SOUTH AUSTRALIAN CENTRE
FOR ECONOMIC STUDIES

THE UNIVERSITY of ADELAIDE

Economic Issues

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No. 46

The Regulatory Load in South Australia and Impact on Economic Activity

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Executive Director's Note

Welcome to the forty sixth issue of *Economic Issues*, a series published by the South Australian Centre for Economic Studies as part of its Corporate Membership Program. The scope of Economic Issues is intended to be broad, limited only to topical, applied economic issues of relevance to South Australia and Australia. Within the scope, the intention is to focus on key issues – public policy issues, economic trends, economic events – and present an authoritative, expert analysis which contributes to both public understanding and debate. Papers will be published on a continuing basis, as topics present themselves and as resources allow.

This paper is the third of four papers in the Economic Issues series to review South Australia's macroeconomic performance with reference to historical developments and more recent history, including a pointer to sustainable comparative advantages. The second paper in the series (EIP No. 45) examined prospects for growth through a review of the state's manufacturing sector including the role that state government can play in assisting the potential to be realised. In this paper we consider the impact of regulation and industry support policies on economic activity and our search for global competitiveness. In the final paper in this series we consider a range of policy responses to reinvigorate this state's economy..

The authors of this paper are Darryl Gobbett (Visiting Fellow, SACES), Associate Professor Michael O'Neil (Executive Director, SACES) and Steve Whetton (Deputy Director, SACES). The views expressed in the report are the views of the authors.

Michael O'Neil
Executive Director
SA Centre for Economic Studies
February 2016

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Introduction

In the first two Economic Issues Papers in this Series we looked at the recent economic performance of South Australia, including the changes to industry structure and employment. The various aspects of this performance were also considered in comparison with a number of the other Australian States.

Manufacturing was a key focus because of the very large role it played, often in a highly protected and otherwise regulated environment, in employment, income generation and public policy application in South Australia. In addition, the substantial loss of employment in manufacturing in South Australia from the 1970s and more severely in the last few years, has played a significant role in the overall private sector employment performance and broader South Australian economic outcomes. In turn, along with other local and national public policy decisions and influences, those outcomes have adversely affected the budgetary performance of the South Australian Government.

There was also evidence, however, that employment growth was occurring in other sectors and within manufacturing. Importantly there were areas, such as in food processing, that South Australian business appeared to have some comparative advantage in manufacturing with employment growth occurring faster than interstate. Anecdotal information points to this growth continuing and assisting activity and employment growth in other areas.

Into 2016 it seems likely this growth could be largely offset by contraction in other parts of the South Australian economy, including further job losses in traditional areas such as motor vehicle parts and assembly manufacturing and coal powered electricity generation, along with a likely further cyclical contraction in mining employment.

The questions then arise around what is the “right” environment, particularly on the public policy front, for the South Australian economy to show a broadening of economic activity and employment growth with exports as the principal driver. We take as a given in this analysis that sustainable economic advancement for South Australia comes from increasing the value and volume of goods and services which others will freely buy from us, rather than what we subsidise or protect from competition. How does SA industry become more efficient and productive, which are not necessarily the same things?

What is the regulation load we want on our industries and their suppliers? What impact does our regulation have on our ability to compete and adapt in a world of increasing globalisation and freeing up of trade and information flows; of rapid technological change; and rising evidence that generation of wealth may often come from being likely a small part of very large and complex global supply chains?

If we have a view on the appropriate regulation load, how do we determine, implement, review and manage the resulting regulations as efficiently as possible?

That regulation load has various costs, just as the more obvious cost of the tax load and its mix. So at the South Australian level what is the tax load and its mix that are most likely to help South Australian business be globally competitive, adaptive and fit in the global supply chains? That in turn prompts questions about what is the level, mix and focus of South Australian Government spending that is supported by that tax effort.

Those questions about tax and spending include examination of the competitive impact on other industries of taxpayer support or protection provided to others. Does South Australia have a focus of trying to pick winners or aiming to provide a broadly supportive business environment?

We look in this Economic Issues Paper No. 46 at some aspects of the South Australian public policy background, constraints and choices. In Economic Issues Paper No. 47 we consider the aged structure of the population and economic growth with a focus on the size and composition of the youth labour force and the productive age cohort who are the key labour supply cohort. This will be followed with our Economic Issues Paper No. 48 to consider possible policy responses to reinvigorate the local economy.

The Regulation and Tax Load

> *Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker.*
>
> *Paul Krugman, The Age of Diminishing Expectations (1994)*

> *Cross-country analysis provides compelling evidence that product market regulation affects productivity performance…. Regulation inhibits (raises the costs of) adjustment (and) … reduces ability to introduce more efficient work arrangements (and therefore incentives to invest in new technology).* Less-intrusive regulation enhances *flexibility* to become more productive…
>
> *Dean Parham, Economic studies of regulatory policies: some further observations (2008)*

In a civil society, regulation and taxation are facts of life. What are the subjects of each, the coverage, the amount and complexity of each and the cost and benefits vary considerably across jurisdictions and through time in the same jurisdiction. Who is intended to be the principal beneficiary and who will bear the ultimate, and sometimes hidden costs, also often change through time.

In the aftermath of the Great Depression and WWII, Government intervention in economies, industries, product markets and social affairs surged. Through the 1970s, there was increasing concern globally and in Australia (e.g. Bert Kelly and his opposition to high tariff policies) of the impacts and costs of regulation, with the then Industries Assistance Commission (now the Productivity Commission) playing a major, and internationally recognised role, in calculating the impacts on the Australian economy and standard of living. This included the static costs to business and households, along with the impacts on productivity, international competitiveness and economic growth.

The stagflation of the late 1970s and the recession of 1980-81 highlighted the need for change. The newly elected Hawke Labor Government decided the highly regulated path was damaging to Australia's economic prospects and future living standards and started a process of major economic reform which continued with the Keating Labor Government. From the early 1980s to mid-2000s Australia went through a period of generally bipartisan supported deregulation in many industries and sectors.

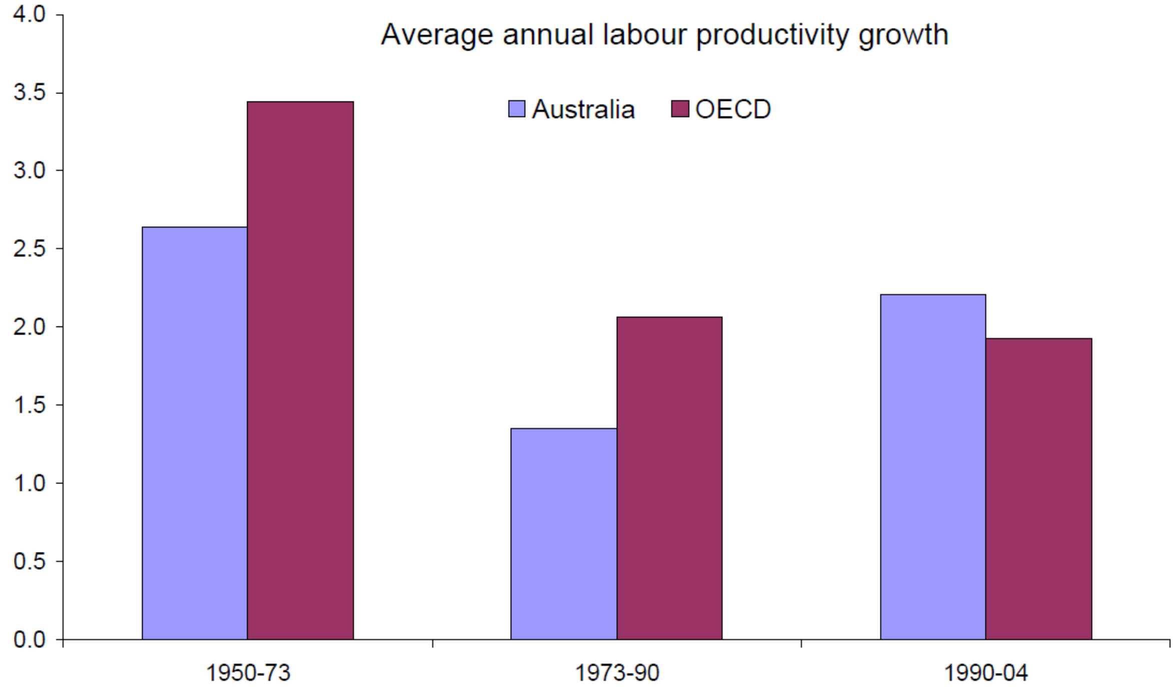
What had been major pillars of the organisation of the Australian economic and industry structures for often several decades were changed substantially. This included setting of wages and labour market relationships, the full deregulation of interest rates and exchange rates; the reduction or elimination of effectively all tariff and quota protection and subsidies and public sector control of many areas of manufacturing and agriculture, including many State based commodity boards; reform of airlines and shipping; business competition policies etc.

While the focus was initially on deregulation and increased competition at the Federal level, the States were required to become increasingly involved in deregulation and harmonisation of regulation which had often previously been used to impede interstate or intrastate competition, e.g. electricity generation and transmission, water utilities; shopping hours; companies regulation; ports and harbours; public procurement, recognition of qualifications and hence labour mobility etc.

The reforms were substantial but as illustrated in the Harper Review[1] in some areas they have "fallen short" of what was intended (e.g. shopping hours, financial reforms, stamp duties, water) and there remains considerable scope for still further reform.

This deregulation and focus on increased competition is credited with being a major factor in the significant lift in labour and multifactor productivity growth in Australia through the 1990s and early part of the 2000s. As shown in Figure 1, the lift in labour productivity growth was both a break with the Australian performance of the previous two decades and compared well internationally.

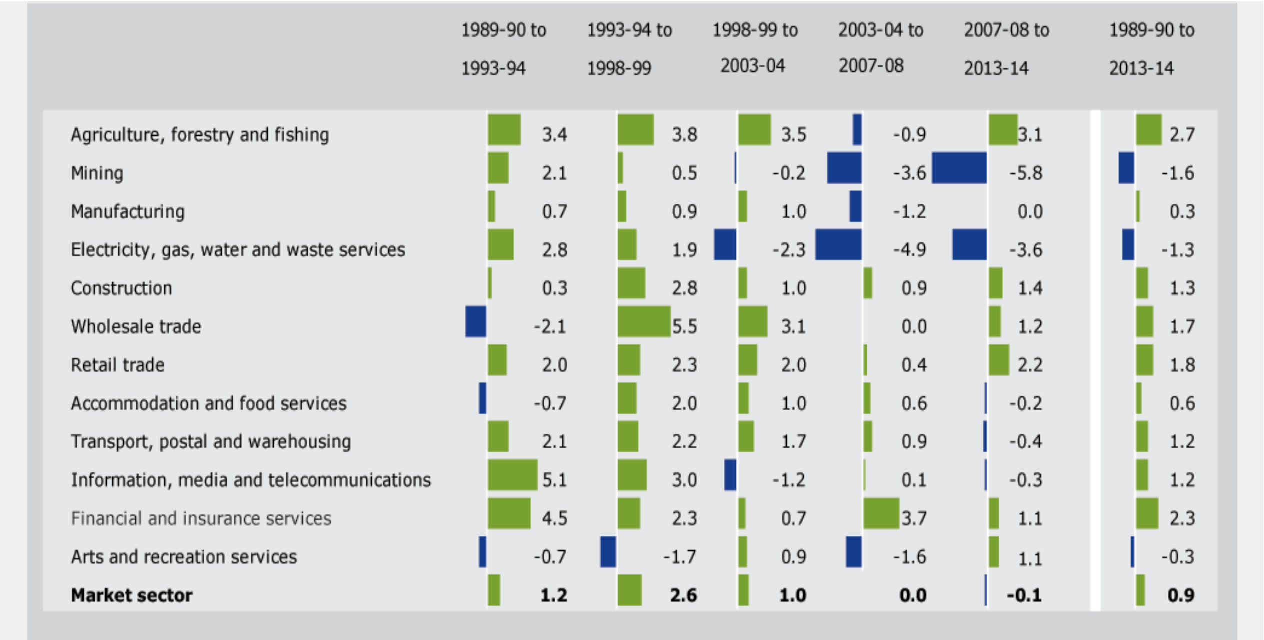
Figure 1: Australia's relative productivity performance



Source: Gary Banks, Chairman of the Australian Productivity Commission, **Structural Reform Australian Style: Lessons for Others**. Presentation to the IMF, World Bank and OECD, May 2005.

Figure 2 shows the Productivity Commission's June 2015 estimates of Multi Factor Productivity change and illustrates the gains by major Industry groups in the reform period and the general slowdown since the mid-2000s.

Figure 2: Industry MFP, 1989/90 to 2013/14, by ABS productivity cycle[a]

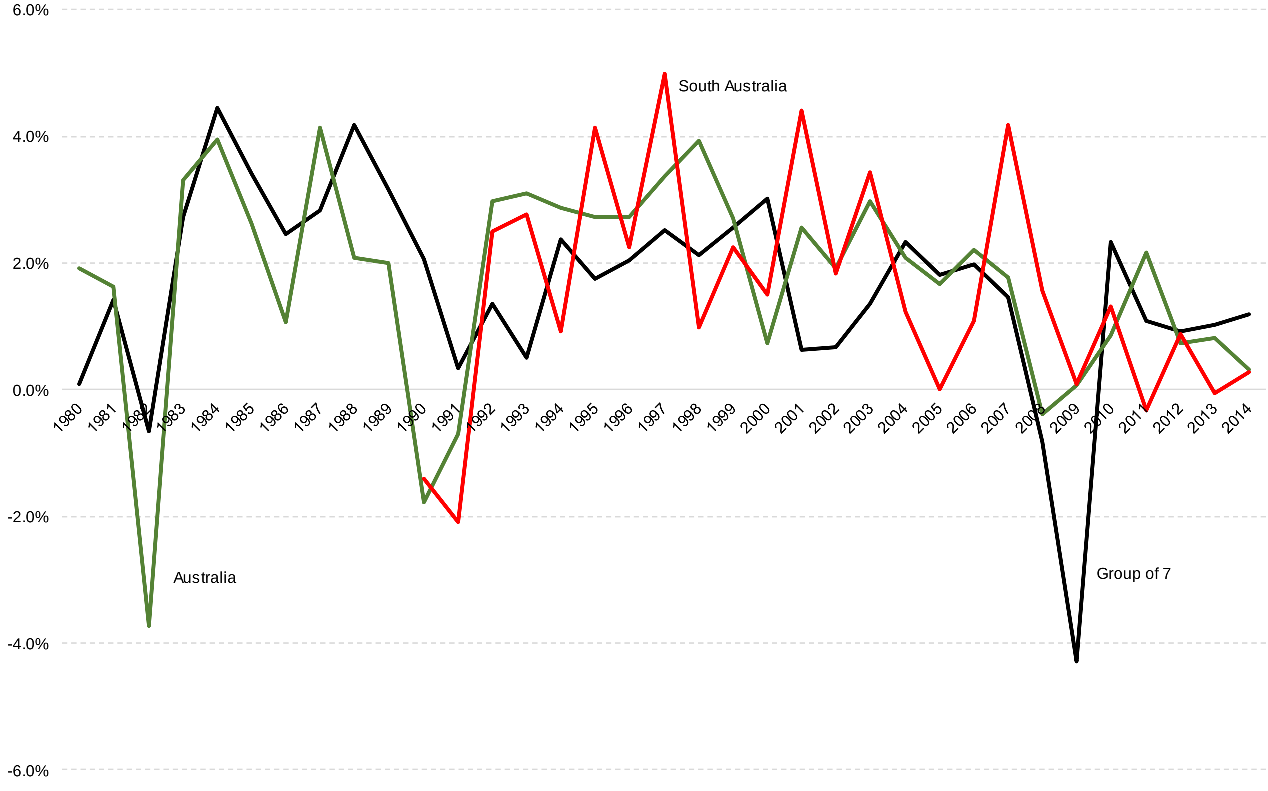


	1989-90 to 1993-94	1993-94 to 1998-99	1998-99 to 2003-04	2003-04 to 2007-08	2007-08 to 2013-14	1989-90 to 2013-14
Agriculture, forestry and fishing	3.4	3.8	3.5	-0.9	3.1	2.7
Mining	2.1	0.5	-0.2	-3.6	-5.8	-1.6
Manufacturing	0.7	0.9	1.0	-1.2	0.0	0.3
Electricity, gas, water and waste services	2.8	1.9	-2.3	-4.9	-3.6	-1.3
Construction	0.3	2.8	1.0	0.9	1.4	1.3
Wholesale trade	-2.1	5.5	3.1	0.0	1.2	1.7
Retail trade	2.0	2.3	2.0	0.4	2.2	1.8
Accommodation and food services	-0.7	2.0	1.0	0.6	-0.2	0.6
Transport, postal and warehousing	2.1	2.2	1.7	0.9	-0.4	1.2
Information, media and telecommunications	5.1	3.0	-1.2	0.1	-0.3	1.2
Financial and insurance services	4.5	2.3	0.7	3.7	1.1	2.3
Arts and recreation services	-0.7	-1.7	0.9	-1.6	1.1	-0.3
Market sector	**1.2**	**2.6**	**1.0**	**0.0**	**-0.1**	**0.9**

Note: a Figures are average annual growth rates in each designated productivity cycle.
Source: Productivity Update, Productivity Commission, July 2015, Canberra.

South Australia was part of this reform process and so participated in and benefited from the stronger national growth in absolute and per capita terms, even as overall employment in manufacturing was being adversely affected by the further reductions in international trade protection.

Figure 3: Growth in real GDP per capita: OECD G7, Australia and South Australia



Source: OECD database, ABS,SACES.

The arguments continue about how much of the increase in productivity and output growth to the early 2000s can be attributed to various elements of the reform process of the 1980s and 1990s. There is also debate as to the social and redistributive impacts of the reforms.

New debates have emerged as to how much of the slowdown, or even reversal, in productivity growth since the mid 2000s reflects the absence of further reform or the, at least partial, reversal of earlier reforms.

That said, few who were participants or observers of the Australian economy in the 1970s would deny it is in far better shape in the 2010s on most measures and delivering substantially higher living standards for most Australians, either directly or through public support.

For South Australia, the current economic difficulties **present an analogous situation to Australia in the early 1980s**. Should South Australia continue on its current path of being a relatively highly regulated and taxed jurisdiction or make a break, as Australia did starting in the 1980s, to aim to be a lightly regulated jurisdiction?

Red tape Reform

In the Business Council of Australia's May 2007 report *A Scorecard of State Red Tape Reform*[2] South Australia ranked relatively well, although behind Victoria, amongst the States on the Benchmarks applied.

Principles of good regulation making:	Good
Accountability:	Adequate/Good
Transparency:	Adequate – but with clear room for improvement
Review:	Good
Overall Assessment of Regulation Making:	Adequate/Good

Nb: No Excellent was awarded to any State. Most common was "Adequate – but with clear room for improvement".

South Australia was noted in the BCA Report for:

- Creation of a Competitiveness Council which was "…to provide progress reports on the implementation of government initiatives to reduce compliance costs";
- Requiring compliance costs to be quantified in regulatory proposals using the Business Cost Calculator; and
- Undertaking a Survey of small business to identify and reduce red tape hot spots.

In 2008, the South Australian Government announced it had exceeded its $150 million target of reduction in regulatory compliance costs per annum[3]. This target was set in 2006 in response to a call by Business SA, the state's peak employer body, to reduce South Australia Government red tape by 25 per cent.

The Organisation for Economic Cooperation and Development in its *Reviews of Regulatory Reform: Australia 2010* noted that South Australia had been one of the "two early reformers" and, along with NSW, Queensland and Victoria, has since 2006 set quantitative targets to cut red tape. It said "South Australia took a broad approach aimed at cutting both administrative costs to Government and compliance costs to business."[4]

The OECD noted in regard South Australia:

1. All Cabinet submissions require an assessment of regulatory impacts;
2. Since 2006, all proposals with a significant impact on business must include a Business Impact Statement (BIS) and a Business Cost Calculator Report, assessing the cost of compliance on business; and
3. The Department of Trade and Economic Development (DTED)[5] reviews and assesses the adequacy of all BISs and provides advice on the preparation of Business Impact Statements (BIS) and the use of Business Cost Calculator (BCC). DTED's assessment of BISs and BCC is included with all policy proposals.

In January 2011 the South Australian government released the *Better Regulation Handbook - How to design and review regulation, and prepare a Regulatory Impact Statement*.[6]

It was noted in the Handbook:

> *Red Tape Reduction Offset: Where an agency does not get Cabinet Office's sign-off on a RIS, but seeks and obtains the approval of Cabinet for their proposal, Cabinet Office will advise the Office of the Economic Development Board (OEDB). The OEDB will then record and assess any business costs imposed by the submission as an increase in costs under that agency's red tape reduction assessment, requiring the agency to find offsetting savings to meet their red tape reduction target (unless Cabinet makes an explicit decision to the contrary).*

In November 2012, the South Australian Government announced in *Reducing Red Tape for Business in SA 2010-11 Final Report* that it was on track to make further savings of $151 million per annum in regulatory compliance costs after the net $168 million saved in 2008. [7]

At that time the South Australian Government also announced the Competitiveness Council was to be wound up.

The Treasurer, the Hon Tom Koutsantonis MP, said:

> *"that does not mean a lessening of our focus on red tape reduction… processes are now in place to consolidate the gains and continue building a culture that avoids an increase of red tape in the future."*

These processes included an increased effort at scrutiny since the OECD Review with the Final Report noting:

> *"The Department for Manufacturing, Innovation, Trade, Resources and Energy provides advice on any business impacts. The Department of Treasury and Finance scrutinises the cost benefit analysis…impacts on the environment and families are also considered. …The Department of the Premier and Cabinet (Cabinet Office) looks at the overall adequacy of the RIS and gives final sign-off before submissions go to Cabinet. Once a regulatory decision has been announced the RIS is published on the Department of The Premier and Cabinet website."*

In the *Reducing Red Tape for Business in SA 2010-11 Final Report,* it was reiterated that development of regulation by the South Australian Government takes place against the Eight Best Practice Regulation Principles agreed by the Council of Australian Governments (COAG) in 2007. These are:

1. Establishing a case for action before addressing a problem.
2. A range of feasible policy options must be considered, including self-regulatory, co-regulatory and non-regulatory approaches, and their benefits and costs assessed.
3. Adopting the option that generates the greatest net benefit for the community.
4. In accordance with the Competition Principles Agreement, legislation should not restrict competition unless it can be demonstrated that:
    a. The benefits of the restrictions to the community as a whole outweigh the costs.
    b. The objectives of the regulation can only be achieved by restricting competition.
5. Providing effective guidance to relevant regulators and regulated parties in order to ensure that the policy intent and expected compliance requirements of the regulation are clear.
6. Ensuring that regulation remains relevant and effective over time.
7. Consulting effectively with affected key stakeholders at all stages of the regulatory cycle.
8. Government action should be effective and proportional to the issue being addressed.

The South Australian Government therefore has a very substantial set of policies, guidelines, handbooks etc for determining the costs of new regulation[8] .

While new Regulatory Impact Statements for those regulations approved by Cabinet may be published on the Department of the Premier and Cabinet website, they are presumably removed in a very short-time-frame as only one was displayed at the time of writing this article.

For those regulations where the Cabinet Office sign off on a RIS is not obtained but Cabinet approves the regulation, there does not appear to be publication of the business costs or the required offsetting savings.

It is therefore difficult, from the information currently available to calculate the overall cost of new regulations and the overall regulatory burden.

This is both in terms of the “static” costs of compliance, of activities foregone by business and the impact on consumers; and the “dynamic” impacts on areas such as future income, employment, business setups, innovation and consumer benefits foregone.

While generally very difficult to quantify *ex ante*, the “dynamic” impacts may well be much larger *ex post* than the “static” costs which are generally the focus of cost benefit analysis.

To take this point further, we may not even be able to know or estimate the cost of what is potentially being foregone as a result of regulation that dissuades entrepreneurs from even considering certain activities in South Australia or Australia.

For example, the export of iron ore was prohibited by the Commonwealth Government from 1938. This was to prevent the Japanese from importing ore from Yampi Sound in Western Australia and in view of the perception that Australia’s iron ore reserves were limited. The embargo was partially lifted in 1960, major iron ore deposits were discovered and the rest is history.

The Cost/Benefit analysis of the embargo in the post war period would presumably have focussed on the, likely small, loss of employment and income from the likely very limited exports and the benefits of lower iron ore prices for the then heavily protected iron and steel industry.

While now a moot point, what would have been the benefits to Australia and South Australia if iron ore exports were not banned from 1945 and discovery and development of the iron ore resources had occurred earlier? A similar question arises with regard the nuclear industry, as is now the subject of the South Australian Nuclear Fuel Cycle Royal Commission.

Another example is the national deregulation of the financial sector which has led to the creation of a much larger and more diverse set of employment, income generation and innovation in products and services to date than would have been envisaged at the time by policy makers and participants.

It is also often the case that adverse impacts of regulation are then dealt with by Government with further regulation. This increases the overall costs and causes distortion and inhibitions elsewhere.

An example is water pricing in South Australia. In setting the price of water per kl and the delivery costs that can be used by SA Water, the Essential Services Commission of SA (ESCOSA) is required to use a value of the water infrastructure network that is determined by the South Australian Treasurer.

If that value is set too high, as seems to be commonly agreed, the resulting water prices will be higher in order to provide SA Water with an agreed rate of return.

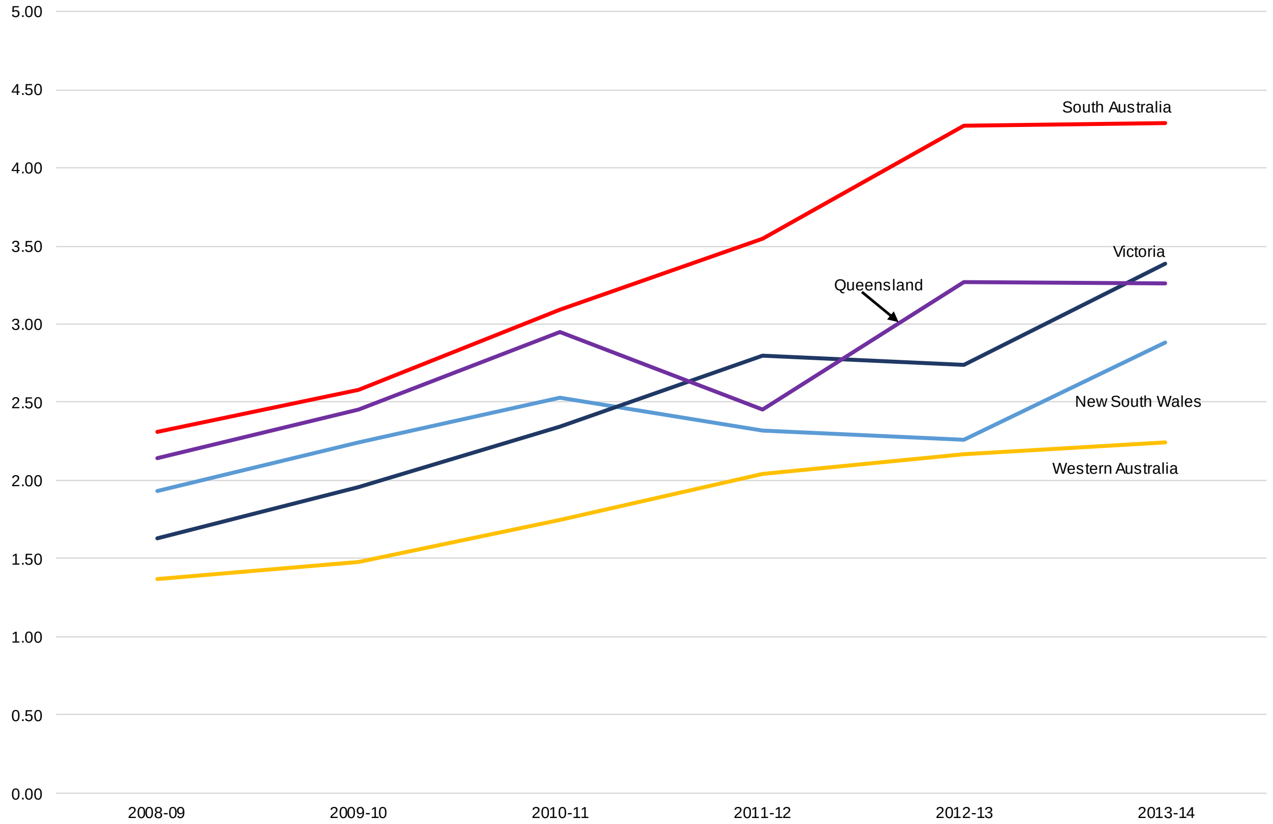
South Australia has Australia's highest metropolitan water usage ($3.63 per kl for more than 130kl per quarter) and water supply charges ($71.60 per quarter).

They are high even in comparison with Western Australia, the likely most comparable State in terms of the similar Mediterranean climate and distribution needs. (Water usage charge of $2.864 per kl for more than 500kl per 61 day billing period and $226 water supply charge per annum).

The costs are also high in comparison with Los Angeles in California, USA, which has been drought affected for several years. In that city, residential water usage prices, which can be varied each month, are the equivalent of $2.525 to $3.143 per Kl.

The chart below shows the overall cost to South Australian households of water per Kl have been consistently higher than the other mainland States and growing generally faster than interstate.

Figure 4: Household water costs per KL by State



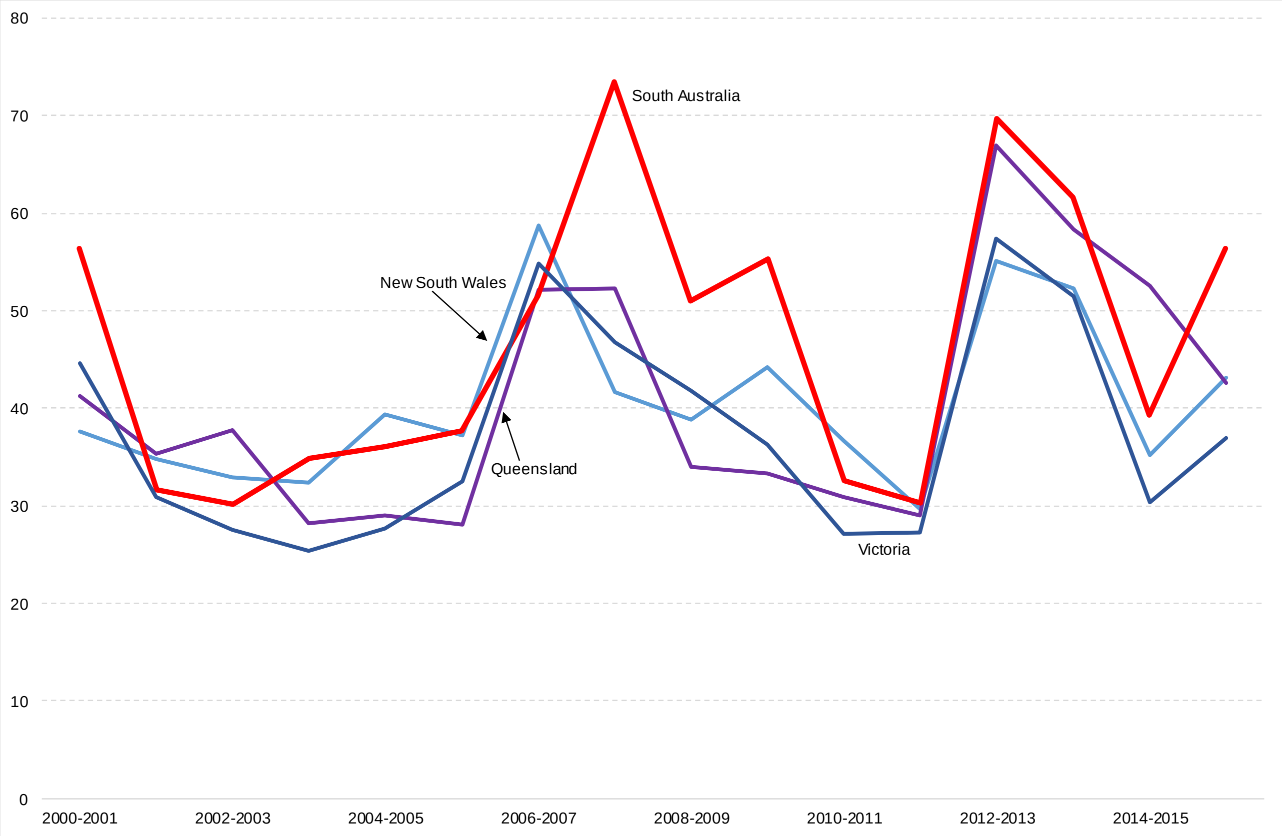
Source: ABS Water Accounts Australia 2013/14.

The high South Australian water usage prices have been justified on the basis of needing the profits to fund public sector spending, i.e. rather than having higher taxes in other areas, and compensation to lower income groups.

As two former Commissioners and a former CEO of ESCOSA have pointed out, the high water prices are a cost to consumers; they make South Australian industry less economically competitive; and they likely impact on location and investment decisions by enterprises and agricultural producers.[9] Many of our principal export industries – agriculture and horticulture production, wine and food processors – face high input costs which are a clear drag on their international competitiveness.

It is likely the same comments could apply to the higher cost of electricity to South Australian consumers and business, compared with interstate and overseas, as a result of the South Australian Government's approach to regulation of renewable energy. Figure 5 shows the average annual wholesale prices paid to generators in South Australia and the Eastern States. This does not include the cost of the poles and wires.

Figure 5: Electricity generator dispatch prices by state, annual average



Source: Australian Energy Market Operator www.aemo.com.au/Electricity/Data/Price-and-Demand/average-Price-Tables

The higher costs to local consumers is presumably part of the reason why household spending on Electricity, Gas and Other Heating as a share of household consumption after tax income has averaged 2.6 per cent over the last four years, second to Victoria but well ahead of New South Wales at 1.9 per cent and Queensland at 1.7 per cent. Presumably this would be reflected in lower spending in other sectors, thereby impeding their growth, and likely higher wage demands, with a consequent impact on business costs.

The higher cost of water and electricity to industry, and the high costs of sewerage and waste disposal, would at the margin affect industry profitability and employment. The most impact comparatively would be in those higher water and energy usage sectors subject to international or national competition. This would in particular include Food Processing and Beverage Production which need high quality, safe and presumably tasteless water in a variety of areas such as washing, sterilisation and as part of the finished product.

As we noted in EIP No 45 (the second in this series), Food Processing and Beverage Production are some of the employment growth areas in a rapidly shrinking South Australian Manufacturing sector and are a focus of government economic development policy with budgetary support.

If, as we believe, South Australia is exhibiting comparative advantage in these sectors, it is likely these water cost and electricity cost disadvantages, and the impacts on cash flow and internal investment funds, may also act as a brake on new entrants and product and service innovation. So not only may activities be smaller than otherwise but South Australia may be missing opportunities for growth.

It also seems likely that some part of this comparative advantage reflects human capital as much as locational factors. Human capital, as demonstrated for example in branding or innovation, is highly mobile and can be increasingly successfully applied remotely. Examples include well known South Australian food brands being manufactured interstate.

South Australian government policies imposing manufacturing cost disadvantages while other policies aim to support innovation and exports in Food Processing suggests regulation may be working at cross purposes, particularly if the successes of the innovation policy can be readily applied outside of the state.

Mining and ore processing is another stated focus of South Australian government Industry policy support, including the redevelopment of the Nyrstar smelter at Port Pirie. These sectors need substantial and consistent supplies of base load electricity.

It would appear, however, that one outcome of the South Australian policies on renewable energy has been a reduction in South Australian base load electricity capacity and a substantial increase in the dependence on imports of Victorian electricity, much of which is generated from brown coal.

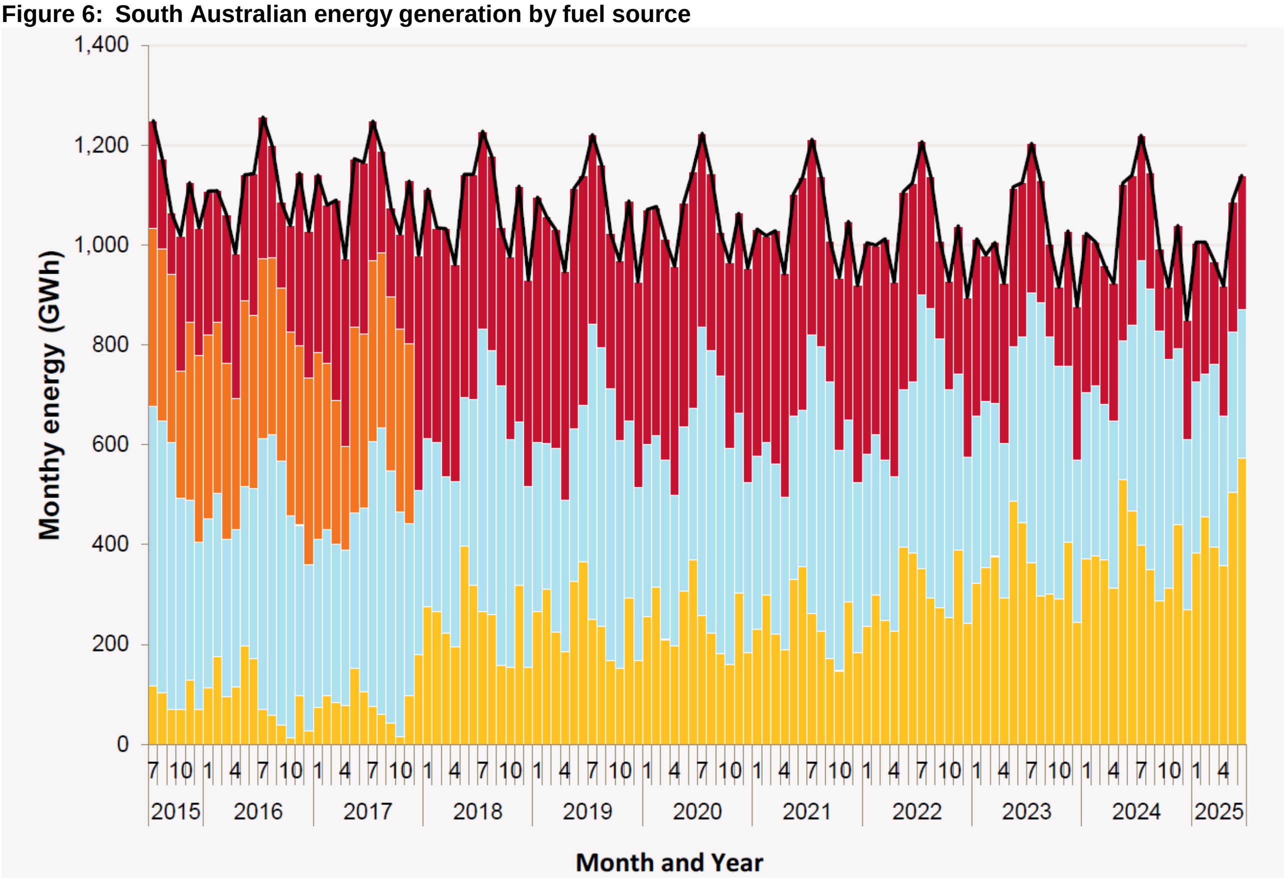
While South Australian total electricity consumption fell some 9 per cent between 2010/11 and 2014/15, net imports of electricity rose by over 60 per cent. In 2014/15, gross imports accounted for some 15 per cent of total South Australian electricity consumption. [10]

With the closure of the Port Augusta coal fired power stations and planned reductions in gas fired capacity, the Australian Energy Market Operator is projecting SA's net imports of electricity from Victoria through to 2022 will range from 30 to 45 per cent of total demand.

It is also noteworthy, as shown in Figure 6 sourced from AEMO, that the dependence on Victorian supplies and the Interconnectors is assumed to decline after 2022 because Victoria is projected to be experiencing its own supply constraints. AEMO assume South Australia will be increasing base load generation from gas.

That too could be problematic in terms of potential Australian gas supply[11]; the price of the electricity generated; and the willingness of investors to invest in base load capacity that will increasingly be treated as a "swing" supply depending on the output from the projected increasing supply of electricity from renewables.

Figure 6: South Australian energy generation by fuel source



Source: South Australian Electricity Report, August 2015, p. 37, Australian Energy Market Operator www.aemo.com.au

The issues in the context of the discussion around regulation and public sector cost benefit analysis are:

- whether the impacts on South Australian households and business of the higher energy costs of the last decade and the potential impacts, including *inter alia*, increased outages and higher costs, from the projected increased energy dependence on Interconnector performance and Victorian supplies have been calculated and are considered to be outweighed by the benefits of increased supply from renewables; and
- what analysis has been, or will be, undertaken of the proposed policies to offset some of these projected impacts, for example the South Australian government proposal to "incentivise" base load electricity capacity.

At another level, regulatory and financial support for particular companies, as part of industry policy, and for public sector organisations in competition with private businesses are other areas that should be examined for their impacts on the overall economy, on the private sector and whether that intervention is actually meeting the stated objectives.

This is particularly important for South Australia. The likely continued structural change impacting employment and the economy and likely continued limited growth in local taxes and "locked in" growth in spending on health and aged care suggest there is less room than ever for poorly directed or contradictory use of public sector resources or intervention, including tax policy.

This is both because of the:

1. likely greater relative adverse impacts, than in a growing economy, on a private sector struggling to deal with the rapid pace of change; and
2. increased relative cost of poor decisions within the public sector as other spending needs are left unmet.

Regarding 1, spending to help a particular company will often mean it is provided a competitive advantage over other companies in South Australia. This may be in competing for inputs such as capital, employees, land and water. That support may also generate expectations amongst suppliers about higher wages or profits rather than expansion of activity or employment.

Support may also create expectations that impede the necessary transition of employment and capital to other sectors and firms. The automotive manufacturing industry, which was of significant importance to South Australia, provides an example.

Public budgetary and other support in 2011/12 to this sector was estimated by the Productivity Commission at the equivalent of some 9.4 per cent of unassisted value added, substantially higher than the estimated 3.8 per cent support on this measure for manufacturing excluding this industry.[12]

Australia was recognised as a high cost automotive manufacturer due to the fragmented and relatively small local car market; high transportation and utilities costs; and amongst the highest labour costs in the developed economies, let alone in emerging economy manufacturers.[13]

However, the Enterprise Bargaining Agreements at Holdens from 2004 to 2011 included pay increases of some 4 per cent plus per annum and from 2011 of some 3 per cent per annum. This was about the same as in the broader private sector economy, despite the difficulties at Holdens, and with no real efforts to link this growth to higher output or exports or more flexible workplace arrangements to sustain the company.[14]

At a broader level, that support is a use of public resources, both the direct financial support and the associated administrative effort, which could be used to reduce payroll taxes or other, less efficient, public sector charges across the broader private sector.

So while public sector support may bring in, or slow the pace of loss of, identifiable jobs at a company, the loss of employment across the broader economy as a result of the financial costs of that support seems to be rarely considered or, if considered, not reported.

Programs such as the Regional Development Infrastructure Fund (RDIF) should be subject to independent and transparent proper cost-benefit evaluation and verification of employment outcomes. The critical focus of any evaluation should be the net economic benefit to the community as private sector/private company subsidies must be justified on community economic benefits, not private benefits.

Private sector company subsidies are high risk in part because they are selective and discriminate between firms or sectors of the economy, while in the conduct of their administration they increase red tape and bureaucracy and potentially encourage the diversion of resources (e.g. labour, capital) away from competitive sectors of an economy. They also divert the attention of management to rent seeking and program applications for support, rather than management and development of their enterprise/business.

There also needs to be examination of the economic impact of public sector organisations competing with the private sector, particularly if there is additional support intervention and no real evidence of market failure. This was a specific recommendation of the Sustainable Budget Commission report (2010).[15]

Cost-Benefit Analysis, Dynamic Impacts and Market Signalling

A significant case is the May 2015 decision by the South Australian government to reduce the number of subsidised training programs from 900 to 700 and to allocate the funding for 90 per cent of the 51,000 new places in 2015/16 to the TAFE SA.

This move is despite acknowledgement by the [then] Minister for Employment, Higher Education and Skills that delivery by TAFE SA of courses is at cost 2 to 3 times higher than for comparable courses provided by the private sector[16] and that the Government does not appear to have estimated job losses in the private sector or the job gains in TAFE.[17]

The Regulatory Impact Statement for such an important change does not yet appear to have been publicly released. It would appear, however, that the decision on funds allocation at such a cost differential over alternative providers would result in a significant reduction in the number and regional distribution of places available at a time of higher unemployment and a premium of human capital formation.

That is a “static” impact, with the associated impacts on skills development of those now not able to be trained; the impacts on employers of a smaller pool of skilled people; and the reduction in employment in the private sector training organisations.

There would also be the “dynamic” impacts of loss of confidence amongst actual or potential private training organisations about the increased “sovereign risk” of competing with TAFE SA and what that in turn means for the future development, offering and cost of training activities.

Often vocational training is provided by Registered Training Organisations linked with industry organisations including BusinessSA and Civil Contractors Federation (SA), and regionally based and so could be expected to be closely driven by changing industry and regional needs. In turn, this would seem to drive higher employment outcomes through time.

This suggests the “dynamic” impacts of the reductions in private sector providers’ cash flow and employment could be a much slower pace of development and change in courses from the private sector. This is an important issue when structural change in the South Australian economy is likely accelerating, requiring a faster pace of change in employee and management skilling.

This would likely mean through time the employment and personal and business income and overall GSP return on each $ invested through the private sector, compared to TAFE SA, would continue to be greater than just from the reported cost differentials, even if a revamped TAFE SA did substantially cut its costs.

The Impact of Regulation on Economic Activity

It is outside the scope and resourcing of this paper to attempt to quantify the various costs of regulation in South Australia.

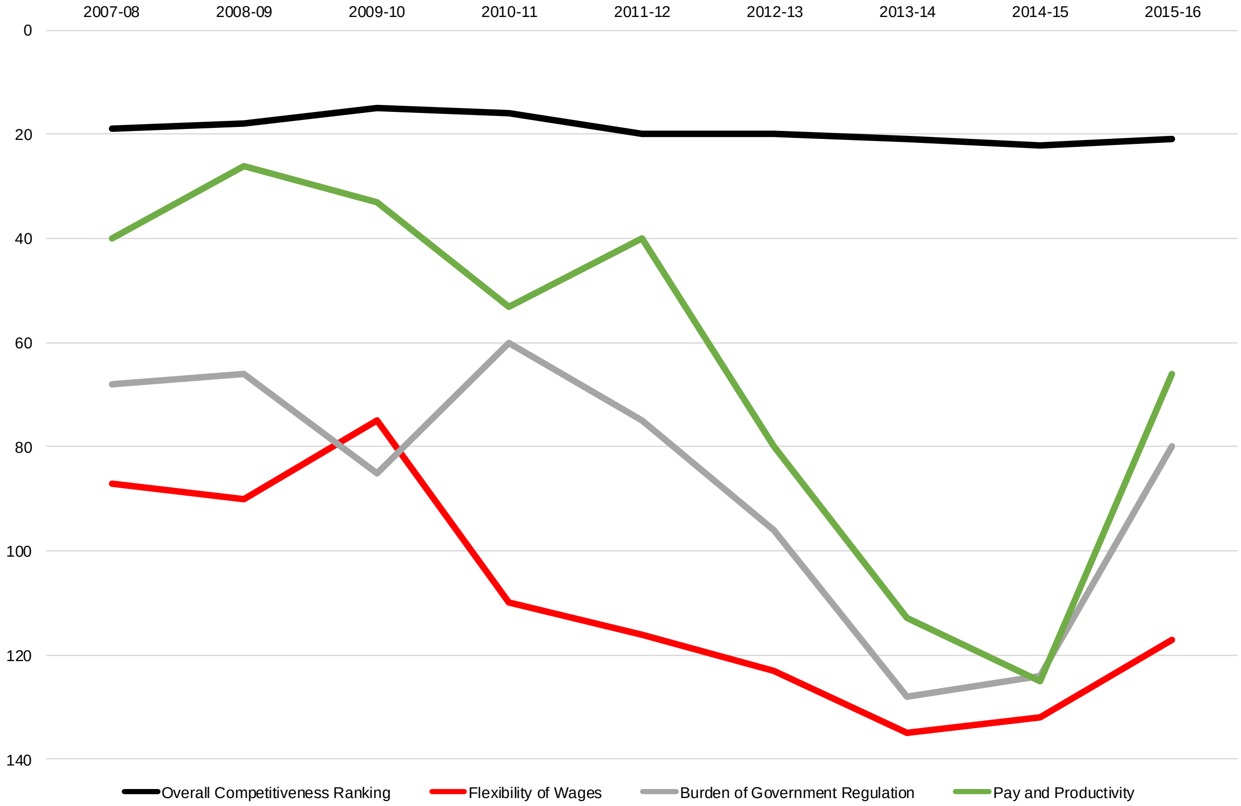
It is likely to be instructive, however, to put in a global and national context where South Australia may sit in qualitative assessments of the impact of the regulation burden on global competitiveness.

The World Economic Forum has recently released its Global Competitiveness Report for 2015/16. Figures 7 and 8 show Australia’s Rankings amongst 180 countries on a number of issues particularly related to regulation.

Australia’s overall ranking has declined from its peak of the 15th most competitive to 21-22 in 2013/14 – 2015/16. This appears to coincide with the deteriorating performance since 2010/11 from what were even then relatively poor rankings, on Pay and Productivity, Flexibility of Wages and Burden of Government Regulation.

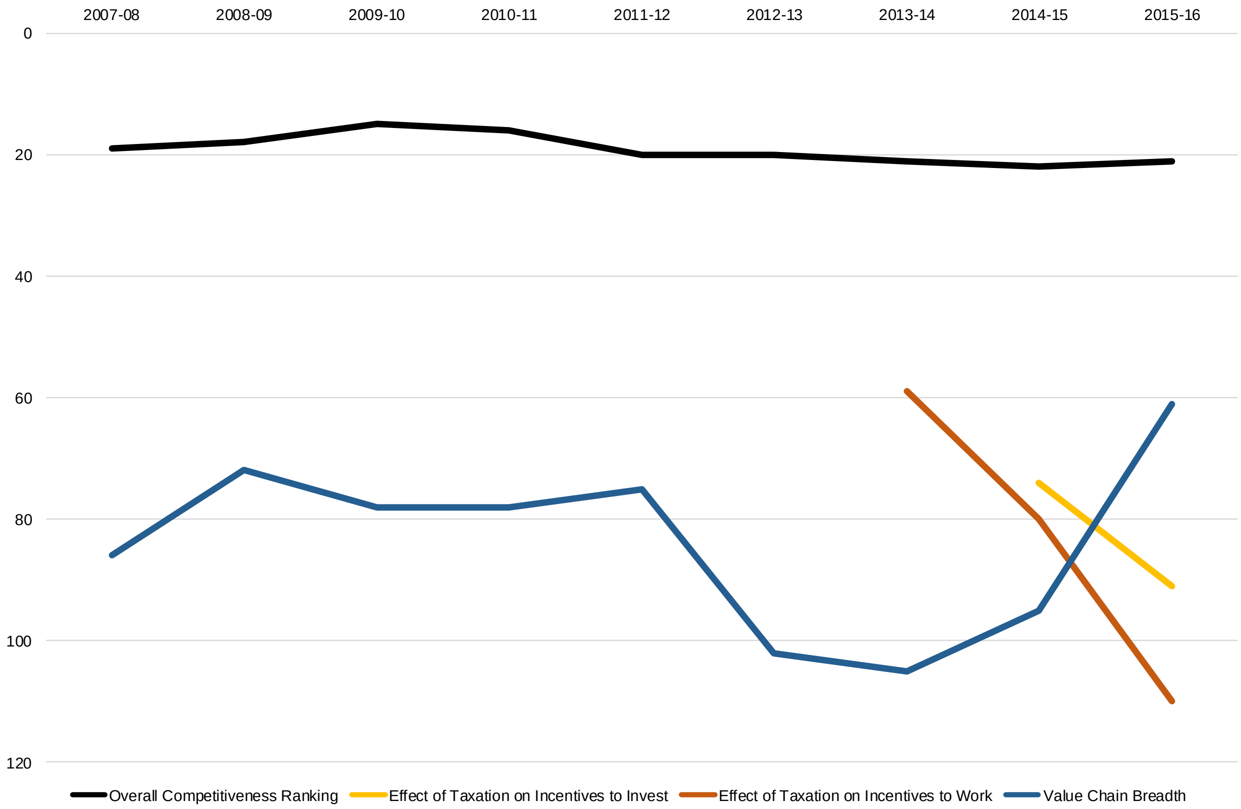
While these showed some improvement in 2015/16, Australia's position was not helped by the deteriorating rankings on the newly introduced factors of the Effect of Taxation on incentives to Work and the Effect of Taxation on incentives to Invest.

Figure 7: Global competitiveness indices: Australian rankings on selected measures



Source: Global Competitive Report, 2015/16.

Figure 8: Global competitiveness indices: Australian rankings on selected measures



Source: Global Competitive Report, 2015/16.

The index on Value Chain Breadth is included as being part of international value chains is increasingly being seen in the economic literature as important to output, employment and income growth. This involvement in the global Value Chains, with the accompanying specialisation and exposure to global knowledge and intellectual property, is seen as one an important driver of economic activity and rising incomes.

This is rather than trying to attempt to do all the value activities in one jurisdiction, often through formal or informal protection. Importantly too for South Australia, it appears cities play an integral role in how effectively local capital and people join and integrate into the value chains.

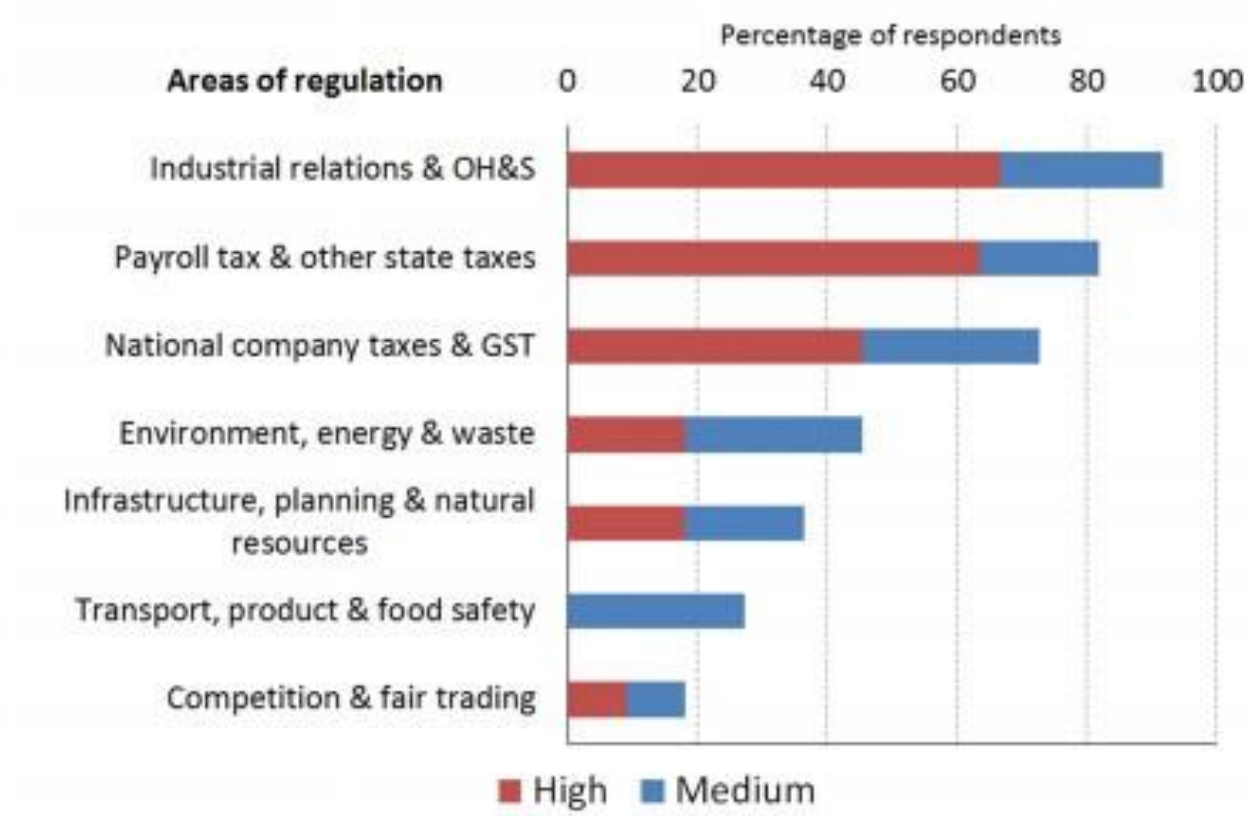
So the regulatory burden may need to be observed and understood at an individual level, not just at a company or industry or economy wide level.

So if we can see where Australia sits on these various factors, where would South Australia sit in the Australian context and therefore in a global rankings?

South Australia is not included as a separate jurisdiction in the WEF Global Competitiveness Index but recent surveys by business groups of the impact of Australian regulation may give us some indication even if the questions are a bit different.

The Australian Industry Group's 2014 *National CEO Survey of Business Prospects*[18] focused on the regulatory burden and whether it has changed over time. The questions ask which of the factors shown in the Figure 9 put a medium to high cost burden on the respondents' business.

Figure 9: Expected degree of regulatory burden in 2014, South Australia



Source: Ai Group, National CEO Survey, 2014.

Compared with the 4 other States on each factor by degree of concern, South Australia ranked:

- 2nd Highest on Industrial Relations and OHS, behind Queensland;
- 2nd Highest on Payroll Tax, behind Queensland;
- 1st on National Company Taxes and GST;
- 4th on Environment, energy and Waste;
- 3rd on Infrastructure, planning and natural resources; and
- 5th on Transport product and food safety and Competition and fair trading

A survey[19] (conducted in November 2014) showed that respondents nationally indicated the regulatory burden had increased from 2013. 73.6 per cent indicated Government Regulatory Requirements had “A significant negative impact” or “A moderate negative impact”, up from 64.4 per cent in 2013. The increase was all in the former.

There was also an increased share of respondents (47.6 per cent in 2014 from 37.7 per cent in 2013) indicating complying with regulatory requirements had prevented business growth.

The impact of regulation on the potential for growth is evident in the results of an as yet unpublished 2015 survey by Business SA (2015) of its members on Red Tape:

- 45 per cent of the survey respondents responded yes to the question “Has a decision or investment relating to your business been delayed or abandoned as a consequence of state-based red tape?”; and
- regarding the cost of regulation, 64 per cent said the overall cost of State-based regulatory compliance had increased in the past two years.

These results together suggest:

1. South Australian government regulation reduction activities are, at least in the perception of the business respondents, being outweighed by the cost of new regulation;
2. the overall burden South Australian business faces from regulation is above the national average and therefore South Australia is likely to be below Australia on the Global Competitiveness Rankings; and
3. the adverse impact on business decisions or investment activities is likely to be growing.

The gross state product or employment impact of these investment decisions delayed or abandoned is very difficult to quantify but is arguably one factor in the differences between South Australia and the other States in employment growth overall.

The Policy and Analytical Responses

That above should lead to a discussion as to what are in South Australia the appropriate:

1. types, reasons, levels of regulation and cost to the private sector;
2. degrees of public sector intervention in the economy;
3. size and cost of the public sector more broadly; and
4. degrees of transparency in the public sector analysis.

We will discuss in more detail issues 1, 2 and 4 in the next EIP but in this EIP we look in some detail at a comparative analysis of South Australia with the other States as to how efficiently the State public sector appears to operate.

That is, at the current level of regulation and intervention, could it be done more efficiently, i.e. with less resources, when looked at from a macro point of view.

This idea of efficiency is important, particularly in the South Australian economic environment, as the revenue raising activities to fund the public sector:

a) are likely to affect the level and type of private sector activity and employment and income generation, depending on what is taxed or licensed, the level and type of revenue collection and how efficiently the revenue raising effort is applied;

b) may well be facing constraints due to the level of tax effort already applied; and

c) could be subject to limited future growth due to cyclical and structural changes in local industry and household activity.

The South Australian government noted in the State Tax Review Discussion Paper of February 2015 it recognised the need for reform on tax and regulation:

> *“While we are committed to ensuring that these services are delivered as cost effectively as possible, if we want to ensure that South Australians continue to have access to high quality services, we need a taxation system that can provide the funding required in a reliable and sustainable manner.*
>
> *To attract new investment and create more jobs we need a tax system that supports those who are trying to create new opportunities that will provide jobs for South Australians.*

> *In addition to reviewing State taxes, the Government has committed to regulatory and planning reforms aimed at minimising costs to businesses."*[20]

While there were some worthwhile changes announced in the South Australian Budget for 2015/16, particularly the move to progressively abolish stamp duty on non-residential real property transfers, a general overhaul was seen as politically and financially too difficult and requiring national action.

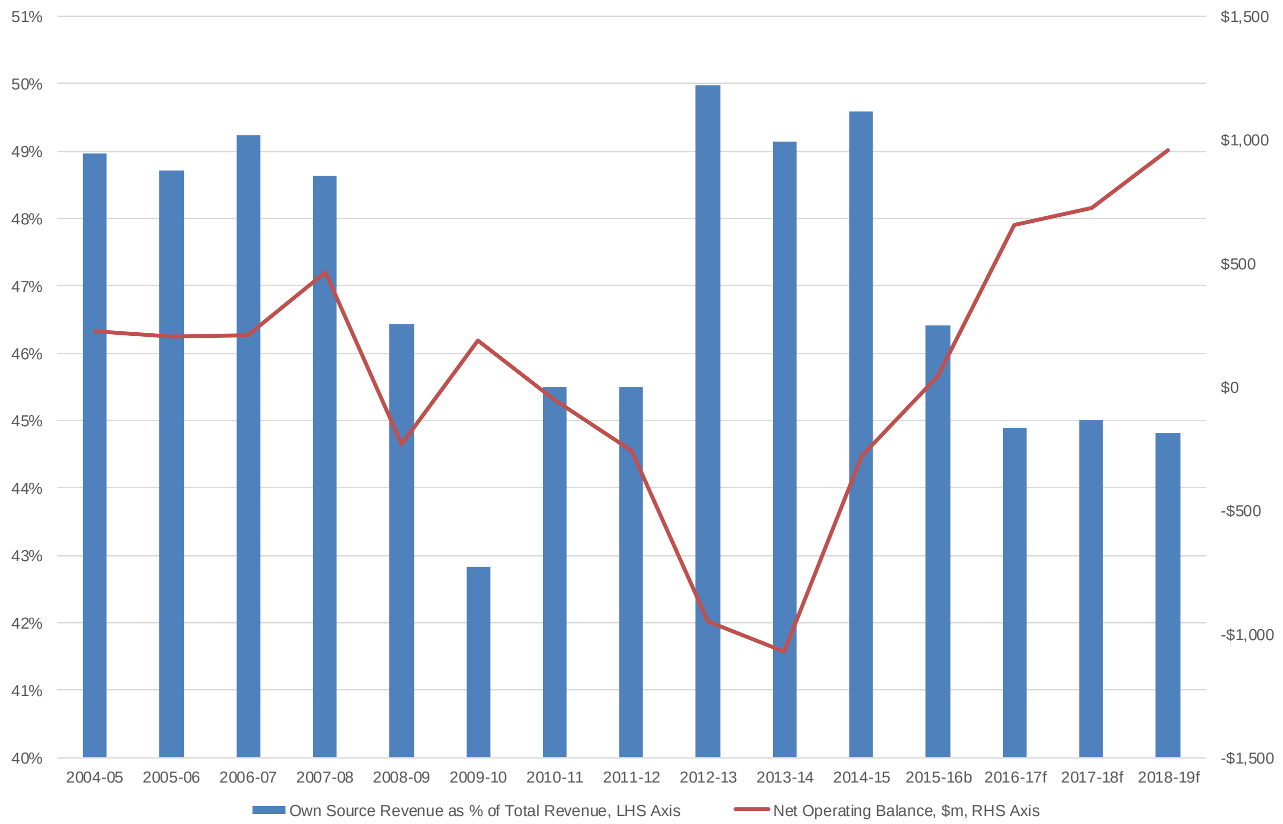
> *"In undertaking the State Tax Review process it has become clear that it will only be possible to reform certain state taxes if they form part of national tax reform."*[21]

In looking at regulatory reform, which includes the tax system, it is important to understand what is South Australia's public sector Budget situation.

South Australian government spending has tended to have grown ahead of "own-source" revenue, so the reliance has grown on the GST distributions and General and Specific Purpose Grants from the Federal Government. 2012/13 to 2014/15 are exceptions to the longer term trend with the 2015/16 South Australian government Budget projecting increasing reliance on the Federal Government, even with what might be suggested as "heroic" assumptions about the growth in the major items of own–source revenue and, in turn, the return of the Net Operating Balance to surplus.

Being efficient in how regulation and intervention is determined and implemented seems therefore even more of a priority if some independence in South Australian government fiscal policy is seen as desirable.

Figure 10: SA general government revenue and net operating balance



Source: SA Government Budgets 2015/16 and 2009/10 Paper No. 3.

Regarding Item 1, (i.e. revenue raising and affect on the level and type of private sector activity) an example of how government regulation through tax policy can affect the private sector directly is Payroll Tax which is the single largest contributor of "own-source" revenue to the South Australian government. It is budgeted in 2015/16 to account for 6.9 per cent of total revenue and 26.1 per cent of total tax revenue, up from 24.8 per cent in 2010/11.

This is at a time when the outlook is on balance for more job losses through further structural adjustment and increasing global competition.

Regarding Item 2, (tax effort already applied) at the aggregate level, South Australia has been generally recognised as being a high "tax effort" State in the Australian context. As the Commonwealth Grants Commission notes:

> *"South Australia has the third lowest assessed fiscal capacity, mainly because of its below average revenue raising capacity in mining revenue, payroll tax, stamp duty and land tax."* [22]

South Australia has in the past attempted to at least partly offset that disadvantage by generally high rates of tax in the main revenue capacity areas. Table 1 shows the comparative tax efforts by each State and Territory.

Table 1: Assessed tax revenue raising effort ratios by jurisdiction

	2009/10	2010/11	2011/12	2012/13	2013/14
New South Wales	106.8	107.0	105.9	107.1	105.5
Victoria	102.7	100.1	102.9	102.1	102.1
Queensland	86.8	89.1	89.4	87.7	88.9
Western Australia	93.5	94.1	93.3	94.5	98.8
South Australia	**111.9**	**110.7**	**110.4**	**111.7**	**103.8**
Tasmania	91.8	88.2	90.9	92.2	93.7
Australian Capital Territory	105.7	114.1	101.6	96.5	96.1
Northern Territory	83.4	77.8	77.6	84.4	86.8

Source: Commonwealth Grants Commission Report on GST Revenue Sharing Relativities, 2015 GST Review, 2014 Update Report.

A comparison of the Commonwealth Grants Commission assessments of South Australia's Assessed Revenue Raising Capacity Ratios is shown at Table 2. The Revenue Raising Capacity Ratios show how much capacity there is with the average of all the jurisdictions rated as 100, and the Assessed Revenue Raising Effort Ratios, again with the average effort of all the jurisdictions rated as 100.

Table 2: Assessed revenue raising capacity and effort ratios by main tax, South Australia

		2010/11	2011/12	2012/13	2013/14
Payroll Tax	– Capacity	77.4	76.7	77.8	78.8
	– Effort	93.3	91.6	92.1	89.3
Land Tax	– Capacity	57.7	58.5	57.6	70.5
	– Effort	136.4	135.5	131.1	128.3
Stamp Duty	– Capacity	71.3	65.3	65.1	58.7
	– Effort	116.7	118.9	123.7	118.2
Insurance Tax	– Capacity	98.3	107.7	106.1	112.6
	– Effort	113.6	103.7	109.5	111.0
Motor Tax	– Capacity	105.6	105.0	104.8	105.1
	– Effort	83.5	83.4	84.0	76.5
Mining Revenue	– Capacity	35.4	35.7	41.0	45.6
	– Effort	62.8	67.5	68.1	77.8
Other Revenue	– Capacity	100.0	100.0	100.0	100.0
	– Effort	103.0	108.0	90.4	89.3
Total Tax Revenue	– Capacity	81.1	80.3	80.4	79.9
	– Effort	110.7	110.4	111.7	103.8

Source: Commonwealth Grants Commission Report on GST Revenue Sharing Relativities, 2015 GST Review, 2014 Update Report.

While the above components for 2014/15 are not yet available, the South Australian government announced in the 2015/16 Budget that South Australia is now a relatively low tax jurisdiction in terms of tax revenue per capita and this will improve further with the tax reforms announced.

As shown in the Table 3, however, the "own source" tax revenue is becoming increasingly reliant on Payroll Tax as other tax sources are projected to show much more limited growth.

Payroll Tax's share of total tax is forecast to rise from 25.3 per cent in 2014/15 to 27.6 per cent in 2018/19. This growth accounts for around 43 per cent of the total projected tax growth to 2018/19. In addition, possibly a third of the Payroll Tax growth of over 5.5 per cent per annum will be coming from "bracket creep" as more companies' assessable payrolls move over the $600,000 threshold. The Budget assumptions are per annum growth of 1 per cent in employment and 2-3 per cent in wages.

Table 3: South Australian government main revenue sources: taxes ($m)

	2012/13	2013/14	2014/15	2015/16b	2016/17f	2017/18f	2018/19f
Payroll	1,077	1,079	1,114	1,184	1,253	1,323	1,388
Growth per cent pa	**6.6**	**0.2**	**3.2**	**6.3**	**5.8**	**5.6**	**4.9**
Conveyances	778	793	907	910	932	934	948
Growth per cent pa	**13.4**	**1.9**	**14.4**	**0.3**	**2.4**	**0.2**	**1.5**
Land Tax (Private)	347	345	347	358	372	384	395
Growth per cent pa	**-3.6**	**-0.6**	**0.6**	**3.2**	**3.9**	**3.2**	**2.9**
ESL on Fixed Property	103	104	190	207	211	218	223
Growth per cent pa	**0**	**1.0**	**82.7**	**8.9**	**1.9**	**3.3**	**2.3**
Gambling	422	388	388	408	419	442	451
Growth per cent pa	**2.7**	**-8.1**	**0**	**5.2**	**2.7**	**5.5**	**2.0**
Insurances	429	435	446	441	457	475	493
Growth per cent pa	**7.5**	**1.4**	**2.5**	**-1.1**	**3.6**	**3.9**	**3.8**
Motor Vehicles	545	567	597	618	637	658	680
Growth per cent pa	**7.1**	**7.2**	**5.3**	**3.5**	**3.1**	**3.3**	**3.3**
Other Taxes	403	374	405	417	432	446	460
Growth per cent pa	**7.1**	**-7.2**	**8.3**	**3.0**	**3.6**	**3.2**	**3.1**
Total Taxation	4,104	4,085	4,394	4,543	4,713	4,880	5,038

Source: SA Government Budget Statement Budget Paper No. 3, 2015/16

In addition to the increasing reliance on a tax on employment, there is an increased share of South Australian government revenue from the Federal Government and the other States, the latter because of the increased share of GST revenue to be received by South Australia in 2014/15 and beyond. South Australia now gets around $1.5b more per annum from the GST pot than if it was distributed on a per capita basis.

Overall, transfers from other Governments as a share of total revenue are forecast to rise from 50.4 per cent in 2014/15 to 55.2 per cent in 2018/19.

On the Expenditure side, the 2015/16 forecasts show a further increase in the amount and share of total spending being driven by demographic change with an implied further reduction in the flexibility of spending. Spending collectively on Communities and Social Inclusion, Education and Child Development and Health and Ageing is forecast to rise from 65 per cent of total spending in 2014/15 to 67.8 per cent in 2018/19.

The factors outlined above on the Revenue side and the Expenditure side of the State's Budget point individually and collectively to reducing flexibility in the State's finances and the need to be as efficient and effective as possible in setting and applying regulation. There is a declining capacity within the Budget for inefficiencies and poor regulation outcomes.

On the other side, the ongoing structural changes and increased global competition affecting the South Australian economy and private sector mean the costs of regulation are likely to have increasingly adverse impacts on employment and investment plans and outcomes.

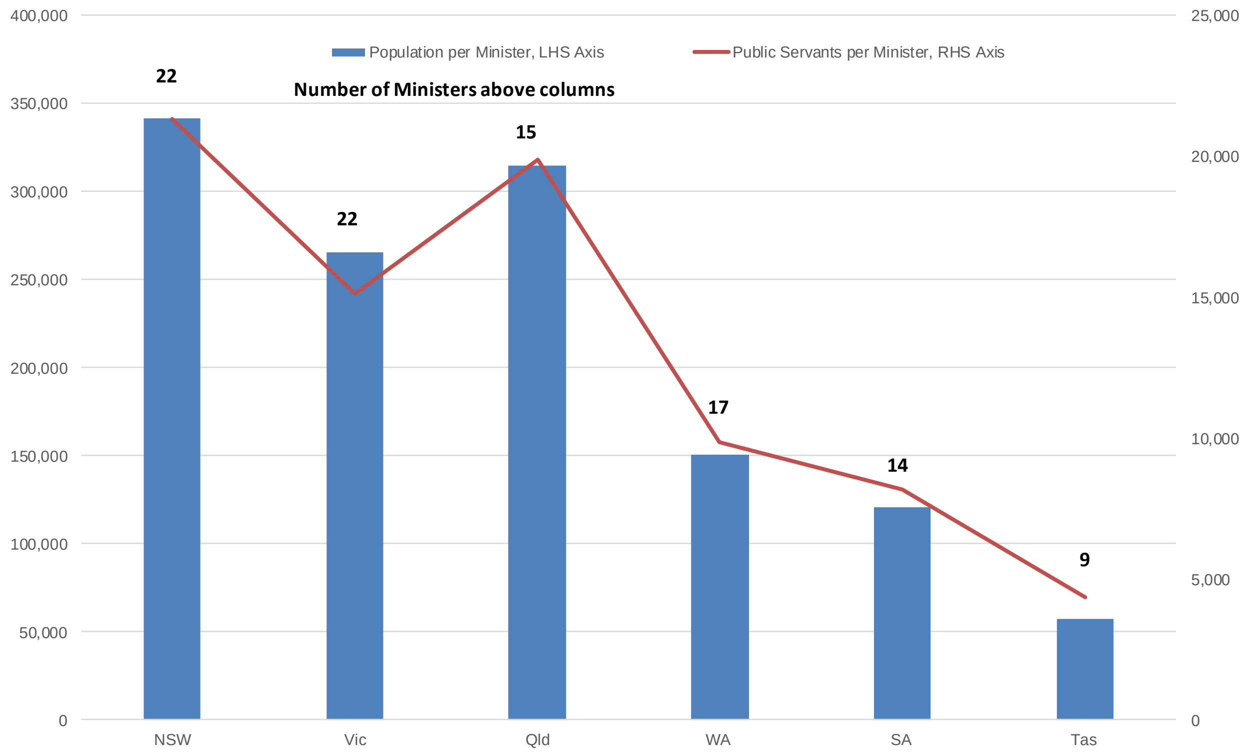
As an overview as to where efficiencies may start, we look at the scale of the State Government.

From Figure 11 South Australia has the second lowest number of State Government Ministers at 14. The population served on average by each Minister at 120,385 at June 2014 is, however, under half the average of the other States (excluding Tasmania).

This might be a result of the higher complexity of public administration in South Australia, although no substantive argument justifying additional complexity appears to have been put forward.

Further, at 8,150 the average number of public servants per Minister in South Australia to develop, implement and oversight policy is under half the average of 16,688 for the other States, excluding Tasmania.

Figure 11: Australian states' government ministers, June 2014



Source: ABS, State Governments' websites.

Suppose we were to accept a 25 per cent "productivity" discount to the national averages, excluding Tasmania, of population and public servants per Minister. That is, assume South Australia would operate at 75 per cent productivity of the national average. On that basis, each Minister would then on average be "responsible" for 12,500 public servants, compared with the national average of 16,688.

This would suggest South Australia could operate with 9 Ministers instead of 14.

This would likely provide savings in Ministerial expenses and coordination costs. In the medium term, this would appear consistent with the South Australian government's stated objectives of reducing and having more efficient regulation, presumably in a net sense, thereby reducing Ministerial workloads.

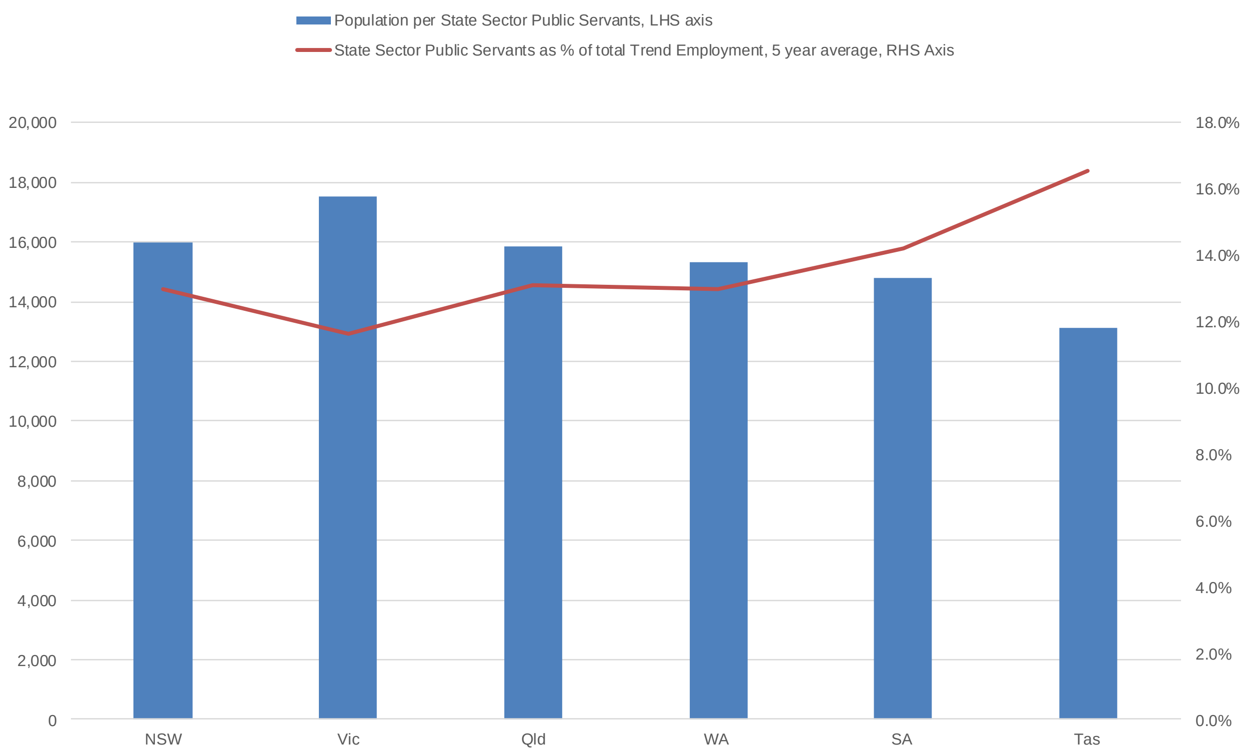
South Australia had, as at June 2014, one State Government public servant per 14.7 of population. This compares with a national average, excluding Tasmania, of 16.3. South Australia's proportion of employment in the State public sector, averaged over the last five years, is 13.9 per cent compared with the national average, excluding Tasmania, of 12.7 per cent.

In South Australia's case, this proportion has been rising as shown in Figure 12, however. This largely reflects South Australia being the only State where overall employment has been flat to lower. In the other States, overall employment has generally been rising.

The South Australian employment outcomes compared with the other States raises questions about how much of the differences relate to local factors, including the regulatory load in South Australia.

How those regulatory issues might be better addressed will be the focus of the next EIP in this series.

Figure 12: Australian states' public servants, June 2014



Source: ABS, State Governments' websites.

The scale of Local Government should also be put under the spotlight. The rationalisation of councils in South Australia is a necessity to enhance their long-term financial sustainability and to achieve economies of scale. Currently there are 68 councils with an average population of 23,200 (Victoria: 69,000; New South Wales 47,000; Queensland 60,000). The average in the 45 non-metropolitan councils is 9,000 persons. That average is inflated by larger metropolitan councils such that there are 52 councils with less than the average population (N=23,200) and 19 councils with less than 3,000 population. Many have difficulty in meeting compliance obligations; there is considerable duplication in some areas of service delivery; but most importantly there is little capacity in many councils to do anything more than "roads, rates and rubbish".

Smaller councils cannot expect to continue to receive increases in grant funding. This reinforces the need to achieve greater scale, scope, operating efficiencies and to reduce the red tape burden of compliance costs. The most compelling argument for change and reform is so that councils achieve greater strategic capacity to partner with other levels of government.

We will examine this further in forthcoming Economic Issues Papers in this series.

End Notes

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[5] The Department of Trade and Economic Development (DTED) is now known as the Department of State Development (DSD).

[6] According to the dpc.sa.gov.au website, this handbook is currently being updated.

[7] Reducing Red Tape for Business in SA 2010-11 – Final Report, Government of South Australia, November 2012.

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[20] State Tax Review Discussion Paper, February 2015 (Government of South Australia, http://yoursay.sa.gov.au/decisions/tax-review-in-south-australia/about) pp2-3

[21] Government Response to the State Tax Review (Government of South Australia) p19, http://servicesa.cdn.on.net/releases2015/2015-16 per cent20BP1 per cent20extra per cent20- per cent20State per cent20Government per cent20Response per cent20to per cent20the per cent20State per cent20Tax per cent20Review.pdf

[22] Commonwealth Grants Commission Report on GST Review Sharing Relativities 2015 Review Vol 1 Main Report (Commonwealth of Australia 2015) p. 19.