6 and Argy 1998, chapters 2 and 8), suggesting that the policy analyst may be abrogating responsibility by not examining the implications of different trade-offs (particularly where the distributional effects are substantial and uneven).

Where the benefits and costs and any transfers associated with a reform proposal are spread evenly across members in society, the ‘dollar is a dollar’ approach is unlikely to be contentious. However, where they are quite uneven various analysts have canvassed alternative approaches.

The use of alternative approaches to weighing benefits, costs and transfers across different groups as a possible aid to policy-making raises a number of challenging and controversial issues. Outcomes are clearly sensitive to the choice of distributional weights. Since any weights involve value judgements, there is no unique answer.

Various proposals have been put forward. These include using weights inferred from existing or past policy decisions, weights based on explicit statements by governments covering a particular area of policy and deriving or postulating weights to highlight the implications of attaching different ‘values’ to distributional outcomes. These proposals are briefly discussed below.

Inferring weights from existing or past policy decisions is unlikely to provide a clear-cut indication of the community’s views about ‘acceptable’ distributional outcomes. Ng (1979), for example, argues that income tax scales reflect not only the community’s views about the desirable distribution of income, but also considerations such as efficiency, administrative simplicity, compliance costs and incentive effects. Hence, ‘appropriate’ implicit weights cannot be directly inferred from these sources. Accordingly, Ng (1979) argues that a dollar should be treated as a dollar.

Some analysts, such as Stiglitz (2000), argue that, in the case of policies where there is a deliberate distributional objective, assessments of reform proposals should make use of differential distributive weights because not to do so would miss the whole point of the policies. This argument has been recognised by the Department of Finance. In a handbook on cost-benefit analysis, it observed that the only readily defensible exception to the ‘dollar is a dollar’ approach (Department of Finance 1991, p. 73):

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... is where an unambiguous government policy objective can be identified to assist the specific groups at which the project or program is aimed; and where the priority of assistance to this group relative to other groups is also clearly established.

In such cases, governments should specify explicitly the appropriate distributional weights rather than leave policy analysts and the community in general to infer an appropriate system of weights from information about the relevant government policy or program for the reasons canvassed above. The Department of Finance (1991, p. 73) argued that:

... even in these instances, it is important to include in the report the estimate of the unweighted net present value, so that the absolute cost of the distributional judgement can be measured. It is also highly desirable to develop an estimate of the efficiency cost of the alternative means of achieving a similar income redistribution. ... In this way a realistic perspective can be maintained on what is an appropriate efficiency 'price' to pay for the redistributive benefits of the project or program.

The remaining proposal is to use postulated weights to illustrate the implications of applying varying assessments to the value of the stream of benefits, costs and transfers of a reform proposal, including highlighting the required size of the divergence from a 'dollar is a dollar' weighting to negate the efficiency gains from a reform. This approach was applied by the Queensland Dairy Legislation Review Committee (1998) as part of its analysis of the merits of deregulating the dairy industry. The Committee recognised, however, that while plausible on equity grounds, economic principles cannot be used to provide an objective basis for the differential weighting of the flow of benefits and costs to different groups within the community (see box 3.3). Further, assessments of the distributional implications of policy changes need to go beyond simple analyses of impacts on income to look at other influences on welfare, such as assets, and consider issues such as whether previously bestowed windfalls from policy settings should be immutable.

The use of postulated weights, therefore, is highly contentious and problematic. Savage (1999, p. 183), for example, has stated that: 'there is no justification for placing a higher weight on losers than gainers' from a reform proposal. Indeed, losers may be poor or rich as may winners and the magnitude (significance) of the loss or gain proportionately small or large. Consequently, 'relative weights should be determined by an individual's relative level of welfare'. This in turn is shaped by their income and wealth positions and life cycle experiences — influences that are largely unknowable in advance.

Kasper (1999) argues that attaching higher weights to the organised interests of the losers relative to the often unorganised interests of the winners is unfair and can have deleterious side effects (such as moral hazard) on the reform process. Distributional weights centred on a point in time do not address the implications of

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shifts in the position of individuals within the distribution of income and wealth over time related to changes in their circumstances, including life cycle effects.

**Box 3.3      The Queensland Dairy Legislation Review Committee:  
efficiency and distributional trade-offs in practice**

In July 1998, the Queensland Dairy Legislation Review Committee (QDLRC) reported on the results of a National Competition Policy (NCP) review of the Queensland Dairy Industry Act 1993.

Under the NCP agreement, Australian Governments are required to subject any potentially anti-competitive legislation to a public interest test to assess whether the legislative provisions that restrict competition should be retained. In undertaking the public interest test, the QDLRC examined the efficiency effects and the transfer or distributional effects of deregulating the dairy industry.

The QDLRC concluded that the consumption and production efficiency gains from removing farm-gate price regulation were likely to be small, while the distribution effects were likely to be large.

The QDLRC argued that, given these likely outcomes, to determine if there is an overall public benefit from deregulation ‘... requires value judgements to be made about the extent to which a large income transfer from farmers to the rest of the community needs to be considered and revalued to reflect social and equity considerations’.

The Committee maintained that the ‘... use of distributional weights is the preferred approach in assessing social impacts and is routinely used in government decisions to respond to a deterioration in equity to an area or group in the community. In the scenario that results in the highest public benefit from deregulation, if the income transfer was revalued such that a dollar loss in income to farmers was revalued to \$1.08 and a dollar gain to other groups in the community was revalued to \$0.92, there would be a net public detriment from farm-gate price deregulation. This level of revaluation is within an acceptable range, in view of the likely social and regional impacts of deregulation’.

In discussing this approach, however, the QDLRC said ‘... value judgement is required to determine whether these incidence effects should be valued in such a way as to affect the overall public benefit conclusion. The application of differential weights to incidence effects effectively means that, if income is transferred from one group in the community to another, a dollar loss to one group can be valued at more than a dollar while a dollar gain to another group can be valued at less than a dollar. This is plausible on equity grounds, but economic principles cannot provide any objective guidance as to the extent of differential weights that are most appropriate’.

As outlined in the main text, there are a number of additional issues which need to be taken into account in assessing the usefulness of the differential weighting technique.

*Source:* Queensland Dairy Legislation Review Committee 1998.

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Harberger (1978, p. S113) also points out that:

When distributive weights are used ... the result is to open the door to projects and programs whose degree of inefficiency by more traditional ... measures would ... be unacceptable to the vast majority of economists and of the informed public.

When ... the differences in weights get to be large, it is all too easy for considerations of distribution to swamp those of efficiency altogether, and for grossly inefficient policies, programs and projects to be deemed acceptable.

Overall, the use of inferred or postulated distributive weights to aid an assessment of the implications of different distributional outcomes introduces into the evaluation process a technique that is difficult to operationalise, potentially misleading and subject to abuse. In the Commission's view, the only defensible exception to the conventional approach would be where governments make an explicit public statement on the appropriate distributive weights to apply for a particular policy area.

Extending this issue to the consideration of the 'public interest' test, a report of the Senate Select Committee on the Socio-Economic Consequences of the National Competition Policy (Quirke 2000, p. xiv) recommended a number of changes to that test, including that:

For the purposes of measuring outcomes of the policy, a method of assessment be agreed by CoAG (Council of Australian Governments) which will provide a numerical weighting that can be attributed to environmental, social and employment factors, wherever possible.

In responding to this report, the Commonwealth Government indicated that it (Treasurer 2000, pp. 2-3):

... does not favour the application of numerical weightings to particular matters which may be taken into account in the public interest test. In practice, it would be difficult to agree on the relative numerical weight to be assigned to particular matters. Even then, it may not be desirable to constrain the weighting which a Government may consider appropriate in a particular case.

The CPA (Competition Principles Agreement) establishes that jurisdictions are free to consider a range of factors in examining various reform options. In addition to efficient resource allocation, these issues may include, but are not limited to, those associated with employment growth, regional development, the environment, consumer interests, welfare and equity. This provides for the full range of benefits and costs to be considered in establishing whether a particular course of action will provide a net benefit to the community as a whole. This process essentially embodies the public interest test. This flexibility provides that jurisdictions may apply different emphasis to particular factors contained within the public interest test.

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A practical way of responding to the challenge of real world complexity in handling possible trade-offs between efficiency and distributional objectives (as well as other objectives) would be for analysts to:

- report on the efficiency, distributional and any other relevant dimensions of a reform proposal and, where possible, quantify these dimensions;
- highlight whether an assessment of the net benefit and distributional outcomes yields an ambiguous result in terms of overall community welfare; and
- identify and assess options for handling reform proposals having ambiguous results, including the possibility of modifying the proposal, applying an alternative policy response (such as direct compensation or adjustment assistance) or not proceeding with the proposal.

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## 4 Should governments assist when policy changes?

### Key points

- The social security and tax systems and other generally available measures can assist adjustment and moderate adverse distributional impacts which arise from policy-induced as well as market-based change.
- These measures, however, are not designed to handle all contingencies. Consequently, circumstances arise where additional measures — direct compensation, specific adjustment assistance, and reform modification through phasing and other responses — are warranted.
- Arguments commonly put forward in support of such specific measures include promoting equitable or fair processes and outcomes, ‘buying-off’ opposition to change, and improving the efficiency of the adjustment process.
- There is a wide range of views on the circumstances which justify the use of these additional measures. Although the need for these measures must be assessed on a case-by-case basis, it is possible to make some broad in-principle observations.
  - In general, the case for additional measures, on equity and fairness grounds, is strongest if a reform: will impose a clear and sizeable burden on a specific group (particularly if the affected group is relatively disadvantaged); delivers benefits mainly to relatively advantaged groups; or involves a largely unanticipated and material change to a well defined and defensible ‘property right’.
  - Assistance to ‘buy-off’ opposition to a policy change may have superficial appeal on pragmatic grounds, but is fraught with difficulties and carries considerable risks. Opposition to a proposed policy may arise because insufficient attention has been given to legitimate efficiency and equity considerations during its development.
  - Where intervention can improve the efficiency of the adjustment process by addressing market-based impediments to adjustment and the costs of intervention are less than the expected benefits, there is a strong prima facie case for intervention. Where adjustment is impeded by government policies and weaknesses in transitional arrangements for introducing a modified or new policy regime, it would be preferable to tackle the problem directly by modifying the relevant policy measure. If this is not possible, it may be appropriate to introduce an offsetting measure.

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It is not uncommon for proposed policy changes to be accompanied by calls for governments to intervene to ameliorate adverse distributional effects and to assist adjustment. The social security and tax systems and generally available adjustment measures (such as job search, placement and training services) encompass a set of universally available measures to help people cope with change. These measures have some distinct advantages in dealing with many of the adjustment and distributional challenges arising from policy changes, but they are not designed to handle all contingencies (see appendix A).

In this context, the question arises as to when additional measures (such as direct compensation, specific adjustment assistance and reform modification through phasing, broad-based reform, reform dilution or ex post modification) might be required to help those affected by policy changes.

Concern about the equitable and fair treatment of people affected by reforms is probably the most common argument advanced in support of additional measures. Another argument is that it is necessary to ‘buy-off’ opposition to reform to avoid the possibility of reform being stalled. There is also an efficiency argument which recognises that market imperfections, policy-related distortions and/or the transitional provisions associated with a reform proposal may impair the process of adjusting to policy changes.

This chapter works through these arguments. Before doing this, the issue of whether there is a basis for treating policy-induced changes differently from market-based changes is examined.

## **4.1 Policy-induced changes versus market-based changes**

Individuals and firms win or lose from market-based changes everyday. This is usually considered to be part of the normal operation of markets. For the losers, assistance beyond the social safety net and generally available measures is rarely provided. As an earlier writer on these issues, Wilcox (1950, p. 884) pointed out:

Workers and investors in a free economy are constantly suffering losses of employment and income as a result of economic change. The textiles industry migrates from New England to the south; coal loses its market to fuel oil, and ice to the mechanical refrigerator; railroads lose business to trucks, natural fibres to synthetics, lumber to metals, and metals to plastics; real income is shifted, in wholesale quantities, between debtors and creditors whenever the general level of prices rises or falls. In none of these cases is compensation offered or proposed.

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To argue for additional assistance when individuals and firms are affected by a policy change as distinct from market-based changes, raises equity and fairness issues. For example, as Rottenberg (1986, p. 134) notes:

Many kinds of phenomena produce losses. These include natural disasters, as well as wars, the discovery and exhaustion of natural resources, technological discoveries, and changes in consumer preference sets — and changes in public policy.

On grounds of equity, it does not seem warranted to select isolated public policy changes from this set as a trigger for making transfer payments. The existence or intensity of suffering is independent of its cause.

Indeed, if an individual requires assistance to cope with changed circumstances, then the source of change would seem irrelevant. This judgement is reflected in the design of the social security and tax systems and generally available adjustment measures — they do not distinguish between individuals on the basis of the source of their difficulty, rather assistance is simply triggered by ‘need’.

Policy and market-based changes share a number of important similarities. Policy changes directed at improving the efficiency and effectiveness of government programs and regulatory arrangements, for example, could be viewed as being analogous to product and process innovations by firms in the private sector. In each case, some people gain and others lose.

Further, the two sources of change often interact and give rise to similar adjustment and distributional challenges. As observed by Argy (1999, p. 65):

A major series of reforms which free up markets can have an initial direct policy-related effect (eg a change in the price structure of banks) followed later by secondary indirect effects (eg banks closing down regional branches). How are the two distinguished? Similarly, a market-based rationalisation of the textile industry (promoted say by a merger or new technological and market developments) can generate long term regional unemployment and increased social inequality — in exactly the same way as a shift in trade policy which leads to a reduction in TCF industry protection. If governments are concerned about ‘social welfare’, they should be concerned with both kinds of shocks.

While there are important similarities between policy and market-based sources of change, one fundamental difference identified by various analysts, including Gray (1999, p. 98), is:

The key differentiating characteristic of reforms is that the community chooses to impose them on itself.

For this reason, he suggested that society may be disposed to assume responsibility for outcomes from policy changes in a way which differs from its approach to market-based changes.

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In this context, VanDoren (1997, p. 41) points out:

Firms and employees who lose wealth or employment as a result of private innovations usually do not make claims for compensation. For instance, slide-rule companies did not demand compensation from engineers who purchased calculators instead of slide rules. And if the industry had demanded compensation, the public would have greeted its demands with scepticism.

In contrast, firms and employees who lose wealth or employment as a result of policy innovations often demand compensation.

Of course, it is not unusual for firms and employees to seek protection or compensation where competition from foreigners threatens loss of market share and employment opportunities.

Withers (1999, p. 247) also reflected on the difference, noting that:

... policy changes are deliberate, clear and transparent decisions of elected individuals explicitly accountable to the public and making decisions on behalf of the community. Market decisions are totally decentralised, indirect and diffuse.

Underlying these views is the proposition that governments should demonstrate that the benefits of a proposed policy change exceed the costs and that the distributional impacts are 'acceptable' having regard to social welfare and equity considerations. Change can be disruptive and inevitably produces winners as well as losers. Individuals and firms organise their activities and expectations around existing rules. Given the costs and uncertainties associated with changing established ways of doing things, it is not unreasonable to require that a good case is made for policy changes. Further, there are often a range of ways of introducing a policy change, providing governments and the community with choices about timing and content.

Various additional assistance measures provide governments with possible alternatives to relying on the social safety net and generally available measures to handle the distributional and adjustment challenges associated with policy changes. The following sections examine the circumstances in which it might be appropriate to use these additional measures.

## 4.2 Equity and fairness

Calls for additional measures often stem from concerns about the 'equitable' or 'fair' treatment of people affected by policy changes. Central to this argument is the notion that if the community as a whole benefits from reform, but some groups are made worse off, then some of the benefits should be transferred to those who lose. The Prime Minister, for example, on announcing an assistance package for the National Textiles workers (Howard, 2000) said:

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It is the obligation of governments to pursue agendas of economic change and reform because they are beneficial to the overall community. But it is also the obligation of governments, where people are hurt through no fault of their own as a consequence of that economic change and reform, ... to give a bit of assistance to those people.

Equity and fairness are inherently subjective and value laden concepts. Perceptions about what is equitable or fair vary across different sections of society, between societies and over time.

The social safety net and other generally available measures play an important role in ‘cushioning’ the effects of policy changes for the poorest and most disadvantaged groups in the community (see appendix A). However, the distributional outcomes arising from policy changes (after taking such measures into account) may still be considered ‘inequitable’ or ‘unfair’ and deemed to require additional intervention, particularly if they:

- place large imposts on the relatively disadvantaged or provide large benefits to the relatively advantaged;
- impose large and/or unexpected losses in income or wealth on a minority of individuals, even if they are not among the most needy or vulnerable in society; and
- involve largely unexpected changes to the ‘established rules of the game’ — the argument being that this may represent a breach of a ‘property right’ or be contrary to legitimate expectations about the processes by which change normally occurs.

### **Specific circumstances and the nature of the policy change matter**

Given the subjective nature of the concepts of equity and fairness and the challenges of assessing the distributional impacts of policy changes, claims for additional measures on these grounds are often controversial and difficult to assess.

In practice, assessments of equity and fairness are likely to be influenced by a variety of considerations including the magnitude of losses involved, the size of these losses relative to the income/wealth positions of the affected individuals, and the nature of the policy change. In relation to the latter, it is often argued that it is appropriate to distinguish between losses arising from the removal of policy bestowed ‘special privileges’ and those arising from other types of policy change and, by some, that governments have an obligation to protect the value of ‘property rights’ which owe their existence to regulation.

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The magnitude of any loss or impost associated with a policy change is generally viewed as a relevant factor. As Michelman (1967, p. 1191), observed:

No one will question that the size of the imposition must be a relevant factor in determining whether compensation should be paid. Even if there may be situations in which disproportionate social cost distribution may justly be tolerated, the claim to compensation must grow more compelling as the disproportionate harm increases towards immensity.

Similarly, Corden (1974, p. 107) submitted that one may view it as:

... unfair to allow anyone's real income to be reduced significantly — and especially if this is the result of deliberate policy decisions — unless there are very good reasons for this and it is more or less unavoidable.

The relative size of any loss or impost is also important. Just as the tax system places limits on the tax burden imposed on individuals (through the threshold and its progressive structure), it may be argued that it is equitable/fair to limit the 'implicit taxes' imposed on individuals by policy changes. Various writers have suggested that under the standard tax equity criteria, an impost could be judged equitable if:

- individuals in similar circumstances bear broadly similar imposts (that is, the notion of horizontal equity applies); and
- individuals in different or dissimilar positions bear appropriately different imposts (that is, the notion of vertical equity applies).

It is important to recognise that many policy changes are about promoting fairer rules or outcomes. For example, some of the reasoning behind past taxation reforms, such as introducing fringe benefits and capital gains tax, was about making the system both 'fairer' and more efficient. In this case, a 'fairer' outcome in the sense of improved 'horizontal equity' (that is, broadly similar tax burdens on individuals with broadly similar taxable incomes) involved relatively large increases in tax burdens for those whose incomes included disproportionately large capital gains and/or fringe benefits. Similarly, the introduction of the higher education contribution scheme (requiring university students to make a part contribution to the cost of their education) and changes to income and asset tests for a range of social security measures were made with the aim of achieving program objectives more efficiently and promoting fairer outcomes. Resorting to additional measures, in such cases, to moderate the distributional impacts would defeat the purpose behind implementing the changes.

Many microeconomic reforms are directed at modifying incentives to improve the efficiency of resource use and/or securing more efficient pricing structures. The distributional impacts arising from many of these reforms are likely to be relatively

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small in magnitude and involve a fairly even incidence across different groups in the community. However, some policy changes can give rise to larger and more diverse distributional impacts which raise legitimate social welfare and equity concerns.

While judgements about when intervention to modify policy-based distributional impacts is justified will invariably differ, Argy (1998, p. 114) has sought to provide some crude benchmarks which focus on whether:

... the redistributional effects of the proposed reform are ‘significantly regressive’ in the sense that:

- it pushes a sizeable number of people below the poverty line (defined, say, as 50 per cent of the mean family disposable income, after adjusting for the needs of each household), even for a short period (say a couple of years); or
- it diminishes (even for a short period) the disposable incomes of families in the lowest income quintile (either absolutely or even relative to the average); or
- it confers all or most of the benefits on high income earners (say the two top quintiles).

He goes on to argue that where the distributional effects are likely to be large and regressive (Argy 1998, p. 115):

... an attempt should be made to provide rough compensation to those considered relatively poor (eg those in the two lowest quintiles) — provided an efficient and effective method of compensation can be found.

The restructuring of the tax system associated with the introduction of the GST provides an example of such a response. The government judged it appropriate to provide direct compensation to pensioners and self-funded retirees to secure a ‘fairer’ outcome.

Calls for additional measures to compensate individuals for changes involving the removal or modification of policy privileges are more contentious. Some argue that compensation should not be paid when policy changes destroy privileges previously created by regulation — given that the government created the privilege and the artificially created returns are ‘unfair’, the government should not pay compensation for their removal. For example, the NCC (1999b, p. 56) has argued that:

... in some cases, the ‘adverse effects’ some people incur from reform are, in effect, simply a removal of the privileges they have previously enjoyed at the expense of other members of the community. This reduces the strength of any equity arguments for providing special adjustment assistance in those cases.

However, such cases are often more complex. Firms in business prior to the introduction of the privilege (say an entry restriction) and who remain in business

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after its removal lose the unrealised windfall gains they originally gained. However, firms that enter the industry while the privilege applies and remain after its removal arguably lose real wealth because they lose the premium paid for the policy privilege when they entered the industry. A Commission paper on the *Regulation of the Taxi Industry* (PC 1999f) identifies a wide range of equity/fairness considerations which need to be taken into account in assessing the merits of providing additional assistance where consideration is being given to modifying or removing policy privileges (see box 4.1).

**Box 4.1      Some equity/fairness factors relevant to the consideration of compensation where regulatory arrangements are changed**

- What is the nature of the taxi licence property right (for example, constitutional, quasi, implied)?
- Was any contract or implicit guarantee given that the degree or restrictiveness (and thus ‘economic rents’) from taxi regulation would be maintained?
- Have significant changes in the nature of licence plates from government action occurred in the past or would deregulation mean that plate holders are subject to completely unanticipated reform?
- If licence plate holders are to be compensated for wealth-reducing reforms, have they also been taxed for policy changes which have enhanced their profits (for example, periods in which no new licences have been allocated)?
- Have governments appropriated any of the ‘economic rent’ through plate auctions?
- Would (uncompensated) reform result in adverse distributional consequences — for instance, what is the wealth profile of plate holders and taxi users?
- Should actual capital losses (new entrants) and losses of potential capital gains (those holding freely allocated licence plates) be compensated in the same way?
- Which groups will bear the burden of the costs of a compensation package?
- What will be the opportunity cost of budget funds expended on compensation and what are the likely distributional consequences?
- Are the interests of plate holders and taxi users and/or taxpayers well represented or does one group have a more effective ‘voice’?

Source: PC 1999f, p. 41.

Another consideration is the ‘fairness’ of the processes by which policy changes are made. As Hochman (1974, p. 322) argues:

The basic issue is the fairness of windfall declines in the absolute wealth of some individuals that occur when the community-at-large, in its quest for a preferable long-run allocative or distributional outcome, alters its rules and institutions.

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The ongoing debate about the processes by which restrictions on competition are modified or removed under the National Competition Policy framework underlines this as a fundamental issue.

The case for additional adjustment measures on the ground that a change in government policy represents a breach of a rightful 'property right' rests on whether the change is akin to removing or devaluing a property right as well as the nature of the 'property right' itself. Such a change also raises an efficiency issue since property rights provide a framework for exchange, including a basis for framing expectations which influence decisions and actions (see section 4.4).

In some cases, the existence of a 'property right' and therefore a 'right' to some form of compensation is clear-cut. For example, under the Australian Constitution, landowners have a constitutional right to 'just compensation' should their land be compulsorily resumed. Also, where governments have entered into contracts for the supply of goods and services, financial compensation is payable in the event of specifically defined events occurring. In Victoria, for example, the State Government has contracted to compensate the private developers of the Citylink toll road should it (the government) make transport investments which reduce the demand for the toll road (Forsyth 1999).

These two examples provide illustrations of 'explicit' property rights where certain events unambiguously entitle their owners to compensation for the loss of a property right or a diminution of its value.

In most cases, however, 'property rights', and therefore 'rights' to some form of recompense for losses incurred, are less clear. Government policies that influence the value of assets, such as taxi licences, water entitlements and statutory marketing arrangements, are sometimes viewed as giving rise to 'implicit' property rights. Compensation is considered appropriate by some if policy changes result in the value of such assets declining. For example, the Managing Director of Wesfarmers Australia in an address to the Regional Australia Summit, (Chaney 1999, p. 7) argued that:

There are very complex issues in defining property rights to irrigation water or to rural land. Yet farmers have made past investment decisions on the basis of legitimate assumptions as to what those rights entailed. If it is necessary, for conservation purposes, to divert water to the wetland habitats of native birds, that is a decision governments are entitled to make. But not without compensating the farmers for the attenuation of their reasonably expected right to irrigation water!

Governments generally do not provide guarantees that regulation will remain unchanged or that asset values will be immune from policy changes. While governments are obliged to compensate for the compulsory taking of land, other

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policy changes that affect land values (or the values of other assets) rarely attract compensation. For example, changes in zoning and land use regulations could result in some individuals incurring capital losses, but compensation is typically not paid. Further, governments have deregulated a wide variety of markets and, in the process, affected the values of a variety of private assets without making compensation payments to adversely affected parties or seeking to recover windfall gains from those that benefit (examples include many statutory marketing arrangements for agricultural products, aviation, energy, transport, postal services and telecommunications).

In many cases, however, decisions to make rule changes (such as to capital gains tax, depreciation provisions, superannuation arrangements and environmental controls over emissions) are made prospectively, not retrospectively. They are directed at influencing new production and investment decisions while recognising that past decisions were shaped by rules applying at the time. Under such an approach, it can be argued that, although changing the rules of the game, governments are not breaching ‘implicit property rights’ or making changes contrary to legitimate expectations about the process by which changes are introduced.

Some contend that the ‘directness’ of the effect of government action should influence whether some form of recompense is appropriate. For example, if the monetary authorities tighten monetary policy and some businesses fail, it could be argued that the case for some form of additional assistance would be fairly weak because the relationship between the change and the consequence is fairly indirect. Moreover, changes to monetary policy are quite frequent and the basis for them fairly clear. On the other hand, in a case like deregulation of the dairy industry, the argument for additional assistance could be considered stronger because of a more direct relationship between the policy change and the consequence (PC 1999g).

## **Risks and expectations about change**

It is relevant to consider whether policy changes are viewed as a normal element of commercial risk or an unexpected change to a long-standing arrangement which warrants some form of recompense or transitional mechanism to assist market participants.

One view is that society is built on established rules and procedures and individuals and organisations have every reason to believe that changes to these will be infrequent and involve fair processes. Hochman (1974, p. 323–4), for example, argues that:

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Most often, individual behaviour presumes the permanence of pre-existing rules. Indeed, if law and the concept of rules are to be credible, individuals must hold this presumption with a high degree of confidence. Not just existing rules, but change in these rules, must be justifiable, and the process through which change is effected must itself be fair ... Rule changes that disappoint such expectations may themselves be unjust.

In these circumstances, it is argued that failure to consider the need for transitional arrangements and/or other forms of additional assistance for major policy changes can undermine investor confidence.

The counter-argument is that individuals base their investment decisions on established rules but they also form expectations about the likelihood of rule changes. Cordes and Goldfarb (1983, p. 358), for example, argue that:

Reasonably well-informed individuals confronting changes over time in zoning laws, tax rules, air pollution requirements, auto emissions standards, and so forth, will observe that current rules or decisions are likely to change in the future. While the exact change is unknown, probabilistic expectations of change can be formed. If such anticipations are present, the ethical requirement for compensation is less compelling.

The period of discussion and debate preceding major policy changes can influence people's expectations about the likelihood of change. For example, in 1995, Australian Governments agreed under the Competition Principles Agreement to adopt a National Competition Policy (NCP), including a forward schedule of the areas that were to be reviewed with a view to removing restrictions on competition unless the benefits to the community of retaining them exceeded the costs. Similarly, Australia's program of broad-based tariff reductions was announced well ahead of its implementation. It would be difficult to argue that such information has not subsequently been taken into account by investors in these areas. For example, Treasury (1978, p. 35), commenting on cases where industry players have knowledge of the future course of protection reductions, said that this:

... can act as a lubricant to change, by giving advance warning to firms and individuals of necessary adjustments. ... The prospect of protection reviews and reductions becomes a normal element of commercial risk. Any claims to 'property rights' in existing levels of protection can accordingly be generally discounted.

While the exact form of policy change will seldom be known in advance, individuals do form expectations about the likely timing and shape of future policy changes. The implication is that if people are in a position to anticipate policy changes, or if they form expectations about likely policy changes, then asset prices and returns on them will reflect the risk of such changes occurring (in the same way that an asset price will reflect the risk of a market change). That is, exposure to such risks becomes part of normal business risk for which the market compensates ex

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ante. In such instances, the case for direct or indirect compensation is not very convincing. Indeed, providing additional assistance in such cases could represent double compensation.

However, where a policy change turns out to be materially different from what individuals might have expected or has a large unpredictable element, the case for direct or indirect compensation becomes stronger. As Cordes, Goldfarb and Barth (1983, p. 298) argue:

... only unanticipated government policy changes generate losses, and the accuracy of an economic agent's expectations affects the magnitude of losses generated by changes in public policies. Since individuals and firms are likely to base their behaviour on expected government policies, it seems appropriate to provide compensation only for those losses resulting from anticipation errors.

The issue of material difference and unpredictability is also relevant to consideration of the effect of a policy change on workers' assets. While many investors can spread their risks by having a diversified portfolio, some workers' assets (for example, the value of their skills and training and houses) are often specific to a particular occupation/industry or location. On these grounds, there may be a case for assisting workers who are adversely affected by policy change.

Although 'precedent' influences expectations about future behaviour, its value can be quickly eroded by inconsistent decision making. Deregulation of the NSW egg industry saw direct compensation being paid to egg producers for the loss of the value of egg quota entitlements. Deregulation of the dairy industry is being accompanied by the provision of specific adjustment assistance. Licences held by importers of a range of quota protected manufactured goods were removed without compensation, though it is arguable that there was an expectation that the quotas were a temporary measure. No compensation was offered to members of the legal profession who suffered income losses when governments removed their exclusive right to engage in property conveyancing.

A consistent approach to handling those affected by policy changes is a necessary requirement for preserving people's belief in process fairness. As Cordes and Goldfarb (1983, p. 358) suggest:

...if compensation awards are excessive, or distributed arbitrarily, payment of compensation could easily be viewed as unfair. ... The claim that compensation promotes belief in fairness implicitly assumes that compensation will be administered in a way which is *perceived* as being fair.

The establishment of clear and transparent guidelines for determining when additional adjustment measures might be provided would promote both procedural and outcome fairness.

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### 4.3 Buying-off opposition to reform

A pragmatic argument for additional measures centres on making reforms politically acceptable. Politically powerful and well-organised lobby groups are sometimes able to mount effective campaigns against reform. Some argue that, in such cases, additional assistance to the potential losers may be needed to overcome opposition to reform. For example, the World Bank, in its World Development Report (1997b, p. 144–5) argued that:

... chief among the barriers to change will always be the powerful interest groups who stand to lose by it. Resistance will be even stronger when the prospective losers are among the political leadership's core constituents. In short, the redistributive effects of a reform and the political strength of groups affected by it may simply render some policy changes politically undesirable.

Or, as Forsyth (1999, p. 240) puts it, 'whether compensation is paid or not may determine whether the change happens or not'.

Modifying the timing or changing the nature of a reform can also lessen opposition to reform. Some argue that gaining support for gradual reform, for example, is likely to be far easier than gaining support for overnight reform. As Michael (1986, p. 46) notes:

The one-stage policy, leading to greater unemployment and larger changes in income distribution may be expected to generate more resistance and thus be less feasible politically.

A perennial difficulty in achieving support for worthwhile reforms is that the costs, although smaller than the benefits, often tend to be incurred up-front and are concentrated on a relatively small group, while the benefits tend to be dissipated throughout the community and often take time to accrue. The provision of additional assistance could be viewed as an investment to secure the benefits from reform. In principle, so long as the amount of compensation required to 'buy-off' opposition is smaller than the net benefits from the reform, then the community could still be better off than not proceeding with the reform. Similarly, it could be argued that if a gradual approach to reform is used as a means of overcoming opposition, then the benefits from the reform would be delayed, but still realised eventually.

Providing assistance to 'buy-off' opposition to reform could, however, yield perverse outcomes — it may actually strengthen resistance to reform. Providing compensation for one reform is likely to encourage lobbying by others affected by reform proposals. This could make it increasingly difficult to get support for reforms without compensating 'everybody for everything' or making modifications

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that ultimately reduce their effectiveness. Kasper (1999, p. 143), reflecting on this argument, said:

Sometimes one hears the pragmatic or opportunistic political argument that compensation payments to affected groups or regions serve to eliminate political resistance to reform. This argument is short-sighted and reeks of political expediency ... biddable governments invite noisy political resistance to adjustment. ... The lesson of history is that policy makers must never promote political 'hold up risks', just as paying the Mafia protection money is dangerous and immoral.

From a national perspective, a government open to lobbying for additional assistance encourages the diversion of private resources from productive uses.

Phasing the implementation of reforms can have many benefits, as discussed elsewhere in this paper. One downside, however, is that assistance through phasing can give special interest groups additional time to campaign against reform. It can also increase the risk of repetitive political struggles where a government's commitment to reform is continually challenged. Gray (1999, p. 116), for example, warned that 'delays in policy implementation can invite lobbying for further delay or abandonment of reform'. And Goldfarb (1980, p. 30) argues that:

If there are compelling arguments and strong political pressures for postponing a deregulation today, is it not likely that the same arguments and pressures will reappear at the future date ... of the policy change? Indeed, opponents of deregulation and tariff reductions may be more than happy to diffuse pressures for change by accepting postponement, knowing they can refight the fundamental decision as the new effective date approaches.

Sometimes the acceptability of reform may be enhanced by pursuing reform on a broad front — such an approach could go some way towards reducing resistance as groups adversely affected by a particular reform are more likely to receive offsetting benefits from other reforms within a broader package. Nonetheless, as Australia's recent experience with broad-based reforms to the tax system demonstrates, this approach does not necessarily provide an effective counter to the activities of special interest groups.

The pragmatic rationale for additional measures is also likely to produce outcomes different from those consistent with the equity/fairness rationale. As Cordes and Goldfarb (1983, p. 362) suggest:

A ... limitation of the political buy-out rationale is its lack of emphasis on equity considerations associated with income distributional factors. If the political influence of the economically disadvantaged is extremely limited, then compensation is less likely to flow to those individuals. This plausible supposition about the distribution of political influence suggests that the political buy-out rationale will distribute relatively little compensation to the disadvantaged.

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One counter to lobbying is to have accountable review mechanisms in place where calls for assistance can be systematically assessed against clear and transparent criteria. Examples of such mechanisms include the provisions for safeguard action against imports available through the World Trade Organization Agreement on Safeguards and the emergency relief arrangements available through Australia's Exceptional Circumstances Relief Payments Scheme.<sup>1</sup> The advantages of these mechanisms include greater transparency, the potential for greater consistency when it comes to adjustment policy making and lessening the risk of ad hoc outcomes.

Decisions about whether or not to 'buy-off' resistance to reform are inherently difficult. They raise a number of particularly challenging issues including whether providing such assistance would actually overcome opposition to reform, its economic costs, its underlying equity and fairness, and whether it impedes opportunities for future reform.

#### **4.4 Efficiency considerations**

As outlined in chapter 2, the existence of market imperfections and policy-related distortions can make transitional unemployment and production losses associated with policy-induced changes larger and more sustained than they might otherwise be. Also, provisions covering the transition to a new policy regime can affect the ease with which adjustment occurs. In this context, appropriate policy responses may be able to improve the efficiency with which resources adapt and/or move during a transition period and thereby reduce adjustment costs.

Lack of information can make it more difficult for firms and workers to devise appropriate adjustment strategies. Insufficient resources may be devoted to training by workers and firms alike as a result of both market imperfections and policy distortions. Reforms that result in large-scale redundancies in particular regions can have adverse flow-on effects to the existing unemployed. Adjustment can be impeded, often unintentionally, by labour market, taxation and social security policies. These matters are discussed below.

Many of these market imperfections and policy-related distortions affect the adjustment process across the economy rather than having effects which are specific

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<sup>1</sup> In 1998, the Productivity Commission (1998d) undertook an inquiry into whether safeguard action, in accordance with the World Trade Organization (WTO) Agreement on Safeguards, would be justified against imports of certain frozen pigmeat and the implications of such action. The Commission found that safeguard measures could be justified under the WTO criteria but noted that measures that directly promote industry restructuring and an export focus, would be more appropriate.

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to particular industries or regions. As such they are likely to be handled more effectively by general measures (such as labour market programs). Nonetheless, there may be a case for additional measures to complement or supplement these general measures related to industry or region specific features of the transition period associated with particular policy changes.

## **Information problems**

Where there is a lack of information on alternative employment opportunities, displaced workers are likely to find it more difficult to devise adjustment strategies and secure alternative employment.

Private firms provide extensive information on job opportunities and offer a variety of job placement services. Advances in technology have dramatically expanded options for making this information readily available. Nevertheless, there may be under-provision of such services because such information has ‘public good’ characteristics. That is, once information is provided to one person, it is difficult to stop them passing it on to others, with no accompanying benefit for the original information supplier. The potential for under-provision is likely to be greater in non-metropolitan areas where markets for these services are typically smaller and costs of information provision correspondingly higher.

Of greater significance is the smaller range of ‘quality’ search methods typically available to displaced workers seeking employment outside their own labour market segment. That is, their network of fellow employees and friends is of less value to them in their search for employment and they will typically have less direct contact with potential employers. This reduction in the depth and reliability of information about employment prospects (and other relevant information about housing, education, etc) in other locations is likely to add to the natural reluctance many people have to shift locations.

Governments may respond by supplementing or broadening privately provided information services to improve the labour market adjustment process. Where policy changes give rise to concentrated adjustment in particular areas, generally available labour market services need to be capable of responding appropriately. This requires adequate information networks to aid co-ordination in the delivery of employment services. In some situations, it may be appropriate to supplement existing services with additional information services tailored to the needs of particular industries or regions.

Information asymmetries may also impede the adjustment process. For example, employers may be reluctant to provide much advance notice about plant closures for

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fear of losing customers, suppliers and workers. For employees, however, advance notice can reduce their costs by giving them time to search for new employment, as well as allowing them time to switch from firm-specific to general training (Hamermesh 1988, Ruhm 1994). Job search is often more effective from a position of employment than from one of unemployment.

Prescribed minimum standards covering advance notice and redundancy can aid the adjustment process, but they also increase the costs of employing people and hence have a negative effect on the overall demand for labour. These costs need to be assessed against the potential benefits to determine whether such policy responses are appropriate.

Efficient adjustment by workers, service providers and users also requires accurate information about the likely impacts of a reform, including clarification of new rules and procedures. Often, however, it takes time for this information to flow through and for new rules and procedures to be settled. Providing advance notice of a reform and/or gradually introducing a reform can aid adjustment by providing individuals and firms with time to assess new arrangements and their options, including deciding on the most appropriate way to respond (see chapter 5).

It may be appropriate to introduce reforms using a co-ordinated sequence of steps to allow time for new institutional arrangements to be designed, evaluated and implemented in response to a policy change. Sequential reform has played an important part for many infrastructure reforms such as electricity and telecommunications. Appropriate sequencing facilitates the design and testing of new access and pricing regimes and the dissemination of information about new arrangements to market participants. It also provides the opportunity for firms, suppliers and users to adjust. Forsyth (1992, p. 13), for example, notes that some regulatory structures such as telecommunications are quite complex and that, ‘... a gradual approach may yield information on how different parts of the system react, and what the most efficient industry structure might be.’

In its position paper covering the *Review of the National Access Regime*, the Commission (PC 2001, p. 53) observed:

Access regulation can involve a significant abrogation of private property rights. Such abrogation can give rise to a range of costs, particularly if access regulation is poorly specified meaning that the implications for property rights are ill-defined. Uncertainty about the property right implications of changes to access regulation can also give rise to similar costs.

The costs emanating from the alteration of property rights under access regulation can take a number of forms, including:

- administrative costs for government and compliance costs for business;

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- constraints on the scope for infrastructure providers to deliver and price their services efficiently;
  - reduced incentives to invest in infrastructure facilities;
  - inefficient investment in related markets; and
  - wasteful strategic behaviour by both service providers and access seekers.

Alternatively, there may be a role for ex-post modifications to a reform to account for new information and/or unintended effects and to develop better ways of meeting particular objectives. As Gray (1999, p. 119) argues:

Often the nature of the adjustment problems triggered by a reform will not be evident until well into the transition phase. There may be a case for fine-tuning a reform or introducing supplementary measures at this stage, if it can improve the outcome.

## Training

General labour market programs include training assistance to aid the adjustment process and reduce the transitional losses associated with retrenchment. Governments may be able to offset policy-related disincentives to training such as minimum or award wages which can reduce training opportunities for workers by preventing firms from paying workers a ‘training wage’ that reflects a lower level of productivity during the training period.

Borland (1990, p. 80) argues, however, that the best policy would be to modify legislated minimum wages to allow greater differentiation between workers based on, amongst other things, their experience.

An important point is that the source of underinvestment is most significant for determining the appropriate policy response. For example, where it is the nature of Australia’s labour market institutions that is the source of underinvestment, it is institutional reform which is required to raise training.

But addressing policy impediments to adjustment directly may not always be possible (at least, in a timely way), so ‘second best’ policies may be the only option. As the OECD (1997, p. 73) suggests:

Public policy can reduce the potential cost of regulatory reform in the short and long term by helping those affected to build up skills that make them employable at their pre-displacement wages. This may be an effective policy of compensating the direct losers of the regulatory reform process, and it avoids the need of difficult and often strongly resisted changes in real and relative wages.

Taxation policies can also affect workers’ incentives to re-train. As discussed by the Industry Commission as part of an examination of labour adjustment issues for the TCF Inquiry (IC 1997c), deductions for self-education expenses are currently

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allowable only where they relate to the individual's current employment and not to future employment. A worker is unable to claim a tax deduction for self-education expenses for training for a job in another industry or for self-employment, even if their current job is on the line. Similarly, for those who are unemployed, deductions for self-education expenses are not allowable, although other measures are usually available to assist with training.

### **Large-scale redundancies and 'knock-on' effects**

Additional assistance may be warranted where a reform induced shock (such as the closure of a dominant firm) occurs suddenly, is large relative to the size of the industry base of the affected region, and where opportunities for alternative employment are limited.

In such circumstances, not only could the local infrastructure for the delivery of generally available measures be placed under considerable strain, but any decline in population resulting from the effects of a reform could place a region at risk of descending into a self-reinforcing decline. The re-employment prospects of any existing unemployed in the region may also be affected if a reform results in large-scale redundancies. As Gunderson (1986, p. 125) notes:

Mass layoffs, especially in small isolated communities where workers have roots, may create significant congestion externalities as large numbers of unemployed workers enter a labour market strained to capacity in the sense of being unable to absorb the new unemployed without affecting the job search of others. With smaller layoffs, and in large communities, individual workers who have been laid off have no appreciable effect on the probability of others finding jobs. They bear the consequences themselves, with minimal effects on third parties.

There is evidence to suggest that workers who experience extended periods of unemployment suffer, or are at least perceived to suffer, a decline in their skills and therefore find it increasingly difficult to become re-employed (see, for example, EPAC 1996b). Argy (1998, pp. 33–4), commenting on this problem, observed:

... prolonged periods of unemployment ... erode the skills, experience, self-confidence, access to job networks, and perceived employability of the jobless. These workers become marginalised by employers and are no longer viewed as part of the effective workforce available to meet the demand for labour.

In such cases, additional measures may be justified if they can reduce the severity and duration of the adjustment challenges associated with a reform. If an industry facing reform has a predominance of older workers, workers with highly firm specific or industry specific skills, or poor English, then a stronger emphasis on particular re-training needs may need to form part of any adjustment package.

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Borland (1997, p. 7) suggests that gradually introducing a reform is one way of reducing the time out of employment for displaced workers:

Other things being equal, as the number of workers displaced in a specific time interval grows, it will take a longer amount of time for the labour market to adjust to that worker displacement. Hence the duration of time out of employment for displaced workers will increase. This suggests that the time period over which microeconomic reform occurs will matter for costs of labour market adjustment. A slower process of reform which involves staggered worker displacement is likely to involve lower adjustment costs than where reform causes worker displacement to be concentrated in a short period of time.

Alternatively, a faster rate of reform (which permits more rapid accessing of the associated benefits) may require the provision of supplementary assistance to handle a more concentrated labour market adjustment process.

The extent of knock-on effects and related congestion externalities associated with large-scale redundancies is questioned by some analysts. They argue that labour markets could, for example, adjust by way of lower wages for workers, new firms could enter the region to take advantage of lower labour costs, and workers who have been laid off could relocate to regions with better employment prospects. The extent to which such adjustments can occur is influenced, in part, by the extent of any policy-related distortions that impede such adjustment. Some of these are discussed below.

### **Inflexible labour market arrangements**

The ability of regions to adjust to policy-induced and market-based changes is influenced, in part, by Australia's industrial relations system and the degree of labour market rigidity. As the Industry Commission observed in its inquiry into *Impediments to Regional Industry Adjustment* (IC 1993a, p. 108):

... where award wages are binding there is little scope for regions facing difficulties to better position themselves to ride out a regional shock and to improve their competitiveness.

One of the recommendations of the OECD's Job Study (1994, p. 43) was to 'make wages and labour costs more flexible by removing restrictions that prevent wages from reflecting local conditions and individual skill levels, in particular of younger workers'.

Over the past decade, however, Australia's industrial relations system has become more flexible through the introduction of enterprise bargaining and a reduced role for centralised wage determination. A recent survey by Wooden (2000, p. 1) comments as follows:

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A major transformation in the structures and processes that underpin industrial relations arrangements in Australia seems to have occurred since the late 1980s. The tribunal-based systems of conciliation and arbitration .... now play a far less pivotal role, and the systems of industrial awards that continue to be administered by industrial tribunals and commissions, are far less central to the determination of wages and conditions. Further, and perhaps most importantly, there has been a clear shift in the level at which wages and employment conditions are determined, from an almost exclusive focus on industry- and economy-wide considerations 10 or so years ago, to a hybrid system which places much greater emphasis on the enterprise and the workplace.

As a result of this transformation, awards are now becoming a minimum standard, or 'floor', below which pay and conditions cannot fall because of the 'no disadvantage' test.

For those regions, or industries, which are challenged by sizeable adjustment pressures, this floor may still inhibit adjustment. However, it should become less relevant over time as improved workplace flexibility leads to better labour productivity and higher real wages.

### **Taxation and social welfare policies**

The physical mobility of labour may also be inhibited by current tax and social welfare policy settings. For example, stamp duty levied on house sales acts as a tax on labour mobility. In its report on *Taxation and Financial Policy Impacts on Urban Settlement* (IC 1993c), the Industry Commission proposed that stamp duties on the sale of homes be removed and replaced with a broadly based tax on land to address the mobility problem.

Unlike some other countries (such as the USA), expenses incurred by employees in preparation for obtaining or changing a job are not allowable as income taxation deductions in Australia because they 'come at a point in time too early to be regarded as being incurred in gaining assessable income' (CCH 1997, para. 14–200). While, in some instances, employers are prepared to bear some (or all) of the costs of relocation, this is not always the case. Relatively low-skilled workers may be more likely to bear fully their own relocation costs. Tax deductions for relocation expenses, while potentially beneficial for some, would not provide effective assistance for those without a taxable income, including those who do not find employment after relocating.

Social welfare policies can also create impediments to the physical movement of displaced workers and their return to work. As discussed in appendix A, poverty traps, created by the interaction between the taxation and social security systems, can act as a disincentive for the unemployed to accept low-paid jobs.

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One of the recommendations of the OECD's Job Study (1994, p. 43) was for governments to reform unemployment and related benefit systems — and their interactions with the tax system — such that society's equity goals are achieved in ways that impinge less on the efficient functioning of labour markets.

The final report of the Reference Group on Welfare Reform concluded that Australia's current social support system may be failing many of those it was designed to help (McClure 2000, p. 2). The report identified four particular shortcomings of the current system: fragmented service delivery arrangements; an overly complex and rigid categorical array of pensions and allowances; inadequate incentives for some forms of participation and inadequate rewards for some forms of work; and insufficient recognition of the importance of participation. It recommended a new framework involving fundamental reform across a number of distinct areas to address these shortcomings. The Report's assessment of the current system, reform strategy and the governments response are summarised in appendix A.

## 4.5 Few hard and fast rules

There are few hard and fast rules for determining when additional assistance measures might be warranted. The papers presented at the Commission's workshop on *Structural adjustment — exploring the policy issues* (PC 1999g) and the general discussion at the workshop, indicated that there are a wide range of views on these issues. A brief summary of the views of speakers, discussants and some participants on circumstances where assistance beyond the social safety net (inclusive of generally available adjustment measures) might be warranted are presented in table 4.1.

A summary of the Commission's position, drawing on these views and its own analysis of the main arguments for additional assistance measures, is set out below.

Claims for additional assistance on the grounds of equity and fairness are difficult to assess because these concepts are inherently subjective and perceptions about them vary. Not surprisingly, they are often controversial. However, the 'in-principle' case for such assistance is likely to be strongest where policy changes:

- impose a clear and sizeable burden on a specific group in the community (particularly if the affected group is relatively disadvantaged);

**Table 4.1 Assistance beyond the existing social safety net?**

Summary of the views of speakers, discussants and participants at the Commission's structural adjustment policy issues workshop

<i>Participant</i>	<i>Comment</i>
Wolfgang Kasper, University of NSW	Policy makers committed to the common good and long-term productivity growth should be extremely cautious about any form of compensation. It has numerous fundamental and practical problems. The decision rules and criteria for using tax resources to compensate certain groups cannot be known. If others advocate or demand compensation schemes they must provide practical solutions. However, the adjustment burdens of citizens and firms can and should be eased by reforms that are pre-announced, well explained and gradually implemented. Anything more ambitious is only likely to hinder overall productivity growth and inflict unforeseen side effects.
Fred Argy, Australian National University	In principle, adjustment/compensatory assistance is warranted when reforms are likely to produce very uneven net benefits in combination with a disproportionate and substantial impact on a disadvantaged or vulnerable region, the people affected are relatively poor or disadvantaged, the benefits go predominantly to the rich, or there is a breach with long standing legitimate expectations. Where difficulties in identifying winners and losers and practical issues preclude the design of efficient and effective targeted assistance, governments should consider broad-based reform or reform dilution as forms of ex ante social smoothing. If these are not feasible, ex-post smoothing may be appropriate.
Cliff Walsh, SA Centre for Economic Studies	Compensation for change — whether market-driven or policy-induced — is generally undesirable other than in 'exceptional circumstances' — such as for the compulsory acquisition of property or changes to the structure of the tax/welfare system. Compensation to reduce resistance to reform or 'oil-the wheels' of reform is naive and can lead to inequitable and costly outcomes. With the tax/transfer system in place it is not obvious that there should be additional compensation for losers from other policy changes. However, good regional, education and training policies would make coping with change much easier, regionally and in industry specific circumstances.
Malcolm Gray, Analytic Outcomes, Pty Ltd	Supplementary measures may be justified where: the impact of a reform is large and difficult to anticipate; those affected are poorly placed to handle the consequences; there is a clear and close link between the consequences and the reform and the distributional impacts, even allowing for the safety net, affront usual notions of equity. Adjustment assistance through pre-announcement and phasing of reforms can improve the efficiency of the transition phase but care is needed — phasing delays benefits and is not applicable for all reforms. Reform packaging can also reduce the necessity for special compensation by spreading costs and benefits across the community.
Elizabeth Savage, University of Sydney	Additional measures may be necessary to address the adjustment and/or distributional consequences of reform proposals. It is preferable to handle any adverse effects in these areas during the policy evaluation/design stage by modifying a reform proposal appropriately. Where this is not possible or unacceptable impacts

(Continued on next page)

**Table 4.1 (continued)**

<i>Participant</i>	<i>Comment</i>
	subsequently emerge, some form of ex-post action may be appropriate. This may entail reviewing pre-existing transitional or phasing arrangements, modifying existing social security and labour market programs or developing new industry or region specific assistance arrangements.
Peter Forsyth, Monash University	Views on compensation and adjustment assistance depend on one's perspective. If an efficiency-only position is adopted, there is no reason to compensate. It may, however, be appropriate to provide adjustment assistance to correct market failures. If an equity/efficiency position is taken, then compensation should be paid if, and only if, it increases overall welfare. Where a change imposes a very large loss on an individual it will often be regarded as unfair. The same loss spread amongst many will be regarded as much fairer. Attitudes to market and policy-induced changes can differ; a society may be willing to accept losses from the former, because they are regarded as inevitable, but may regard policy-induced losses as being more unfair (because they could have been avoided). If regions are to be valued per se, best to grant region-specific incentives for further economic activity in the region.
Glenn Withers, Australian National University	Useful to distinguish adjustment assistance (based on market failures) from compensation measures (based on equity). On fairness grounds, compensation is appropriate for the innocent victims of policy change where adverse outcomes cannot be better handled by adjustment measures. Compensation presents problems — adverse incentive and rent-seeking effects. To deal with this there is a need to design reforms to get offsetting benefits, facilitate change and include tailored packages for area or community-specific disadvantage.
Andrew Stoeckel, Centre for International Economics	Impossible to calculate 'proper' compensation. Phasing can sometimes be inequitable and also lead to policy reversal with severe adjustment costs. Regional assistance is fraught with difficulties and will simply lead to 'pork barrelling'. There are better ways to facilitate adjustment besides assistance and compensation programs, such as by improving the flexibility of labour markets.
Peter Saunders, Social Policy Research Centre, University of NSW	The 'exceptional circumstances' rule provides a potentially useful vehicle for debating compensation issues — when to provide, to whom and in what form? Noted that there are gaps in the safety net and other practical problems that create difficulties for any compensation package. However, if the public is to be convinced of the need for reform, any distributional offsets must be fair, adequate and practical.
General discussion (including speakers, discussants and a range of invitees)	Broad agreement that while there isn't a single rule to determine when to compensate there are circumstances where providing compensation would be sensible and fair. But different views on the appropriate circumstances and measures reflecting varying assessments of the role of regulation in influencing asset values, the meaning of fairness, the role of legitimate expectations about rule changes and the implications of practical problems for whether effective measures can be applied. A general feeling that compensation should be directed to the 'innocent victims' of change rather than to those who have had 'special privileges' stripped away.

Source: PC 1999g.

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- deliver benefits mainly to relatively advantaged groups in the community; and/or
  - are largely unanticipated (they occur with limited notice) and involve material changes to a well defined and defensible ‘property right’.

Assistance to ‘buy-off’ opposition to policy changes may have superficial appeal on pragmatic grounds. However, on closer analysis, the provision of such assistance faces fundamental difficulties and carries with it considerable risks. The provision of such assistance to the opponents of a reform is likely to provide incentives to lobby against other reforms in the hope that this ‘pays off’. Further, singling out particular lobby groups for special or differential treatment is likely to jeopardise fair process giving rise to inconsistent and inequitable outcomes. Importantly, opposition to proposed policy changes may simply reflect that insufficient attention has been given to legitimate efficiency and equity considerations during the evaluation and design stages of their development. Designing packages to compensate for weaknesses in proposed policy changes is a poor substitute for effective policy development.

The efficiency case for additional assistance is more straightforward. Where specific adjustment assistance or some other additional measure can improve the efficiency with which resources adapt and are transferred so as to reduce the adjustment costs arising from market-based impediments (and the costs of intervention are less than the benefits), there is a strong in-principle case for intervening. Where existing government policies, including transitional measures, impede the adjustment process, the preferred policy response would be to treat the problem directly. Where this is not possible, indirect offsetting policy responses may be appropriate, depending on a benefit cost analysis of the intervention.

Additional measures are only likely to be appropriate where they can cost-effectively improve the efficiency of the adjustment process or better address adverse distributional effects relative to outcomes which could be achieved by relying solely on the social safety net and generally available measures.

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## 5 Adjustment policy — making the right choices

### Key points

- A number of additional measures, beyond the social safety net and other generally available assistance programs, can be used to handle adjustment problems or lessen adverse distributive outcomes associated with policy changes. They include direct compensation, specific adjustment assistance and various forms of reform modification — phasing, broad-based reform, reform dilution and ex post modification. The appropriate measure(s) to use will depend on the circumstances of particular cases.
- Where a policy change is likely to impose large losses or result in large adjustment costs, and those affected can be readily identified, well designed direct compensation or specific adjustment assistance may be appropriate.
- Often, however, it is difficult to identify the potential losers and quantify the magnitude of their losses or the characteristics which contribute to adjustment difficulties. Where this occurs, the relative merits of various forms of reform modification need to be carefully assessed.
- Phasing — the graduated introduction of a reform — has limitations, but also has distinct advantages where:
  - the ‘existing rules of the game’ are to be changed and a ‘breathing space’ would facilitate a smooth transition to a new regime;
  - existing institutional arrangements are being fundamentally changed and industry participants and regulators alike would benefit from having time to adapt; and
  - direct compensation or specific adjustment assistance is not feasible due to limited information on the distributional incidence of a policy change or the adjustment capacity of different groups of workers and firms.
- Broad-based reform — introducing a package of reforms— can moderate adverse adjustment and distributional impacts by exploiting complementarities between reforms, lessening ‘double adjustment’ problems and providing offsetting benefits to groups adversely affected by particular reforms.
- Reform dilution — modifying the content of a proposed reform — may represent an effective way of lessening potentially large adjustment costs or modifying markedly uneven distributional outcomes. The costs of reform dilution, however, are on-going and need to be carefully assessed against the potential benefits of using this measure.
- Ex post modification recognises that it is often difficult to deal fully with adjustment and distributional effects at the time a reform is introduced. Information gained during the implementation phase of reform can be used to identify the need for subsequent modifications to improve the overall effectiveness of a reform.

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Community support for reform is more likely if the adjustment and distributional challenges arising from policy changes are well handled. The social safety net and other general adjustment measures are available to help individuals adversely affected by policy and other changes (see appendix A). But, as discussed in chapter 4, sometimes these measures are not adequate for the range of challenges presented by policy changes. This raises the question — what additional measures best address these challenges?

This chapter reviews the main additional measures that can be employed and examines their relative merits.

## 5.1 Overview of additional measures

A number of additional measures can be used to tackle adjustment problems or lessen adverse distributive outcomes associated with policy changes. They include:

- direct compensation;
- specific adjustment assistance;
- phasing;
- broad-based reform;
- reform dilution; and
- ex post modification.

The first two measures do not involve changing the content or timing of a reform proposal. Rather, they represent ‘add-ons’ designed to address adjustment and distributional concerns directly where they arise. The remaining measures involve modifying a reform proposal. This could occur either prior to, or as part of, the implementation phase, or, alternatively, at a later date.

*Direct compensation* typically takes the form of a lump-sum payment to losers from a policy change. It may be provided as restitution for the loss of a specific property right or entitlement (such as resumption of land or the removal of a marketing quota) or to offset adverse distributional impacts. A recent example is the \$27 million financial assistance package that accompanied deregulation of the taxi industry in the Northern Territory.

*Specific adjustment assistance* covers a diverse range of measures aimed at helping individuals and firms by reducing adjustment costs and cushioning the adverse effects of a policy change. These measures are often industry or region-specific and are usually tailored to the circumstances of particular reforms. An example is the

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adjustment assistance package that accompanied dairy deregulation. The package includes a structural adjustment program, a exit program and a regional assistance program.

*Phasing* involves the graduated introduction of reform over time, either in accordance with a predetermined schedule, a staged sequence of changes, or the provision of advance notice of a reform with a nominated date of application. Most tariff reforms in Australia over the past two decades have been introduced gradually in line with a pre-determined schedule. Sequencing has often been used for reforms to infrastructure industries, while advance notice was used to introduce lifetime rating for setting private health insurance premiums.

*Broad-based reform* refers to the practice of either extending the base for reform in a particular area (such as taxation or competition policy) or reforming across a broad front (such as across-the-board tariff reductions combined with reforms to infrastructure industries and labour market regulations). It can lessen adverse adjustment and distributional impacts by providing offsetting benefits to groups adversely affected by a particular aspect of a reform package.

*Reform dilution* involves changing the content of a proposed reform prior to its implementation to lessen potential adjustment or adverse distributional effects where it is neither feasible nor appropriate to do so through other additional measures. Some recent reforms to labour market regulations provide an example of this approach.

*Ex post modification* involves modifying a reform after it has been partially or fully implemented to take advantage of ‘learning by doing’. This approach is often well suited to reforms involving broad ranging changes to areas like competition policy or the deregulation of the financial market. Reform proposals can accommodate this approach by scheduling follow-up reviews, or initiating these in response to community concerns. Recent examples include the Commission inquiry into the *Impact of Competition Policy Reforms on Rural and Regional Australia* (PC 1999c) and the report by the Australian Bureau of Agricultural and Resource Economics which assessed the impact of deregulation on dairy farmers and regional communities (ABARE 2001).

## **5.2 The relative performance of additional measures**

When trying to identify whether additional measures are warranted and, if so, what form they should take, it is useful to consider the following issues:

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- the nature of the adjustment problem, distributional outcome or other impediment associated with reform that provides an ‘in-principle’ case for assistance;
  - whether assistance available through the social safety net (that is, the social security and tax systems) or other generally available measures is sufficient, and if not;
  - whether the use of an additional measure (or combination of measures) would yield a better outcome.

If additional assistance is considered warranted, the decision about 'which measure' needs to be guided by how well they meet the following four criteria:

- effective targeting of the problem;
- cost efficiency;
- equitable sharing of financing costs; and
- transparency and appropriate accountability mechanisms.

A broad assessment of how the additional measures perform against each of these criteria is provided below.

### **Effective targeting of the problem**

In principle, additional measures should target a particular problem as directly as possible (that is, provide assistance to the adversely affected group), and facilitate the process of change. In practice, the appropriate measure and its timing will be influenced by three main considerations. First, is it possible to identify the distributional or adjustment impacts in advance, or is it better to address them once they become clearer? Second, are the impacts likely to vary between groups and regions and, if so, is it possible to take this into account? Third, is the source of any adjustment problem primarily due to limited information and an incomplete understanding of the implications of new rules and procedures arising from a policy change?

These considerations are taken up in the following discussion which handles the more direct additional measures first — direct compensation and specific adjustment assistance — followed by the various forms of reform modification.

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*Direct compensation and specific adjustment assistance — handling adverse distributional outcomes and adjustment problems directly*

Some reform proposals assessed as yielding an efficiency gain for the community as a whole may not be viewed as welfare enhancing in the absence of compensation to the losers. This could arise where a proposal is likely to impose large costs or losses on relatively disadvantaged individuals, or involve a significant and unexpected change to the existing ‘rules of the game’ which would inflict large losses on workers or firms. In these circumstances, there may be an in principle case for compensation on equity or fairness grounds.

In principle, the most straightforward measure to address adverse distributional outcomes is direct compensation via a cash or lump-sum payment. For example, the increases in base pension rates and the self-funded retirees’ savings bonus sought to offset income/wealth reductions arising from the introduction of the GST. These compensation measures involved one-off adjustments, made because it was judged that the social safety net was not equipped to handle some of the adverse distributional impacts.

Governments often provide compensation on a conditional basis, or as an ‘in-kind’ payment to improve its target efficiency. Specific adjustment assistance is one form of conditional compensation. For example, displaced workers may be offered subsidies to retrain or relocate to areas with better employment prospects. Such assistance, by offsetting the effects of market failure, can improve the efficiency of the adjustment process by reducing the severity and duration of adjustment costs.

Specific assistance may be an appropriate response to facilitate adjustment by workers and firms where a reform involves a largely unexpected and concentrated shock, is large relative to the size of a region and where opportunities for alternative employment are limited. It may also be appropriate where the characteristics of workers within an affected industry limit their adjustment options or reduce their capacity to adjust (see, for example, IC 1997ac and PC 1999c).

An attractive feature of direct compensation and specific adjustment assistance is that neither requires modification to the timing or content of a proposed reform. Each seeks to match any assistance directly to the underlying distribution or adjustment problem. And, unlike indirect additional measures, neither delays implementation and receiving the benefits of reform.

However, several practical issues need to be resolved where the use of these measures is being considered. Direct compensation requires an ability to identify the potential losers and the size of their losses. Similarly, effective specific adjustment assistance requires an understanding of the causes of potential

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adjustment problems and the sources of differences in the capacities of workers, firms and regions to adjust.

The complexity of this task will vary between reforms. While the initial losers from some reforms, such as taxi and dairy deregulation and the GST, may be broadly identifiable, in many cases the task is difficult, if not impractical. As noted by Argy (1999, p. 60):

A great many cases will not lend themselves to any reasonable ex ante identification of either winners or losers. This is true, for example, of financial deregulation or changes in industrial relations policy (for example, measures which severely reduce the role of the trade unions and the protective role of the Australian Industrial Relations Commission) or general changes in trade and competition policy. Indeed, many structural reforms only impact gradually over a considerable period of time and in a very diffused way. The effects on regional or household distribution are not easily assessable and predictable in advance.

Other factors that complicate the task of identifying losers and the extent of their losses include:

- the time period used. For example, in the case of broad-based reform, relative losers at one stage may become relative winners at a later stage (and vice versa). Determining the appropriate level of compensation would require an evaluation of the impacts for the whole reform sequence;
- determining the appropriate boundaries for compensation. Should compensation be confined to displaced workers in the industry directly subject to reform, or should it take account of flow-on effects to workers in related industries?;
- the difficulty of separating the specific effects of policy-induced changes from concurrent market-based changes;
- the extent to which a policy change is anticipated, with its likely impact reflected in past prices paid for assets, as distinct from being unexpected. In many cases, there will be elements of both attaching to a proposed policy change; and
- in the case of modifications to an existing ‘policy privilege’ or ‘rent’, the extent of any loss will depend on the proportion of firms which acquired assets after the ‘rent creating’ policy change as distinct from prior owners who would have experienced a windfall gain.

After considering these and other problems with the design of compensation schemes, Kasper (1999, p. 141) argued that:

No-one — and certainly no political agent — can have the knowledge to calculate ‘proper’ compensation, because the transient gains and losses cannot be known or measured.

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Similar difficulties arise in relation to specific adjustment measures. Adjustment difficulties will vary between individuals, firms and regions. For example, while past labour force studies covering the experiences of retrenched workers provide some indication of the influence of various factors on expected transition paths (such as the age of workers, their skill levels, and the regional unemployment rate), at best, only rough ex-ante estimates can be derived. As a number of case studies of adjustment demonstrate, actual experiences vary considerably and, where justified, measures need to be applied flexibly to take this into account (BIE 1983, 1985, Carless 1986, Connell 1981, Curtain 1985, Deery et al. 1986, Kriegler et al. 1986, Webber et al. 1996, Weller 1997).

One advantage of the social safety net and generally available adjustment measures is that there is no need to determine the cause of loss or the likely extent of any adjustment problem. A person's financial position drives access to, and provision of, such assistance.

The difficulties associated with identifying and estimating potential losses in advance suggest that often it will be impractical to provide compensation via direct measures. In such cases, the potential role of indirect measures needs to be assessed against the merits of relying on the social safety net and general adjustment measures.

*Modifying reform proposals — handling adverse distributional outcomes and adjustment problems indirectly*

The use of indirect additional measures — phasing, broad-based reform, reform dilution and ex post modification — may be more appropriate in some cases, such as where the design of effective direct compensation and specific adjustment assistance is impaired by information gaps. In other cases, indirect measures may have distinct advantages over direct additional measures (see discussion below).

The relative merits of the various forms of reform modification and their feasibility depend on the circumstances of particular policy changes. Accordingly, it is useful to examine their 'target efficiency' on a measure by measure basis.

- *Phasing*

Phasing provides adversely affected parties with a 'breathing space' to assess their adjustment options and/or moderate the magnitude of a policy change (while at the same time delaying the receipt of benefits from a reform).

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The provision of advance notice to facilitate adjustment has been widely used where governments make significant changes to the existing ‘rules of the game’. For example, foreshadowed changes to business taxation arrangements were intended to provide businesses with more time to assess the implications of the changes and make the necessary adaptations to their administration and accounting procedures. It also allowed governments, regulators and affected groups to assess and review a variety of implementation issues. Advance notice represents an effective targeting strategy where reforms cannot be broken down into smaller stages, or in some other way are unsuitable for graduated introduction in accordance with a pre-determined schedule.

Another form of phasing — sequencing — involves the progressive introduction of reform via a step-by-step process. It is particularly well suited to reforms where their implementation requires the progressive development of new institutional arrangements, such as in the reform of infrastructure industries. Prior to the structural separation of the contestable and natural monopoly activities of some public utilities, many governments have undertaken commercialisation/corporatisation, followed by the development of new access, pricing and regulatory regimes and, in some cases, the sale of public assets. The successful introduction of many reforms in this area has required a careful staged approach to allow the content of reforms to evolve over time. Indeed, reforms in this area have often evolved to encompass a combination of approaches to implementation — phasing, broad-based reform and ex-post modification or review.

In addition to accommodating adjustment to revised ‘rules of the game’, phasing may represent an effective way of lessening adjustment costs by:

- giving workers time to search for another job or to retrain, which reduces congestion in labour markets and retraining programs, as well as time out of employment;
- allowing firms to take advantage of natural attrition — this minimises the number of people who leave their jobs involuntarily and, hence, helps reduce personal losses and overall adjustment and redundancy costs; and
- reducing redundancy losses to firms with large investments in industry-specific capital equipment by allowing existing capital to be run down over a longer period, while also ensuring that new investments are assessed on the basis of expected post-reform rates of return (Baldwin, Mutti and Richardson 1980, Dorfman 1981).

One of the attractions of phasing is that it can be used in cases where it is simply not practical to identify the extent of the losses imposed on different individuals or

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firms or take account of differences in their capacity to adjust to a policy change. Reflecting this, Mussa (1986, p. 91) notes:

... it is difficult to design and implement policies that directly compensate those injured by trade liberalization without distorting economic incentives. The practical means of providing compensation is simply to slow the pace of liberalisation.

Phasing, however, can be a fairly blunt instrument. Commenting on the target efficiency of phasing, Cordes and Weisbrod (1985, pp. 186-7) observed that:

Delaying the implementation of a project or program for a given time period, however, will not provide equal compensation to all groups. Different groups may have different time preferences, hence different discount rates; and different groups may use the delay with different degrees of effectiveness to reduce their eventual losses. There is, therefore no assurance that postponement will provide the desired distribution of compensation benefits. ... Whether that possibility actually exists depends on the nature of the proposed project or policy; in many cases the possibility will not exist as a practical matter.

- *Broad-based reform*

*Broad-based reform* — the grouping together of related reforms — can reduce overall adjustment and redundancy costs as well as the ‘double adjustment’ problem which can arise from piecemeal or sequential approaches to reform, and lessen adverse distributional outcomes.

This approach has been used for tariff reductions. Instead of adjusting tariffs on an industry-by-industry basis, since the late 1980s, reductions in tariffs have generally been undertaken in a coordinated, ‘tops-down’ fashion, whereby rates of protection for different industries have converged (with some exceptions such as PMV and TCF) and average rates of assistance to industry as a whole have been reduced. Under this approach, many industries faced reductions in tariff protection for the goods they produce, but benefited from reductions in tariffs on their inputs.

There are also gains from pursuing reform simultaneously across quite different policy areas. As the OECD (1987, p. 42) notes:

Not only are the effects of reform cumulative, but they are often complementary, with the full benefits of improvements in one area only obtainable if there is action in another — as with reform of education and of labour markets, or removal of trade barriers and of domestic market distortions.

For example, while Australia’s manufacturing industries have experienced increased competition brought about by tariff reductions, they have benefited from lower prices for electricity, transport services and communications following reforms in these areas. Because broad-based reform can result in those who lose

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from one reform gaining from another, it can promote a more even distribution of benefits and costs. In this context, the Treasury (1998, p. 10) maintains:

A comprehensive and co-ordinated approach to reform can also facilitate the adjustment process. Undertaking competition reform on a broad front, and in conjunction with other areas of microeconomic reform, will ensure a wide distribution of the costs and benefits across the community. Where specific individuals and industries find that they are negatively affected by change from one direction this can be offset, albeit partially, by changes in other areas that affect them positively.

A number of analysts participating in the Commission's Workshop on *Structural adjustment — exploring the policy issues* recognised that broad-based reform may reduce the need for direct compensation (PC 1999g). For example, Gray (1999) argued that, by spreading the costs and benefits, 'packaging' reforms reduces the need for compensation.

Nevertheless, there are significant practical as well as institutional and political constraints on the use of this approach. And, even if it is feasible to adopt a packaging approach, direct compensation or specific adjustment assistance may still be justified for some groups.

Broad-based reform, for example, is unlikely to constitute an alternative to direct compensation for those who have suffered a large loss — such as lengthy unemployment or a substantial capital loss. On a practical level, Quinn and Trebilcock (1982, p. 123) argue that:

The effectiveness of the log-rolling phenomenon as a compensation device is extremely difficult to evaluate. A full netting out of gains and losses requires assessment over a very long time frame and a multitude of different issues, which makes it extremely difficult to make judgments about whether a particular loss suffered by a particular voter or group of voters is a permanent or transitory loss ... .

Hence, it is not unusual to combine broad-based reform with other additional measures — the recent new tax system reforms being an obvious example. This involved a combination of advance notice of the reform proposals, direct compensation to some groups for the effects of the GST and broadening the ambit of reform to include the personal, corporate and indirect tax bases as well as elements of the social security system. The final package also included an element of reform dilution — the exclusion of basic food items from the GST tax base to make the tax package 'fairer' and thereby 'acceptable'.

- *Reform dilution*

Where measures such as direct compensation, phasing or broad-based reform are either not feasible or sensible, what Argy (1998) calls *reform dilution* may be

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appropriate. It can improve the social acceptability of reform by targeting elements likely to have pronounced adverse distributional effects or uncertain efficiency impacts. In this context, Argy (1998, p. 117) observed:

... radical labour market deregulation has certain economic advantages and potentially severe equity effects. Yet, it is difficult to devise a compensatory mechanism which is both effective in terms of its target group (low-paid workers) and at the same time avoids high marginal effective tax rates. So a compromise is needed.

Reflecting, in part, such considerations, recent reforms to Australia's labour market arrangements adopted this approach. More radical reform proposals were softened by retaining the safety net provided by award wages and adding a 'no disadvantage' test.

There is an important difference between phasing and reform dilution. Specifically, the costs associated with phasing, in terms of delays in the receipt of the efficiency benefits of reform are limited to the phasing period. However, with reform dilution, these costs tend to be ongoing. To this extent, reform dilution may not be the most cost effective means of targeting transitional costs, which typically are of limited duration.

- *Ex post modification*

The ability to identify and address possible adjustment or distributional problems in advance is often limited. And, difficulties associated with a reform often emerge during its implementation. Further, experience and new information gained as part of the implementation process can be used to facilitate the design of better arrangements.

Consequently, there is a role for *ex post assessment and associated modifications to reforms* as an alternative way of targeting distributional and adjustment concerns. This can promote greater consistency in responding to concerns across reform areas, improve the design of new regulations and improve public understanding of the issues (including the importance of policy relative to other factors influencing change). For example, following Australia's early experience with reforms to its financial system and a revealed problem with various aspects of the revised regulatory framework, an improved regulatory regime was introduced as one outcome of the Wallis inquiry.

Several authors at the Commission's Workshop saw a role for ex post modifications to policy (PC 1999g). Argy (1999), for example, argued that flagging such an approach at the time of implementation could create a more receptive climate for reform.

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## Cost efficiency

Intervention to lessen adjustment and redundancy costs or to moderate the distributional impacts of policy changes should not only be effectively targeted, but should also achieve stated objectives at a lower cost than feasible alternatives.

While each additional measure involves costs, the size and form of these costs differ between measures. The main types of costs associated with these measures include: financing costs; administrative and access costs; behavioural costs; and costs related to interactions with other programs and policies.

While some of these costs can be readily quantified (for example, financing and administration and access costs), others are difficult to measure, although they can be potentially significant.<sup>1</sup>

### *Financing, administration and access costs*

These costs can be more readily quantified for direct compensation and specific adjustment assistance measures than for indirect forms of additional assistance. In the case of the former, they correspond to the direct budget provision covering assistance and administration costs. The assistance element corresponds to the direct payments made to workers, firms and regions targeted by these measures. Administration costs arise because responsible government agencies incur costs in identifying potential recipients, reviewing and processing applications and monitoring the relevant measure. Recipients incur access costs (such as time and travel) in applying for assistance.

For direct forms of additional assistance, these costs will be largely determined by the number of applicants and the amount of assistance provided. Administration and access costs will be influenced by the ease with which potential applicants can be identified and the complexity of eligibility criteria, risk management and monitoring procedures. Conditional assistance, such as ongoing qualifying requirements to limit assistance to intended beneficiaries, raises administration and compliance costs.

For indirect forms of additional assistance, administration and access costs are usually negligible as assistance is provided automatically by modifying the timing

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<sup>1</sup> One aspect of cost not covered in the following discussion covers considerations relating to interactions with other programs and policies. Avoidable costs are likely to arise where additional assistance provides support which is either already available through the social safety net, other generally available or industry or region specific adjustment measures, or could be more cost effectively provided by increasing funding to existing programs. Additional measures should also be consistent with Australia's international treaty obligations and, in particular, World Trade Organization agreements.

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or content of the reform itself. The ‘financing costs’ for these measures are not readily observable — they need to be estimated.

In the case of phasing, the ‘notional financing cost’ typically corresponds to the benefits forgone when reforms are introduced gradually. The size of the benefits forgone will be determined by the extent of the benefits and how they accrue over time, the length of delay before the full implementation of a reform and the discount rate used to convert the forgone benefit stream into an estimate of its present value. In general, the ‘notional financing cost’ will be larger, the greater is the overall benefits, the longer the phasing period and the lower the discount rate.

As the Treasury (1998, p. 39), in a report on *The Socio-Economic Consequences of the National Competition Policy*, said:

While the speed of implementation needs to be flexible, delaying reform is not costless. It perpetuates existing distortions and inefficiencies, such as those arising from barriers to entry and monopoly pricing, and postpones the potential flow of benefits to the community in terms of higher incomes and employment. Maintaining anti-competitive arrangements often allows business to sustain higher prices and profits at the expense of consumers. In many cases distributional equity will be enhanced by accelerated reform and allowing ordinary consumers access to alternative suppliers.

Nonetheless, the graduated introduction of reform provides workers and firms with more time to adjust, which will often enable them to adjust at lower private cost than otherwise. To the extent that this occurs, the overall ‘notional financing cost’ of phasing will be reduced. However, depending on the nature of the reform, these costs may be increased if implementation delays reduce the potential benefits of a reform. For example, undue delays in introducing reforms to regulations covering salinity and biodiversity may reduce costs to farmers but give rise to irreversible damage to the environment.

In the case of the other indirect forms of additional assistance (that is, reform dilution, broad-based reform and ex post modification), the size of the ‘notional financing cost’ will depend primarily on the timing and extent of any modification to the content of the reform.

### *Behavioural-related costs*

These costs arise because additional measures can alter the behaviour of individuals or firms in a way which imposes real costs on the community. Such costs include those arising from lobbying activity, moral hazard problems and the ‘deadweight costs’ of taxes/levies used to finance such assistance.

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In general, some of these costs are likely to arise for each form of additional assistance, although, arguably, some indirect measures may attract higher lobbying costs (see below). Compared with financial and administrative/access costs, the intangible nature of these costs make them more difficult to quantify.

- *Lobbying costs*

Provision of additional assistance to a particular group, industry or region may create an expectation that other areas targeted for reform will be similarly assisted. As Walsh (1999, p. 222) said:

The supply of compensation creates its own demand.

The decisions to provide ‘tariff pauses’ for the PMV and TCF industries also promoted pleas for special treatment from other industry sectors.

Delaying the implementation of reform, while giving workers and firms more time to adjust, also provides interest groups — particularly those who benefit from existing arrangements — time to campaign against reform. Gray (1999, p. 116), for example, warned that:

... delays in policy implementation can invite lobbying for further delay or abandonment of reform. Supposedly temporary interruptions to the implementation of reform, as with the recent decision on car tariffs, or long lead-time pre-announcements of change particularly invite this kind of lobbying.

Additional measures should be designed to facilitate, not impede reform. From a national perspective, lobbying represents an avoidable waste of resources (see, for example, Krueger 1974, Buchanan 1980 and Bhagwati, 1982).

Reforms that are particularly susceptible to lobbying are those where adjustment costs are large relative to the benefits and are borne by a well organised and concentrated group. In this context, Douglas (1990, p. 4) notes:

Vested interests seeking to preserve their privileges will always argue strongly for a slower pace of change. It gives them more time to mobilise public opinion against the reform.

There is also the risk that delaying reform and an ongoing ‘fine-tuning’ of reforms can send mixed signals to workers and firms in the affected industries about the government’s resolve. Back-tracking and inconsistencies in implementing reforms can increase adjustment burdens on firms and individuals.

It has been argued that a ‘big bang’ approach may be preferable as it is often easier to commit to a one-off reform without further changes than to a series of graduated changes (see, for example, Karp 1998). Nevertheless, it is by no means clear that a

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phased approach is likely to be consistently less or more credible than other strategies. Depending on the reform history of an industry, the announcement of a large and immediate reform could be viewed as less credible than phasing.

Governments can lessen the attractiveness of lobbying activities by promoting informed public debate and discussion about reform options. Success in this regard is likely to be enhanced by ensuring that the beneficiaries are effectively identified and that the requirements for particular forms of additional assistance are clearly and rigorously specified.

- *Moral hazard problems*

Providing additional assistance may encourage individuals and firms to modify their behaviour to qualify for assistance — the moral hazard problem. For example, the amount of direct compensation provided is often related to the size of the loss incurred by individuals or firms as well as their asset holdings. As a result, those likely to be adversely affected by a policy change have an incentive to overstate their losses. As Rottenberg (1986, p. 139) puts it:

Income stream expectations will be falsely enlarged if compensation is based upon income streams forestalled by policy change; or human capital assets will be exaggerated if compensation is based upon the diminution of human capital values that occurs.

By insuring individuals against some of the risks of change, additional assistance could encourage investors and workers to engage in ‘riskier’ behaviour, at the expense of taxpayers or consumers. As Riddell (1986, p. 19) claims:

...adjustment assistance policies insure individuals against the risks associated with change. The better the insurance protection, the more willing people become to take risks, and thus the greater the costs of economic disturbances to society.

Careful program design can reduce some of the undesirable incentive effects associated with assistance by making it conditional on workers and firms undertaking adjustment that is compatible with the broader aims of any reform initiative. Moral hazard problems could be lessened, for example, by requiring those receiving assistance to bear some of the costs (that is, by providing less than full compensation). Alternatively, compensation or adjustment assistance could be conditional. For example, the \$45 000 exit payment for producers who choose to leave the dairy industry is conditional on the applicant having been a dairy farmer for the past two years and undertaking not to become a dairy farm owner or operator again within five years of receiving an exit payment.

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However, tighter or more specific eligibility criteria aimed at targeting genuine cases to lessen moral hazard problems can give rise to higher administration and compliance costs — this points to one of many trade-offs in the design of additional measures.

- *Deadweight costs*

There are also costs associated with financing additional measures because the associated taxes or levies alter prices facing consumers and producers and alter the rewards between engaging in work and leisure activities.

In this context, the ‘marginal deadweight costs’ — the costs of raising an extra dollar of revenue to finance additional measures — of different taxes are relevant. Estimates of deadweight costs for different taxes (such as those for income, labour, wine, beer, tobacco and petroleum products) range from between \$0.10 to \$1.39 in the dollar of revenue spent (see, for example, Findlay and Jones 1982, Campbell and Bond 1997, Albon 1996, and Gabbitas and Eldridge 1998).

Where additional assistance is likely to involve large scale compensation or adjustment measures or extended periods of phasing, it will be desirable to examine the likely magnitude of these deadweight costs. Modifying adjustment costs or distributional impacts through these transitional measures can be efficiently pursued if the resulting cost is less than the deadweight cost of pursuing such modifications through the tax-welfare system.

### **Equitable sharing of financing costs**

The way in which additional measures are financed may have equity implications. For example, if the benefits of a reform accrue largely to a group of direct users of a particular good or service, it may be more equitable for this group to bear the associated financing cost. Where a reform results in widely dispersed benefits, it may be preferable for the costs to be financed by a large proportion of the community, such as taxpayers in general.

From a financing perspective, a policy maker can decide whether to fund a direct measure from taxation revenue or to charge users of the good or service associated with the reform a levy for a period of time.

The \$1.8 billion dairy adjustment package is funded by a levy of 11 cents per litre on the retail price of all liquid milk products, including imported products. The levy will remain in place until 2008 (ADIC 1999).

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In contrast, the \$61 million compensation package paid to egg producers by the NSW Government to allow the immediate removal of egg quotas in 1989 was financed from general government revenue. A specific egg levy on retail sales was rejected on a number of grounds, including the likelihood of high collection and administration costs and enforcement difficulties. As many taxpayers consume eggs, general government revenue was considered to be a more appropriate source of funds (IC 1991 and Strong et al. 1990).

Although, in principle, a distinction between reforms with concentrated benefits and those with widely dispersed benefits may be made, it may be of limited relevance when flow-on effects are considered. Improvements in publicly funded infrastructure arising from microeconomic reforms have resulted in price reductions for large commercial users of services such as power, rail freight and telecommunications. However, the savings to these users are often passed on to households in the form of lower prices for goods and services which embody these infrastructure services (IC 1996b). In such instances, it may be inequitable to assign the full financing burden of any additional measures to the direct beneficiaries (that is, large commercial users) alone.

There is less flexibility in the way the financing costs of indirect measures are shared. Measures that affect the timing of reforms, such as phasing, can provide assistance to affected parties, broadly equivalent to the payment of direct compensation or adjustment assistance. Although phasing does not have direct financing costs, it is not costless — the costs are borne by consumers (both direct and indirect) of the relevant goods or services over the phasing period. In light of this, when assessing phasing, it is important to consider who the main users of the goods or services are and, related to this, the distributional incidence of the costs.

The distributional incidence of financing costs for the remaining group of indirect measures will depend on the nature of the measures. In some cases, these measures will not require government expenditure and associated taxpayer funding. For example, broad-based tariff reductions which take advantage of complementarities across activities, would spread gains more widely or reduce losses. They would usually have only very limited direct financing costs — the associated reductions in customs revenue. Reform dilution involving the removal of basic food items from the revenue base for the GST reduced the revenue raised by the tax and required offsetting adjustments to other aspects of the budget.

Clearly, the different forms of direct and indirect additional measures can result in differences in the financing burdens imposed on groups across the community. In this regard, the greater flexibility inherent in direct measures can be advantageous in some instances, particularly if resort to user-based or beneficiary pays mechanisms

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are either administratively difficult or likely to have large adverse effects on low-income households.

## **Transparency and accountability mechanisms**

Transparency in the delivery and administration of additional measures is important to:

- facilitate effective public scrutiny and increase the discipline on those delivering these measures to act in the public interest;
- to ensure that the measures are readily understood by potential participants; and
- to aid effective monitoring and assessment of the performance of these measures over time.

The degree of transparency and the nature of accountability arrangements differ between these additional measures reflecting their characteristics and mode of delivery. For instance, it is often claimed that direct measures involving lump-sum payments and the like are inherently more transparent than indirect measures and, hence, are exposed to stronger disciplines from public scrutiny.

### *Transparency*

Descriptions of programs and their objectives, grant or subsidy rates, and total financial costs associated with direct assistance measures are usually documented in annual budgets and portfolio statements and have a reasonable degree of transparency. Transparency is often reduced somewhat where there is revenue forgone.

For indirect measures, such as phasing, it is rare for information on rates of assistance and associated financing costs to be quantified and publicly available. Similarly, most forms of reform dilution and broad-based reform are not usually accompanied by detailed assessments of their financial costs or associated changes to the distribution of benefits and costs across different groups in the community. In part, the absence of such assessments reflects difficulties inherent in quantifying the effects of these measures. But, in some cases, the absence of taxpayer funding seems to lessen incentives for assessing their impacts.

However, it is possible to exaggerate the significance of these differences. Weaknesses in the specification of objectives have also impaired the effectiveness of direct measures. For example, in its TCF Inquiry, the Industry Commission noted

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in relation to the industry development strategy (which included some specific adjustment facilitating measures) (IC 1997c, pp. 284-5):

The effectiveness of some individual programs may have been hindered by the fact that their objectives were not clear. The most striking example of a lack of clarity in objectives is in the Infrastructure Support Program ... 'Infrastructure' is not defined and priorities for improved infrastructure are not stated. The result of this fuzzy objective, was a large number of disconnected grants, few of which appear to have made a difference to the competitiveness of the industries today.

Although direct measures tend to have more readily available information on financing costs and transfers, often there is little information on their overall effectiveness in relation to their objectives. And confidentiality clauses often impair the transparency of direct measures. For example, the Industry Commission raised concerns in its report on the Pharmaceutical Industry (IC 1996a) that clauses in the Factor f scheme (which provided compensation to firms for regulation of product prices) granted confidential status to the amount of assistance given to individual firms and what they have done to secure that assistance. Of course, indirect measures are not immune from problems relating to unclear objectives or informational weaknesses — transparency challenges are inherent in all measures.

Assistance provided by indirect measures is automatically available to all in the affected industry. In contrast, assistance from direct measures only becomes available as a result of potential participants applying for it. Hence, the effectiveness of direct measures requires effective dissemination of information about these measures and clear eligibility criteria.

Clear and well advertised eligibility criteria can increase the actual and perceived fairness of direct measures. But a question arises about the appropriate trade-off between process fairness and administrative discretion. Specific adjustment assistance or compensation programs may require scope for some flexibility so that assistance can target the most adversely affected workers, firms or regions.

The capacity to assess the likely effectiveness of both direct and indirect measures will be influenced by the quality of publicly available information on how well the different measures address concerns about adjustment costs or adverse distributional outcomes.

### *Accountability mechanisms*

Effective review arrangements are a central element of good accountability. Lessons learnt from monitoring the performance of additional measures, including assessing outcomes against objectives, can be used to refine measures, ensure that they remain relevant and identify problems in design and delivery.

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In this context, ex post assessments can be a useful way of judging whether follow-up action is warranted. The importance of ex-post assessments of the effectiveness of government policies is reflected in the requirement that all new proposals for developing or amending Commonwealth Government legislation and regulation contain a regulatory impact statement, which, among other things, requires a description of (ORR 1998, B7):

... how the recommended option will be monitored, with a view to its amendment or removal should the circumstances which led to its introduction change. The information should include an assessment of the feasibility of: a 'sunset' clause; ongoing arrangements for consulting with the interest groups affected; provision for regular review; and provision for regular reporting to the public, such as in an agency's annual report.

Evaluations of additional measures should address effectiveness issues rather than assemble descriptive information on participation rates and the like. For example, there have been a number of criticisms of past evaluations of Australia's labour adjustment programs (LAPs). The National Institute of Labour Studies noted (NILS submission to IC 1997a, Q19):

These studies do not answer the question as to whether LAPs are effective, either in terms of outcomes or in terms of costs. The PMV study was mainly concerned with participants' satisfaction with LAP assistance and how the LAP could be improved for participants. (sub. 202, p. 26)

The Industry Commission noted that other assessments of some industry-specific LAPs reveal disappointing results. For example, the TCF Labour Adjustment Package achieved good participation rates, but lower direct employment outcomes than generally available training programs, including its primary target group of overseas-born women workers (IC 1997c).

The benchmark for all additional measures should be whether they are adding value (net of their costs), relative to assistance provided by the social safety net and other generally available measures. Transparency and effective assessment and monitoring arrangements for the different additional measures are important in this regard. Indeed, making quality information available on their likely merits and performance as transitional mechanisms, contributes to better informed community discussion, greater accountability and ultimately to better policy choices.

An overview of how the six additional measures perform against the four evaluative criteria, drawing on the preceding discussion, is presented in table 5.1. It provides a broad indication of their performance rather than yielding a clear-cut ranking of the measures.

Table 5.1 An overview of how the additional measures perform against the four evaluative criteria

Criteria	Direct compensation	Specific adjustment assistance	Phasing	Broad-based reform	Reform dilution	Ex post modification
<i>Effective targeting</i>						
- the source of the problem?	Can be provided as a restitution for the loss of a specific property right or entitlement or to offset an adverse distributional impact.	Can be used to reduce adjustment costs and/or cushion the adverse effects of a policy change.	Can be used to provide affected parties with a breathing space to assess their adjustment options and lessen the magnitude of adjustment costs.	Can reduce adjustment costs and promote a more even distribution of the costs and benefits of reform.	Can be used to reduce adjustment costs, adverse distributional outcomes and handle aspects of a reform where efficiency effects are uncertain.	Can be an effective way of dealing with adjustment and distributional problems where responses prior to implementing a reform are not feasible or desirable.
- the right target group?	To be well targeted the 'losers' need to be identified along with the size of their losses (the extent of any loss is likely to vary for individuals, firms and regions). If the same amount of compensation is paid across the board - likely to result in low effective targeting.	To be well targeted the cause of any potential adjustment problems need to be identified along with the sources of differences in the capacities of workers, firms and regions to adjust. Targeting may be improved if measures are designed to take account of the actual experiences of losers.	Phasing can be a fairly blunt instrument — it typically does not discriminate between individuals, firms and regions even if some are more affected (incur larger adjustment costs) than others. However, capacity to effectively discriminate may be impaired by information gaps.	Fairly blunt instrument — unlikely that costs incurred as a result of reforms would be exactly offset by benefits from others. Likely to be inadequate when there are sizeable adverse effects on specific groups.	Scope to effectively target specific groups will be determined by the feasibility of linking changes in the content of a reform to problem areas.	Offers the prospect of effectively targeting appropriate groups to the extent that modifications can take advantage of improved information on the identity of losers and/or specific adjustment problems.
<i>Cost efficiency</i>						
- financing, administration and access costs	These costs correspond to the direct budget provision to cover any payments. Administration costs include the costs of identifying losers and determining the extent of their losses. The complexity, and (therefore) costs of this task will vary between reforms.	These costs will reflect the direct budget provision and administration costs associated with assessing the extent of adjustment costs/losses for individuals. The complexity, and (therefore) costs of this task will vary between reforms. Conditional assistance is likely to involve higher	Notional financing costs correspond to the forgone benefits from reform over the phasing period. These costs will be larger the greater the overall benefits, the longer the phasing period and the lower the discount rate used to convert the forgone benefit stream into an estimate of its present	The size of these costs, will depend on the nature of the reform package — likely to be low in most cases.	The size of these costs will depend on the timing and extent of the 'watering down' of the reform. Forgone benefits/costs are on-going.	The size of these costs will depend on the timing and extent of the modifications to the reform.

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Table 5.1 (continued)

<i>Criteria</i>	<i>Direct compensation</i>	<i>Specific adjustment assistance</i>	<i>Phasing</i>	<i>Broad-based reform</i>	<i>Reform dilution</i>	<i>Ex post modification</i>
	Conditional compensation is likely to involve higher administration and compliance costs.	administration and compliance costs.	value. This cost may be lessened if phasing lowers adjustment costs.  Administration and access costs likely to be negligible.			
<i>-behavioural-related costs</i>	May invite lobbying activity and give rise to moral hazard problems — incentive for recipients to overstate losses/ engage in riskier behaviour.  Deadweight costs associated with financing compensation.	May invite lobbying activity as well as presenting moral hazard problems — incentive for recipients to overstate losses/ engage in riskier behaviour.  Deadweight costs associated with financing assistance.	Provides time for interest groups to lobby to delay or reverse reforms. Backtracking can lead to increased adjustment costs for firms and individuals. May give rise to higher deadweight costs.	May encourage lobbying — for example, resisting reform in one industry until reform has occurred in another.	Risk of sending mixed signals to affected parties and encouraging lobbying activities. Depending on the form of dilution may increase deadweight costs.	Possibility of sending mixed signals to affected parties and encouraging lobbying activities. Depending on the form of any modifications, may raise deadweight costs.
<i>Equitable sharing of financing costs</i>	May be financed out of general revenue (cost spread across all taxpayers) or by, say, a levy on reform beneficiaries. Can, therefore, adapt method of financing to the nature of the benefits.	May be financed out of general revenue or by, say, a levy on reform beneficiaries. Can, therefore, adapt method of financing to the nature of the benefits.	Typically those who are likely to benefit from a reform are those who bear the cost of phasing (for example, consumers continue to pay higher prices for cars as tariffs are phased down).	Will depend on the nature of the policy package and the accompanying flow of benefits and costs across affected parties.	Will depend on the nature of the reform dilution — may involve reductions in general revenue with an accompanying need for offsets.	Will depend on the nature of the modifications.
<i>Transparency and accountability</i>	Subject to the design and reporting requirements of the actual mechanisms used, scope for relatively good transparency and accountability from public scrutiny.	Subject to the design and reporting requirements of the actual mechanisms used, scope for relatively good transparency and accountability from public scrutiny.	Rare for information on associated financing costs to be quantified and publicly available.	Rare for detailed assessments of the financing costs or associated changes to the distribution of benefits and costs across different groups in the community to be made available.	Rare for detailed assessments of the financing costs or associated changes to the distribution of benefits and costs across different groups in the community to be made available.	Rare for detailed assessments of the financing costs or associated changes to the distribution of benefits and costs across different groups in the community to be made available.

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### 5.3 Some general comments

The social safety net and generally available measures are not designed to handle all the adjustment and distributional challenges arising from policy changes. Consequently, there is a role for additional measures in some circumstances (see chapter 4).

In principle, the ‘right’ additional measure (or combination of additional measures) to use will be the one which best targets the transitional problem, involves the least overall costs, yields the more equitable sharing of the financing costs, and provides the highest degree of transparency and accountability.

In practice, the ‘right’ additional measure to use will depend on the nature of the policy change, the likely adjustment and distributional impacts and the availability of information to assess these impacts. Accordingly, the criteria set out in section 5.2 need to be addressed on a case-by-case basis. Nonetheless, on the basis of the Commission’s experience in analysing a wide range of reform proposals, it is possible to provide some broad guidance on the suitability of individual additional measures.

Where a policy change is likely to impose large losses or result in large transition costs and the affected individuals and firms can be readily identified, well designed direct compensation or specific adjustment assistance can be relatively effective and efficient forms of additional assistance. An added advantage of these measures is that reforms can proceed immediately — allowing the community to receive the benefits of reform without delay.

Even so, these measures often give rise to behavioural-related costs as people modify their behaviour to qualify for assistance or undertake riskier activities in response to the existence of such assistance. Some of these costs can be reduced by designing clear and well targeted eligibility criteria and sound monitoring arrangements. Indirect measures also give rise to difficulties in this regard. Phasing, for example, provides interest groups with opportunities to lobby for a delay or reversal of reforms.

Often it is difficult to identify the potential losers, the magnitude of their losses or the impact of other influences on their financial circumstances. In these situations, some form of reform modification through the use of indirect additional measures — phasing, broad-based reform, reform dilution or ex post modification — may offer an appropriate way of improving a proposal which would otherwise be likely to impose markedly adverse distributional impacts or generate large transition costs.

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Phasing has a number of limitations. For example, it delays receipt of the benefits from reform and risks making reforms susceptible to reversal. Even so, it has some distinct advantages for certain types of policy changes, notably those involving:

- a change to existing rules of the game where a ‘breathing space’ would facilitate a smooth transition to a new regime;
- marked changes to institutional arrangements for the operation or funding of an activity where industry participants, users and regulators alike would benefit from having time to adapt; and
- scope for ‘undue disruption’ where direct measures are unlikely to be feasible due to limited information on the distributional consequences of a reform or the adjustment capacity of different groups of workers or firms.

Broad-based reform may provide an effective response to expedite the reform process. It can lessen adverse adjustment and distributional impacts by exploiting complementarities between reforms, lessening ‘double adjustment’ problems and providing offsetting benefits to groups adversely affected by particular reforms. However, a number of practical issues constrain the scope for the extensive use of this approach. Further, it may not effectively address the adverse effects of sizeable imposts on particular groups.

Some reform proposals may include elements which are likely to impose potentially large transitional costs, cause markedly uneven distributional outcomes or yield uncertain efficiency impacts. Where it is possible to modify a reform proposal to remove or redesign such elements prior to implementation (and this represents the least cost approach to handling these problem areas), reform dilution may remove an impediment to progressing worthwhile reform. The costs of diluting a reform, however, are on-going. For this reason, reform dilution is unlikely to be the most cost effective means of targeting adjustment costs which typically are limited in duration.

Ex post modification enables policy-makers to build a ‘learning by doing’ element into the reform process. It recognises that it is often difficult to deal fully with adjustment and distributional effects at the time a reform is initiated. The information gained during the implementation phase of the reform process can be used to identify the need for subsequent modifications to improve the effectiveness of reforms.

In some cases, the successful implementation of reform may be enhanced by using a combination of additional measures. An obvious combination is to team an ex ante additional measure (such as direct compensation or specific adjustment assistance) with ex post assessment of a reform to determine whether follow-up action is desirable. Beyond this, effective targeting considerations may justify the use of

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more of these measures as a package to deliver a better overall policy outcome. Implementation of the new tax system reform initiative took this approach.

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# A The social safety net and other generally available measures

The social security and tax systems (the ‘social safety net’) and other generally available adjustment measures represent a collection of universally available measures which, among other purposes, assist individuals to handle the adverse effects of change in the economy.

This appendix provides a broad profile of such measures, focussing on those which aid the process of adjustment or moderate the adverse distributional impacts arising from market or policy-based changes. It also identifies the main advantages of relying primarily on these measures while recognising that they do have weaknesses and are not designed to cover all contingencies. As outlined in chapter 4, circumstances do arise where these measures need to be supplemented by additional measures to facilitate the effective implementation of policy changes. The Government recognised this in responding to the recommendations of the Commission’s inquiry into the *Impact of Competition Policy Reforms on Rural and Regional Australia* (PC 1999c) noting that (Treasurer 2000, p. 2):

... special circumstances can exist that require governments to consider specific adjustment assistance of a time-limited and targeted nature to facilitate the necessary change.

The effective ongoing performance of the social safety net and other generally available measures requires that their objectives, structures, resourcing and funding be periodically reviewed. The appendix concludes with a brief discussion of some recent reviews of these measures.

## A.1 A broad profile of generally available measures

For many individuals, a large proportion of the costs of adjusting to new circumstances are funded from their own resources. But where their circumstances reach certain thresholds, Australia’s taxation and social security systems provide some assistance to mitigate the effects of both market and policy-based changes. For example, if an individual’s income is reduced their tax burden is reduced, both in absolute terms and as a proportion of their (reduced) income. They may be entitled to some form of support to boost their income or be eligible for various

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labour market programs to aid their adjustment process. A feature of these measures is that they only provide assistance after the event.

Income support measures are largely based on ‘equity’ considerations and are designed to ensure that people in a wide range of circumstances are provided with an ‘adequate’ income (see box A.1). In a number of instances, income support available to potential recipients may be delayed where those individuals have assets in excess of specified thresholds (for example, the Newstart and Youth allowances) while for others, support is only available where an individual’s assets fall below a specified dollar value (for example, Farm Help and Retirement Assistance for Farmers). A number of these measures also include conditions and elements of assistance designed to aid the adjustment process, including activity tests to encourage recipients to improve their employment prospects and, in the case of low income farmers, assistance to offset hardship in exiting farming.

**Box A.1 Some key income support measures**

The Commonwealth Department of Family and Community Services is responsible for a range of income support measures delivered through Centrelink. Centrelink also delivers support measures and programs from other agencies such as the Commonwealth Department of Agriculture, Fisheries and Forestry — Australia. Income support measures of direct relevance to changing employment circumstances and market conditions include:

*Newstart Allowance:* Paid to people aged 21 and over who are unemployed and actively looking for work. Recipients must enter into, and comply with a Preparing for Work Agreement and satisfy an activity test (this involves participating in activities designed to improve their employment prospects, such as job search, vocational training, work experience and voluntary work). Newstart recipients may also receive other allowances (for example, rent and remote area allowances).

*Youth Allowance:* Paid to young unemployed people aged 16 to 20 and students aged 16 to 25. Recipients must participate in approved activities designed to assist their employment prospects, such as job search, job search training, vocational training, work experience or voluntary work.

*Mature Age Allowance:* A non-activity tested income support payment for people aged between 60 and age pension age, who have been in receipt of other income support and face barriers to finding employment because of limited participation in the labour force.

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**Box A.1 (continued)**

*Special Benefit:* May be granted to people who do not qualify for other income support payments, but who are unable to earn a sufficient livelihood for themselves and their dependents and are in financial hardship.

In addition, there are schemes specifically designed to assist people in the rural sector. These include:

*Exceptional Circumstances Program:* Provides short-term income support (equivalent to Newstart Allowance) and other forms of assistance for farmers in a region or industry identified by the Federal and State/Territory governments as suffering an exceptional downturn in income as the result of a discrete, rare event.

*Farm Help – Supporting Families Through Changes:* This program provides income support, financial counselling and re-establishment and retraining grants for low income farmers who are unable to access commercial finance.

*Retirement Assistance for Farmers:* Assistance to low income and pension age farmers living in hardship to exit from farming by ‘gifting’ their farm to their dependants without affecting access to the age pension.

*Source:* Centrelink (2001).

A range of employment assistance programs are also generally available. Many of these programs, aimed at making markets work better and achieving social equity goals, assist the unemployed, or those likely to become unemployed, through support services or subsidies to help them find a new job. They include information on job opportunities, job placement services, training in job search techniques, literacy and numeracy training, small business management training and career counselling. A number of the programs target disadvantaged jobseekers, such as those with English language and literacy difficulties and the long term unemployed (see box A.2).

**Box A.2 Generally available labour market programs**

There are a wide array of generally available labour market programs, including:

*Job Network:* The key labour market program comprising a network of around 200 private, community and government organisations that provides tailored employment services to jobseekers. Services available include:

- *Job matching* — matching the skills and experience of job seekers to job vacancies;

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**Box A.2 (continued)**

- *Job search training* — includes activities such as resume writing, interview techniques and effective methods of approaching employers;
- *Intensive assistance* — specialised help for job seekers who need more intensive assistance, or who are experiencing, or are likely to experience, difficulty in getting a job;
- *New Enterprise Incentive Scheme* — provides training in small business management skills, business advice and mentor support to those unemployed who wish to establish their own business; and
- *Self-Employment Development Scheme* — allows job seekers to research and develop a business idea that could lead to the establishment of a business.

*New Apprenticeships:* This program offers employers wage subsidies, payroll tax exemptions and other incentives to employ young people across a range of industries.

*Career Counselling:* Provides job seekers with information on how best to match their goals and abilities, what job opportunities exist in their area of interest and what training is required to meet their goals.

*Financial Information Service:* Provides people with independent and free financial information so that they are better equipped to understand their own financial affairs and available options.

*Literacy and Numeracy Program:* Aims to provide basic literacy and numeracy training for eligible job seekers whose skills are below the level considered necessary to obtain a job.

*Indigenous Employment Program:* Comprises measures such as wage subsidies, structured training, a cadetship for indigenous undergraduates and a fund to support the development of business enterprises.

*Regional Assistance Program:* A program to encourage business and communities to take action, in partnership with government, to build business growth and to stimulate sustainable employment. Assistance is provided through seed funding of approved projects by not-for-profit organisations and is aimed at generating employment and building the skills base of regions.

*Sources:* Department of Employment, Workplace Relations and Small Business (2001) and Department of Education, Training and Youth Affairs (2001).

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## **A.2 Advantages of relying on generally available measures**

Relying primarily on the social security and taxation systems and other generally available adjustment measures to address any adverse consequences associated with policy or market-based changes has several advantages.

First, these measures treat people adversely affected by changed circumstances the same, regardless of their location (metropolitan, regional or rural) or the source of the change (policy or market-based).

Second, the net effects of all sources of change are addressed. As a result, problems which arise in attempting to identify and separate out the effects of individual changes — including individual policy changes — are avoided. For example, some policy changes may impose costs on individuals whereas other policy changes may provide benefits to the same individuals. Moreover, these costs and benefits could fall in different periods.

Third, because these measures are designed to help individuals and families affected by change rather than particular industries or activities, they are better able to target those in genuine need. While a policy change that affects a particular industry will adversely affect some players in the industry, others could actually benefit. For example, some dairy farmers (such as high cost producers with limited opportunities for lifting their productivity) will be adversely affected by deregulation of the industry, but other farmers operating more efficient farms are likely to benefit (including through the acquisition of less efficient farms). Assistance provided at the industry level could mean that not only those adversely affected receive assistance, but the winners (who have no need of assistance) could also gain. There are also risks associated with measures aimed at supporting particular industries or activities — they can impede rather than facilitate adjustment, they can protect jobs in one industry at the expense of jobs in others, and they can encourage lobbying.

Finally, generally available measures can take account of unforeseen circumstances. Often it will not be possible in advance to clearly identify the winners and losers from a policy change. The eligibility thresholds associated with generally available measures ensure that those who are adversely affected are supported. This feature is particularly important since the distribution of gains and losses from a policy change often takes time to become apparent.

There is some evidence to suggest that Australia's general support programs effectively target those in genuine need. The Business Council of Australia (BCA

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1999, p. 15) in a discussion paper on *Rebuilding the Safety Net*, quotes a senior World Bank official's views on Australia's social security system:

The World Bank's interest in the Australian social security system comes from a couple of elements: ... it is one of the most cost effective in the OECD in terms of net expenditures as part of GDP; it has also ... one of the most comprehensive coverages. Cost effective comprehensive coverage is a magic element in what we're looking for. And the other thing is that it also probably benefits the poorer parts of the population more than most other systems.

Similarly, in a conference paper — *Examining the future of the welfare state and the need for innovative approaches to service delivery* — Michael Raper, President of ACOSS, (2000, p. 1) observed:

I would like to begin by pointing out that our social security system is generally acknowledged to be one of the most efficient of all the developed countries. Australia spends a lower proportion of GDP on social security payments than almost any other OECD country — around 64 per cent of the average. In addition, the system is tightly targeted and means tested, and provides assistance to people based on demonstrated need.

Finally, in a discussion paper — *The Challenge of Welfare Dependency in the 21<sup>st</sup> Century*, Senator Jocelyn Newman (1999, p. 3), noted:

On many indicators, Australia's welfare system compares well with those of other countries. It combines comprehensive coverage with efficient targeting and effective poverty alleviation.

### **A.3 Some weaknesses of generally available measures**

Notwithstanding the advantages outlined above, the social security and tax systems and other generally available measures do have weaknesses. For example, Senator Jocelyn Newman (1999, p. 7) observed that while the social security system:

... redresses short-term poverty by meeting immediate needs, it does not have a sustained focus on helping people to move beyond reliance on income support to self sufficiency. Some parts of the system still create work and savings disincentives.

And (p. 9):

The experience of the past two decades has shown that we cannot rely on economic growth alone to solve the problems of worklessness and welfare dependence. The system must do more to encourage self-reliance and give more practical support to people in vulnerable situations, to help them avoid the trap of welfare dependence and gain their fair share of the community's economic wellbeing.

In seeking to promote equitable outcomes, the eligibility tests and phase-out provisions associated with various aspects of the social security and tax systems can

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create perverse incentive effects that can impede the re-entry of displaced workers into the workforce. As noted by Keating and Lambert (1998, p. 1):

The interface of the taxation and social security systems and the over-lapping of different means tests can result in very high marginal rates of tax. Furthermore, the overall system is complex and people find it difficult to even understand their entitlements, let alone determine their entitlements or how they might change if their private income increased.

The combination of complexity and high tax rates has created strong disincentives to move from welfare to work among those on low incomes. For some, marginal rates of tax are so high that they effectively represent a poverty trap, locking them into welfare dependency.

As a person moves from being unemployed back into work, the combination of the withdrawal of means-tested benefits and the taxation of their earned income, may leave them only marginally better off. For example, a single person with no children receiving the Newstart Allowance faces effective marginal tax rates (EMTRs) of 67 to 81 per cent over an income range of \$31 to \$293 per week. This is due to the combination of the withdrawal of their allowance, the withdrawal of the Low Income Tax Rebate, a reduction in their Beneficiary Rebate entitlement, the 'shading in' of the Medicare levy and ordinary income tax.

A number of recent reform initiatives have sought to improve jobseekers' incentives to undertake work and lessen the poverty trap problem. Eligibility for unemployment benefits, for example, has been made conditional on improved activity tests to encourage active job-seeking or strategies to improve job prospects. The Government's July 2000 tax package was aimed, in part, at improving work incentives for low to middle income families. Restructuring of the income tax scales together with the simplification of family benefits and reductions in their rate of withdrawal should reduce the EMTRs for many low to middle income families.

Raper (1999), while acknowledging these initiatives, argued that many single people still face severe problems with the existing social security system. He maintained that addressing these problems would require a number of key changes, such as: the elimination of the gap between pensions and unemployment benefits; removing disincentives for part-time work; and introducing an 'income bank' for people on unemployment benefits similar to that available for recipients of the youth allowance.

Similarly, in its submission to the Reference Group on Welfare Reform, the BCA (2000a, p. 3) observed that while the government's recent tax reforms had lessened high EMTRs:

Nevertheless, ... problems remain with high EMTRs. There are many examples of individuals (for instance those on Newstart) and families (for instance low to middle

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income families with dependents on Austudy) where EMTRs remain very high. We would urge you to undertake a comprehensive review of the problem and ways in which it can be addressed.

The Final Report by the Reference Group on Welfare Reform (McClure 2000, p. 3) identified four particular shortcomings with Australia's current social support system (that is, the social security and generally available labour market programs).

- Service delivery arrangements are fragmented and not adequately focused on participation goals for all people of workforce age.
- There is an overly complex and rigid categorical array of pensions and allowances for people of workforce age.
- There are inadequate incentives for some forms of participation and inadequate rewards for some forms of work.
- The system does not provide enough recognition of participation.

While generally available labour market programs help unemployed people to return to the workforce, they are not without problems. For example, labour market programs can have substitution and displacement effects (sometimes referred to as 'churning' or 'shuffling' the queue) whereby jobseekers targeted by particular programs simply substitute for or displace non-targeted jobseekers in filling existing vacancies. Most programs also have an additional indirect cost that covers the proportion of funds spent on jobseekers who would have gained employment without participating in the particular program. These effects decrease the net efficiency of the programs and, to the extent that unemployment is 'churned', they also raise equity and access issues, particularly where programs target one group of jobseekers over others with similar levels of labour market disadvantage (Piggot and Chapman 1995 and Hawke et al. 1997).

Where general labour market programs are found to be inadequate for workers with certain characteristics, one option is to alter their design and associated delivery arrangements. One example of this is the 'tailored' assistance package provided to the 2500 retrenched Nissan workers in 1992, many of whom were from non-English speaking backgrounds. In co-operation with Nissan and the Federation of Vehicle Industry Unions, the former Commonwealth Employment Service established an assistance centre at the plant to assist those about to be retrenched. Part of the assistance included providing information in several languages based on the major nationalities at the plant (IC 1997a).

In the third discussion paper in its New Directions series — *Pathways to Work: Tackling Long-term Unemployment* — the BCA (2000b) argued that better managed support during critical transition periods offers scope for substantially

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raising the effectiveness of various labour market programs. Analysis of the experiences of redundant workers highlighted the importance of early risk profiling to isolate ‘high-risk’ workers (that is, workers who are likely, in the absence of labour market assistance, to have a high risk of becoming long-term unemployed) combined with provision of job placement and training assistance much earlier than typically occurs to enhance the probability of achieving a successful re-employment outcome.

Where general labour market programs cannot be tailored to reduce adjustment costs, specific programs may be needed. Two past examples relate to specific programs for retrenched workers in the TCF and the PMV industries. These programs were set up in recognition of difficulties some retrenched workers from these industries were likely to experience in finding alternative employment (because of their labour market characteristics, including their age, low skill level and non-English speaking backgrounds). Assistance for these workers included wage subsidies, training (including English language training) and relocation assistance.

A large number of studies have been undertaken to assess the types of labour market programs that are most effective, including the characteristics that make them so. Useful reviews of the literature can be found in OECD (1993), Fay (1996) and Martin (2000). Box A.3 provides a broad summary drawing on Martin’s (2000) review of the literature.

While the social safety net and other generally available measures can make important contributions to facilitating adaptation to policy and market-based changes and remedying many of their adverse effects for those most directly affected, they are not intended to cover all eventualities. Inevitably, therefore, circumstances can arise where there is a legitimate role for additional measures — such as direct compensation, specific adjustment assistance and reform modification through phasing and other responses — to secure better adjustment and/or distributional outcomes for the community (see chapter 4).

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### Box A.3 **Lessons from the labour market program evaluation literature**

*Job-search assistance:* Usually the least costly active labour market programs which consistently display positive outcomes across countries. Investment in active placement efforts and raising the motivation of the unemployed, as well as taking steps to encourage and monitor job-search behaviour, pays dividends in terms of getting the unemployed back into work faster.

*Special youth measures:* Results from these measures are often not very effective. Successful programs display the following features: a close link to the local labour market and good targeting of jobs; an appropriate mix of education, occupational skills and on-the-job training, ideally in an integrated manner; provision for different pathways for education and training; the availability of support services for young people and their families; and provision for on-going monitoring to adjust and adapt programs.

*Public training programs:* Evaluations point to a very mixed track record. Three factors emerge as critical determinants of success: the need for tight targeting of participants; the need to keep programs relatively small in scale; and the need for a strong on-the-job component built on strong links with local employers.

*Direct job creation in the public sector:* These measures are, in general, of only limited effectiveness in helping the unemployed to access permanent jobs in the open labour market. These measures can, however, be used as a work test for the unemployed and as a means of maintaining contact with the labour market.

*Evaluations:* If the range of knowledge on what works and why among active labour market programs is to be expanded, it is vital that more countries undertake ongoing and systematic evaluations of their programs to facilitate progressive improvements to their design and delivery over time.

Source: Martin (2000).

## **A.4 The need for ongoing review and modification**

In order to ensure that the social safety net and other generally available measures perform well over time, their structures, resourcing and funding levels need to be kept under review.

For example, when considering the effectiveness of generally available measures for workers in the textiles, clothing and footwear industry as part of an inquiry into future assistance arrangements for this industry, the Industry Commission found them wanting, particularly with regard to eligibility criteria and funding levels (IC 1997c). In this case, the Industry Commission recommended that eligibility for employment services should be separated from eligibility for social security benefits so that jobseekers who were not immediately eligible for benefits (such as newly

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arrived migrants, people receiving redundancy payments and those with employed spouses), could, subject to means testing, gain immediate access to employment services. The Industry Commission also observed that such a change was likely to require an increase in funding for these services. The Industry Commission also recommended that funding for the then Assistance to Depressed Regions Program should take into account any significant regional impact arising from TCF activity reductions associated with reductions in assistance to these industries (IC 1997c, p. 367).

Effective co-ordination arrangements for the delivery of these measures are also important. The Review of Business Programs observed that the Commonwealth Government has in place a number of programs that seek to improve business competitiveness at the firm and industry level. However, the Review (Mortimer 1997, p. 17-18) observed that:

... many programs in this area have serious problems, often adjustment based programs have represented quick and uncoordinated responses which have not addressed the long term pressures facing the affected industry. There are inconsistencies between the availability and level of adjustment assistance to different sectors. The terms and conditions of support for each sector are seldom comparable and the objectives behind the programs also differ.

The Review believes that support should be available at the same general level to all sectors of the economy facing adjustment pressures. Firms must demonstrate they are viable in the long term, support should be time limited and, generally, firms should receive continued assistance only if they meet specified productivity objectives and are seen to be helping themselves. The multiplicity of similar programs should be addressed.

In September 1999, the Commonwealth Government initiated a review of Australia's social security arrangements and related services. The Review was tasked with exploring ways of assisting people who are disadvantaged while striking a better balance between retaining a strong safety net and providing adequate incentives for recipients to participate in education, training and work. The Reference Group's Interim Report was released in March 2000 followed by a Final Report in July 2000.

The Final Report of the Reference Group on Welfare Reform (McClure 2000, p. 2) maintained that:

Australia is in the midst of a profound economic and social transformation. The consequences of this transformation require us to re-think and re-configure our approach to social support.

The report called for a fundamental re-orientation of the social welfare system and related labour market programs away from a focus on meeting people's immediate

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financial needs towards a support system which places greater emphasis on ensuring that recipients are encouraged to participate, as fully as possible, in the nation's economic and social life.

The report's recommendations covered five distinct areas — individualised service delivery, simpler income support, better financial incentives and assistance, mutual obligations and fostering social partnerships — directed at addressing identified shortcomings in Australia's social support system (McClure 2000, p. 6).

In December last year, the Government announced its initial response to the McClure report acknowledging that (Howard and Newman 2000, Foreword):

The social security system needs to change from a passive and rigid structure that does not encourage participation to one based on engaging people in social and economic participation.

Following a period of consultation with representatives of community services and business on the detailed design and implementation of welfare reform, the Government announced additional funding of \$1.7 billion over four years to 'build a more active participation-based social security safety net to substantially improve our welfare system' as part of the May 2001 Budget. The key measures announced in the initiative — *Australians Working Together – Helping People to Move Forward* (Vanstone and Abbott 2001) — included the following.

- Mutual obligation requirements for job seekers aged up to 49 years receiving Newstart Allowance. From 1 July 2002, job seekers who have been unemployed for three months (and receiving income support) will be required to undertake Job Search Training. After six months or more on unemployment payments, options such as Work for the Dole, community work, study and part-time work will apply.
- A new Training Credit system. Under this system, training credits worth up to \$800 each will be available to (i) people who complete at least 16 weeks in Work for the Dole or equivalent hours of community work and (ii) eligible mature age workers and indigenous people through Job Search Training or Intensive Assistance providers.
- A Working Credit scheme aimed at encouraging workforce-age people on income support to take up full-time, part-time or irregular casual work, by allowing them to keep more of their income support payment while working. In weeks that they don't work, people on income support will be able to accumulate credits of \$48 a fortnight up to a total of \$1000. This accumulated balance can be offset against any earnings they make when they take on paid work.
- A literacy and numeracy training supplement to help people undertaking courses with costs like transport expenses.

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- An expanded network of Centrelink Personal Advisers aimed at ensuring people's needs are assessed better and they receive the right assistance.
  - A new assessment period of up to four weeks to be introduced in the Intensive Assistance programme aimed at ensuring people get access to the right programmes (such as literacy and numeracy training and Work for the Dole).
  - Additional funding and assistance to mature age workers. Also from 1 July 2003 new entrants will be eligible for Newstart Allowance rather than the Mature Age or Partner Allowance. This change should mean that mature age workers have greater access to services and programs.

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