Discussant Remarks

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Introduction

The objective of this workshop is to understand better the political economy of subsidy reform. Put another way, we are trying to understand *how* to get reform rather than to understand *what* reform should be undertaken. For the pessimists among us, the objective might instead be thought of as trying to understand *why* reform does not take place.

The perspective I hope to bring is not that of an expert in sustainable development, but instead as an Australian policy adviser. Australia has been continually reforming for more than 20 years and my assumption is that lessons from other areas of microeconomic reform may be useful in understanding the preconditions for subsidy reform.

My role as a discussant is made more challenging by the fact that the papers attempt to do quite distinct things. Stephan Barg, Aaron Cosbey and Ron Steenbilk (2006), for example, start from the presumption that greater information will lead to reform of subsidies and then outline a framework that allows the relevant information to be systematically collected. They state that "the framework assumes the best policy result is obtained when there is an understanding of the distribution of the costs and benefits of subsidies and this information is made available to policy makers and the public." Most of the other papers discuss reforms in particular sectors, such as reform of forestry subsidies in Finland or distortions in the pricing of transport in Europe.

There are certain key factors that may assist reform. Importantly, these factors start from my own presumption – that if we are concerned with achieving reform, then we need to conceptualise reform as an exercise in change management. In addition, to help illustrate the principles, I will introduce an example of a successful reform program from Australia, the National Competition Policy (NCP). Along with examples from the papers, I hope this will shed some light on the key question of *how* we can achieve reform.

National Competition Policy

Australia's National Competition Policy (NCP) was a substantial program of coordinated reforms that began in the early 1990s (Productivity Commission, 2005). However, the preconditions for the NCP were laid down long before the actual reforms. Australia's economic performance had deteriorated in the 1970s and 80s which led to a widespread consensus that reform was essential. Key decisions in the early 1980s included the floating of the currency and removal of controls on foreign capital. Trade reforms followed, initially with the abolition of import quotas and then with phased reductions of tariffs.

The opening of the economy highlighted inefficiencies in infrastructure service provision as businesses became increasingly concerned about their cost structures and competitive positions. As the reform momentum increased, it became apparent that the competition policy reforms were needed to address sectors that were not constrained by the external sector reforms.

In 1992, an independent committee – the *Committee of Inquiry into a National Competition Policy for Australia* (the Hilmer Inquiry) was established. The Committee's recommendations focused on extending the reach of competition policy to improve the performance of the economy in areas where external market discipline was less effective, including in the non-traded sector (where arbitrage discipline was weaker) and in spheres dominated by government ownership and regulation.

The Council of Australian Governments (COAG), the peak intergovernmental forum in Australia, comprising the Prime Minister, State Premiers, Territory Chief Ministers and the President of the Australian Local Government Association, asked an independent statutory body, the Industry Commission, to quantify the potential economy-wide effects of the key reforms. The Industry Commission estimated that the aggregate gains would be substantial – around 5.5% of GDP and also identified a range of other benefits including higher employment and lower unemployment. In view of the potential benefits, COAG agreed in 1996 to a six-year program of reforms to implement the NCP. This was later extended to 2005.

The reform package included four main elements: extension of the coverage of the *Trade Practices Act 1974*; review of anti-competitive regulation; reforms to public monopolies; and related infrastructure reforms. The element I would like to highlight is the review of anti-competitive legislation under which each jurisdiction agreed to list, review, and, where appropriate, reform all legislation that restricts competition by 30 June 2000. This deadline was later extended to 30 June 2003, partly reflecting the size of the task. The guiding principle was that legislation should not restrict competition unless it can be demonstrated that the:

1) benefits of the restriction to the community as a whole outweigh the costs; and
2) the objectives of the legislation can only be achieved by restricting competition.

A critical point is that this reversed the usual onus of proof. The status quo was not given a privileged position. Instead, advocates of existing arrangements were required to demonstrate why a restriction was in the public interest.

Around 1 800 individual pieces of legislation were listed for scrutiny. This was clearly an ambitious task. The Productivity Commission has noted the National Competition Council's (NCC) assessment that no Australian Government had complied fully with the legislative review program – either in procedural terms or in terms of a reasonable application of the public interest test. That said, by June 2004, 81% of all legislation scheduled had been appropriately reviewed. It is hard to argue with the proposition that the total reform effort was higher than it would have been in the absence of the competition policy framework.

An important feature of the NCP is the competition payments made by the Australian Government to the States and Territories for satisfactory progress. Funds totally AU$ 5.7 billion were allocated for competition payments over the period 1997-98 to 2005-06. As part of the NCP an independent body, the NCC was established to, among other things, assess progress against the commitments. The NCC makes recommendations to the Federal Treasurer on whether the States and Territories should receive NCP payments in full. The Treasurer is responsible for the final decision on the level of payments.

Reform lessons

The NCP reform experience suggests at least five key elements are required for successful reform:

1) policy objectives must be defined transparently and rigorously;
2) the distribution of benefits and costs must be transparently identified;
3) government must engage broadly with stakeholders;
4) government should set ambitious endpoints but cautious timetables for reform; and
5) fiscal transfers are often required to facilitate the transition process.

Define clearly and rigorously policy objectives

My experience as a policy adviser leads me to believe that the most important issue is to clearly specify a policy's objective. My experience also suggests that this is a very difficult and subtle process.

Policy advisers must define objectives that are sufficiently broad, but not so broad that they are operationally meaningless. I once asked a regulatory agency to explain to me their objective. They replied – "to regulate the industry". This was clearly too narrow, is not a sensible objective and precludes the use of alternate instruments. Perhaps at the other end of the spectrum the Australian Treasury's mission is to improve the wellbeing of the Australian people. While elegant, this is clearly not operational without additional thought.

Accordingly, the Australian Treasury has developed a wellbeing framework which identifies five elements of wellbeing: consumption possibilities; distribution; complexity; risk and opportunity and freedom (Australian Treasury, 2004). Whilst this provides greater guidance to policy advisers, this framework needs to be applied in a sophisticated manner to the consideration of individual policy initiatives. In terms of this framework, the art is to define objectives that are aligned sufficiently with the elements of wellbeing, but that are concrete enough to be operational. Regulating an industry is not an objective that would fit these criteria. Regulating with the objective of reducing societal risk to an acceptable level might be.

Those resisting reform have a strong incentive to obscure the objectives of policy. This is a great risk in the area of sustainable development. The existence of three pillars often lends itself to multiple objectives. Single policies that attempt to hit multiple objectives rarely represent good policy, particularly as circumstances evolve over time. As Tinbergen so aptly put it, *n* objectives require *n* instruments (Tinbergen, 1956).

In the discussion at the workshop there was a debate about whether the approach of seeking *n* instruments for *n* objectives was sensible. Some were concerned that this would not result in holistic and integrated decision making. I have sympathy for these concerns. However, I would argue that holism is achieved best by comprehensively identifying the suite of objectives and then designing a well targeted package of instruments. As circumstances evolve, the relative importance of each of the objectives is likely to change. The existence of separate instruments is likely to facilitate more continual adjustment of the policy response, than a single policy instrument. This conclusion may be tempered in practice by the need to keep complexity and administrative costs as low as possible.

The first element of Barg *et al.*'s (2006) framework is the features scan that examines the objectives and design of the subsidy. I cannot agree more that this is the essential element. However, I cannot stress enough that the way in which you define the objective in practice is critical to whether the analysis is of real help in the process. Indeed, their paper illustrates the need to be very careful.

For example, one of the objectives of biofuel policy is to promote energy security. However they note that

> *"…There are two elements to energy security: assurance of supply and protection from wild swings in fuel prices. Governments frequently combine these two notions and equate energy security with energy self-sufficiency. That is to say, they assume that domestic production of energy – any energy – will* a priori *improve national energy security. This assumption, naturally, ignores the potential that always exist for disruption of domestic production, such as through natural disasters." (Barg et al., 2006)*

This is a careful description of the energy security objective. However, there may be even more helpful ways of defining the objective. For example, take the second limb "protection of wild swings in petrol prices". Why is this an objective? Are we really worried about fluctuations in energy prices or the resultant fluctuations in income (consumption possibilities) and the distribution of that income? If it is the latter, then how would that change our view of the possible instruments that could be used?

Pentti Lahteenoja (2006) focuses on the broadening of the objectives of policies for sustainable forestry in Finland. It is hard to disagree with this focus, but one does need to be cautious about the way this is done in practice. For example, Lahteenoja's abstract notes that

> *"According to the* 1997 Act on the Financing of Sustainable Forestry*, subsidies can only be granted to ensure generally the sustainability of timber production, to maintain the biodiversity of forests, and for forest regeneration, prescribed burning, tending of young forests, harvesting of energy wood, forest remedial fertilisation, renovation ditching and forest road construction."*

Although this is a reasonably long list of objectives the latter elements appear to be more in the nature of instruments than objectives. This is an important distinction. Confusing objectives and instruments often leads to poor policy. For example, many OECD countries wish to increase innovation. The European Union's Lisbon Agenda sets targets for research and development. This may be an appropriate *strategy* for attaining the goal of enhanced innovation, but it should not be seen as a sensible policy *objective* in its own right.

Returning to forests, Lahteenoja also comments that "Finland…also relies on the forestry sector to maintain social sustainability in the Finnish countryside." It is possible that these two statements are consistent. Forestry may be maintained in order to achieve sustainable timber production and biodiversity and this may in practice be at a sufficient level to "maintain social sustainability in the Finnish countryside", but one suspects that this is really the third objective. If it is the third objective, then any lack of clarity as to its status is likely to reduce the likelihood of considering alternate means of ensuring social sustainability.

A good example of a similar issue is the reform of the Common Agricultural Policy. In a very succinct analysis Christopher Haskins (2005) notes that:

> *"Until 2003 subsidies were directly related to production, so farmers had to grow a crop or milk a cow in order to receive the payment. This encouraged them to produce food even if the land was unsuitable…The Fischler reforms changed all that. Farmers no longer have to produce food to receive a subsidy, but, instead, are given a straight payment, known as the single farm payment, as long as they adhere to minimalist environmental rules…In this new situation the single farm payment can only be justified as a social payment to mitigate the distress of small, largely tenant farmers and to a lesser extent as an incentive to landowners to protect the rural landscape."*

Multiple objectives should not be an excuse for sloppy analysis. Instead they should be an invitation for careful analysis of each of the objectives and then careful design of, often independent, instruments. Separating objectives and instruments enhances transparency and increases the likelihood that unjustified interventions will whither over time. This is an important component of Barg *et al.*'s framework which considers the cost-effectiveness of other alternatives. It is also a feature of Lindberg's analysis of the transport sector. "Refined pricing policy" is code for disentangling the underlying objectives and instituting price signals that allow these constituent parts to be targeted correctly.

Reconfiguring subsidies may seem like a boring alternative to radical reform, but the dividends can be substantial. Detailed analysis of the effects of a subsidy in terms of meeting different objectives is important, but it probably is easier to apply pressure to a program with a single, well defined and transparent objective, particularly where the program involves direct fiscal costs that are subject to annual review. Two examples of this outside the environmental area are instructive. Economists have long argued in trade policy that a tariff in a small open economy is equivalent to an equal value production subsidy and consumption tax. The same level of domestic support can be provided by a production subsidy financed by general taxation. Such a subsidy would need to compete annually with other demands on the government. In the area of public finance, economists have long argued that tax expenditures are less transparent than direct expenditures.

In terms of subsidy reconfiguration the Forest Biodiversity Programme for Southern Finland (METSO) appears promising. Lahteenoja notes that this is a specific program whereby the landowner enters into an agreement to maintain or improve specified biodiversity values of the forest and in return receives a regular payment from the State. By separately targeting the biodiversity objective, the program is more transparent than general forestry subsidies.

In the case of the legislative reform program under the NCP in Australia, clear specification of the objectives of the reform was the starting point. This is not to say that it was always done perfectly. The NCC's assessment was that 81% of the scheduled legislation had been reviewed by June 2004 in a manner compliant with the original goals (Productivity Commission, 2005). Political obstacles were certainly a part of this lack of full compliance. However, another factor, the difficulty in marshalling high level analytical capacity, also played a role. This reinforces the point that subtle analysis is often required for real world policy and there are limits to the total volume of analysis that can be undertaken let alone implemented.

Transparently identify the distribution of benefits and costs

While reform normally results in substantial aggregate benefits, changing existing arrangements affects different groups in different ways. Most microeconomic reforms have some losers as individuals structure their arrangements to make the most of existing rules.

Understanding the extent of potential losses is critical. If transitional losses are small enough, then appropriate transitional assistance can pave the way for reform. Failing to be explicit about the transitional costs of a reform may appear the easy way out but is unlikely to result in durable reform (either of a particular reform, but also of reform more generally).

Barg *et al.* (2006) explicitly considers the costs and benefits of reform, making them as transparent as possible. In particular the "incidental impacts scan" draws attention to the broader consequences of a particular policy, not least of which is the fiscal implications of subsidies. Lindberg (2006) clearly sets out the winners and losers of existing arrangements in the European transport sector. The process of NCP reviews in Australia also led to a clear identification of the transitional issues associated with reform.

Engage broadly with stakeholders

The first two elements focus on good analysis and transparency, raising awareness that may increase reform impetus and enrich our understanding of desirable reforms. The third element, engaging broadly with stakeholders, also contributes to understanding what should be reformed, but may be more important in terms of assisting the path of reform.

For example, Barg *et al.* (2006) note that:

> *"It is beyond the scope of this paper to describe the actual process for using the results of this framework. But it is worth noting that the process needs a strong participatory element… While a strong stakeholder engagement process is inherently important, there perhaps is even greater need to have a process for co-operation and horizontal analysis among government departments and agencies whose mandates, policies and programmes may overlap within the subsidized sectors."*

The typical formal way of engaging with stakeholders is to conduct a review. I am indebted to a former colleague of mine, Greg Smith, for the observation that policy reviews can have three functions: to inform; to empower; and to delay. All reviews are motivated by varying combinations of these three goals. Reviews inform because policy advisers are not omniscient. Stakeholders often have access to the best information. Engagement also allows stakeholders to be informed which can narrow the range of contentious issues.

Arguably, the workshop discussion focuses too much on the process of informing and not enough on the question of empowering decisions. In a world where everyone objectively assesses and is influenced by the evidence, this may not be an important distinction. We do not live in that world. In many cases, the decision of who should conduct a review and how they go about it may be just as important as the analytical content of the report. A supportive review of subsidy reform, authored by a member of the industry benefiting from the subsidy, and which consulted all relevant stakeholders may be more influential than the same report prepared by a technocratic institution. There is no one size fits all solution to this, but key institutional design issues are likely to affect the outcome. For example, one might ask: "what is the best way to organise a review of transport policies to increase the chances of empowering reform proposals?"

While my focus here is on the need to consider empowering, I should also note that delay can be important as it alters the timing of a decision and can ensure that the final decision is made in an environment more conducive to positive reform. For example, a review may delay a decision within the political cycle or may allow time to pass after a high profile incident that may lead to unbalanced policy decisions. In the case of the Australian NCP, jurisdictions had considerable flexibility to choose the modality of the review process. This probably assisted reform in some places and alternatively provided governments with the opportunity to stifle reform in others. Either way, there is little doubt that review design was an important issue.

Across OECD countries, the nature and allocation of decision making and advising functions varies considerably. That said, even in countries where policy advisers do not have decision making power with respect to political issues management, it is still necessary to advise on the transitional management process.

Set ambitious endpoints but cautious timetables

The fourth element focuses on the speed of reform once an opportunity arises. In the case of the Australian NCP, a window of opportunity was presented by the pressure created by earlier reforms and by the recession of the early 1990s. This created a strong consensus that more was required to continue the transformation of the Australian economy.

The temptation as a policy adviser is to attempt to use a window of opportunity to jump straight to the best solution. This rarely works for at least four reasons:

1) government capacity for reform is limited so that reform can only be pushed on a limited number of fronts at any one time;
2) the adaptive capacity of the community is limited;
3) *ex ante* analysis of the benefits of reform is rarely as compelling to the public as the demonstration of actual experience; and
4) dramatic reform also increases the likelihood of policy reversal.

Given these considerations, often the best approach is to set ambitious endpoints, but have slow (but credible and pre-specified) phasing of the changes. This was the Australian approach to tariff reform and to the NCP. Phasing can allow adaptation by those affected without compromising the final objective. In some environmental areas, this conclusion may need to be qualified by consideration of stock/flow and irreversibility issues. If adverse effects are smaller than estimated by stakeholders (they do find ways to adjust), then phasing allows the truth of this to be revealed over time.

Phasing also increases the chances that reform will be continued when the policy environment is less favourable than it was before. The pre-commitment to reform legislation embedded in the NCP agenda allowed a range of reviews to be conducted (which itself maintained pressure for reform) even when a key initial driver, the poor performance of the Australian economy, had ceased to be relevant.

Facilitating the transition

Finally, many reforms that require the elimination of existing rents will need transitional assistance to succeed. We should not be afraid of this assistance. After all, the recipients were previously receiving these benefits, only in a non-transparent form. The key is to ensure that any transitional assistance facilitates rather than hampers the required adjustment.

In many cases, transitional assistance will not result in a net cost to the government's budget as the government will benefit from reduced expenditure on an initial subsidy. However, this will not always be the case. Where the subsidy is hidden by underpricing or regulatory controls (such as monopoly marketing arrangements), the reform may dissipate rents, that were not being directly paid by the government.

In the case of the NCP, the Australian Government provided annual payments to the States and Territories contingent on them meeting their commitments under the agreement. In a number of cases, the States and Territories and the Australian Government paid transitional assistance to groups affected by the competition reforms.

The need for budgetary funds may constrain the capacity for reform. However, given that reform is a continual process, this indicates that fiscal authorities may need to permanently factor in a portion of funds each year to facilitate structural reforms. Naturally the area in which these funds will be required will change over time and all claims for assistance will need to be assessed on a case-by-case basis in terms of their benefits in facilitating reform. The key point is that it is unlikely to be correct to think of a one-off investment in structural reforms that will not need to be repeated in other areas. This may be an important point in the context of the Stability and Growth Pact. Some countries have argued that they should be allowed to breach the 3% deficit ceiling on the basis that funds are needed to facilitate structural reform. This argument does not appear compelling if there is a continual expectation of the need to fund (different) structural reforms.

Conclusion

The objective of the workshop was to try and understand better *how* to achieve subsidy reform. My contention is that this requires an understanding of the change management process of reform. I have outlined five elements that I think are important: defining clearly objectives; identifying transparently winners and losers; engaging broadly with stakeholders; setting ambitious endpoints but cautious timetables; and facilitating the transition with fiscal transfers that do not hamper the adjustment process.

The first two elements are mainly focused on transparency and bringing to light the desirable direction of reform. I have noted that these are subtle tasks that require high quality personnel. Given this, we must always be mindful of the limited capacity to undertake reform on too many fronts at once. The last three elements are more focused on the reality of managing the transition process.

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