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Principles for national reform
Learning lessons from NCP



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Principles for national reform

Learning lessons from NCP

Prepared for

National Competition Council

*Centre for International Economics
Canberra & Sydney*

October 2005

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ISBN 0-9758210-0-8

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An appropriate citation for this paper is:

Centre for International Economics 2005, *Principles for national reform: learning lessons from NCP*, Report prepared for the National Competition Council as part of the NCC Occasional Series, Canberra.

The National Competition Council

The National Competition Council was established on 6 November 1995 by the Competition Policy Reform Act 1995 following agreement by the Australian Government and state and territory governments.

It is a federal statutory authority which functions as an independent advisory body for all governments on the implementation of the National Competition Policy reforms. The Council's aim is to 'improve the well being of all Australians through growth, innovation and rising productivity, and by promoting competition that is in the public interest'.

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Foreword

Australia's recent microeconomic reform program has paid a substantial dividend.

The Council of Australian Governments (COAG) considered the National Competition Policy (NCP) to be 'pivotal' in boosting the competitiveness and growth of the economy and the living standards of all Australians. The Productivity Commission's 2004 review of NCP arrangements was overwhelmingly positive, while the Organisation for Economic Cooperation and Development saw Australia's 'competition culture' as important for a flexible and resilient economy.

A distinctive feature of the NCP is that it involves an economywide principles based approach to economic reform. Under the Competition Principles Agreement of 1995, all governments committed to broad reforms to ensure competitive outcomes, unless it could be shown through robust evidence that restricting competition is in the public interest.

While recognising the gains under the NCP, COAG nevertheless emphasised the importance of avoiding complacency about Australia's economic performance. It saw further reform as essential if economic growth is to continue, and established a review of existing NCP arrangements, focussing on developing a new national reform agenda. This review is to report by the end of 2005.

The National Competition Council asked the Centre for International Economics (CIE) to produce a short research report drawing together the lessons from Australia's experience with the NCP and identifying factors that are central to the success of a new national reform program. The CIE's report forms part of the Council's Occasional Series, which the Council produces to help explain and promote the NCP to the community.

A handwritten signature in black ink, appearing to read 'David Crawford'. The signature is fluid and cursive, with a long, sweeping underline.

David Crawford
Acting President

A handwritten signature in black ink, appearing to read 'John Feil'. The signature is more compact and stylized than the one to its left.

John Feil
Executive Director

ABOUT THE CIE

The Centre for International Economics is a private economic consultancy operating out of Canberra and Sydney. It undertakes economic analysis for clients around the world.

The CIE solves problems for clients by rigorously analysing markets and regulations, appraising risks and evaluating strategies. We build economic and strategic frameworks to distil complex issues to their essentials. In this way we are able to uncover new insights about emerging developments and assess payoffs from alternative strategies.

The firm has been operating since 1986. Contact details are set out below and more information on what we do and our professional staff can be obtained from our website at www.TheCIE.com.au.

The CIE also co-produces a quarterly report called Economic Scenarios. This analyses global risks and scenarios and can be accessed from www.economic.scenarios.com.

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Contents

Preface	v
1 Life after NCP	1
2 The NCP experience	4
A successful experiment . . .	4
. . . with important lessons	4
3 An ongoing process	8
Unfinished reform	8
Reviewing and reviewing again	10
4 Maintaining a principle based approach	12
Core propositions of good governance	12
Principles for coordinated national review and reform	13
Why focus on principles?	18
References	20
Boxes, charts and tables	
1.1 Summary of ideas in this report	2
3.1 Two core government activities	8
3.2 The dynamics of regulation review	10
4.1 Core propositions of good governance	13
4.2 Principles for regulatory review	14
4.3 Expected and unanticipated reforms can be supported by the same principles	19

Preface

Discussion and research into a new national reform agenda is well advanced. All levels of government, through the Council of Australian Governments (COAG) lens, are considering where to go next following the past ten years of nationally coordinated microeconomic reform.

The CIE has been engaged in undertaking and advising on National Competition Policy (NCP) matters since the process began in 1995. We have observed the experience from the perspective of non-government practitioners of reform analysis. This has provided a very interesting perspective on what has, and what has not, worked in the NCP process.

While an agenda for future reform is crucial, so too is a renewed understanding of the principles that must underlie that reform. Sound and well understood principles help the process from the ground up – from practitioners to overseers. Thinking about the future of NCP is an ideal opportunity to revisit those principles and examine why they continue to work.

There has been extensive analysis pointing to the benefits from Australia's recent microeconomic reform program, including from NCP. This report is deliberately brief. Its purpose is to set out concisely the core principles that have been powerful in microeconomic reform – thereby reinforcing the hard-learned lessons of recent practical experience.

1

Life after NCP

‘The case for continuing reform on a collaborative basis is clear’

COAG

Thirteen years after the initial ideas were floated, and ten years after explicit national agreement, the process now known as National Competition Policy (NCP) has left an indelible mark on the Australian economic landscape. Many analysts and commentators have attributed the improvement in Australia’s relative performance in part to NCP style reforms.

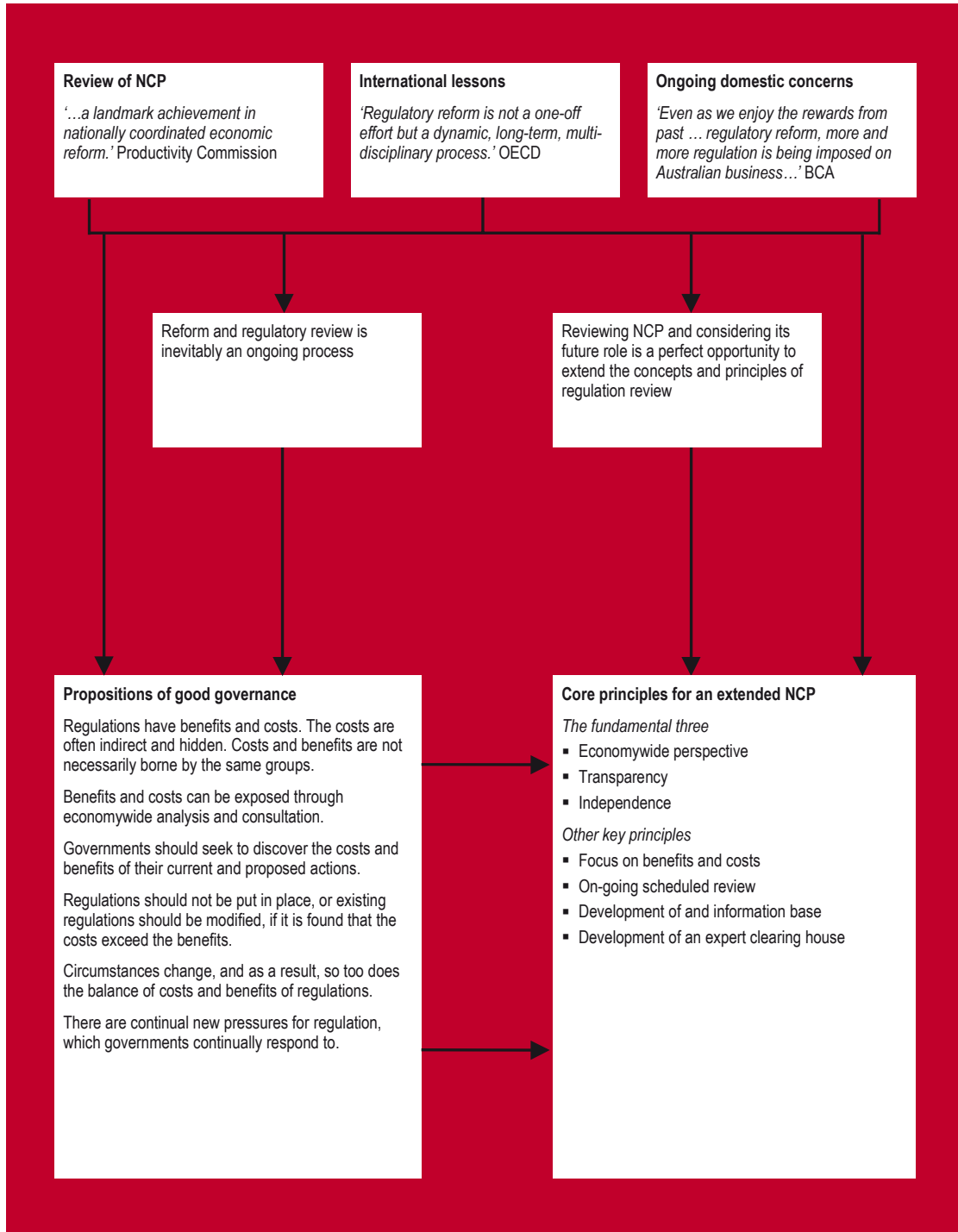
At the same time as this general recognition of success, other commentators have pointed out that there are still major unresolved issues in the Australian regulatory system. These commentators, including business groups, researchers, and domestic and international government agencies have produced substantial analyses of the need for further review and reform.

The fact that NCP has been successful on the one hand, but that there are calls for more review and reform on the other reflects three fundamental features of modern governance:

- there is constant demand for new regulation in response to a variety of forces including the pressures of interest groups, the need to respond to public concerns and the inherent logic of particular government policies;
- circumstances are constantly changing, which means that regulations that were previously meeting a particular need may no longer be appropriate; and
- as needed reforms proceed and the economy adjusts and grows, the need for additional and related reforms becomes clear.

While it might be tempting to conclude that a COAG based NCP process has run its course, in fact the opposite is true. NCP and regulatory reform processes at a COAG level need to continue building on the many lessons learned in the past ten years, both in Australia and overseas.

1.1 Summary of ideas in this report



Addressing the ongoing need for regulatory review and subsequent reform that is demonstrated by business groups and others requires a sound *process* based on well established core *principles*. While the various lists of

needed reform that have been compiled to date are important, it is also crucial that these lists are backed by a comprehensive process.

That a good process is needed is, of course, already built into the NCP agreements that have worked over the past ten years, and the recent lessons provide some natural extensions to this process. Indeed, the core principles can easily be derived from the experience to date.

The purpose of this report is to explicitly state what these core principles should be. None of these is new, they have been well understood for many years within the disciplines of regulatory review and reform. And they are derived from Australian and international experience and so are not really controversial. But they are nonetheless powerful.

The ongoing development of NCP is a major opportunity to address regulatory issues from a national perspective with the common consent and commitment of all levels of government.

2

The NCP experience

A successful experiment . . .

By all accounts, the NCP has been a valuable experience. COAG itself recognised this in its communique of 3 June 2005, noting that the agreement to implement NCP was a key part of the reforms that have transformed Australia over the past 20 years, ‘boosting the competitiveness and growth of the Australian economy and the living standards of all Australians’.

The Productivity Commission’s extensive review of NCP (Productivity Commission 2005) was overwhelmingly positive, estimating that NCP as a ‘landmark achievement in nationally coordinated economic reform’ had increased Australia’s GDP by at least 2.5 per cent.

NCP has also been described as a ‘distinctive innovation in Australia’s structural reform story’ (Banks 2005b). While it was indeed a distinctive innovation, it is also important to note that it was an Australian incarnation of a rapidly growing international body of evidence about the costs of particular kinds of regulation. NCP as an important development in Australia was a particular adaptation to a global process of regulatory review and reform (see, for example, Allen Consulting Group 2004).

The genius of NCP is the idea that regulation – which constitutes a significant proportion of government action – should be subject to coordinated, systematic and ongoing review and subsequent reform. Section 5 of the Competition Principles Agreement committed governments to review existing and new anticompetitive legislation, as well as to review such legislation at least every ten years. While NCP focused on anticompetitive regulation, the principle of ongoing review and reform applies to a broad stock of regulation.

. . . with important lessons

There are several lessons to be learned from the NCP process.

The underlying philosophy was sound

A fundamental recognition underlying NCP was that competition in general leads to increased economic efficiency and therefore increased incomes.

Underlying this is a fundamental proposition: the idea that regulations have costs and benefits, and that good governance involves maximising the benefits and minimising the costs. Properly understood, these costs and benefits have many dimensions. The core techniques of benefit-cost analysis combined with transparent public consultation can be used to estimate and compare them.

Related to this is the proposition that government action should be subject to a simple test: do the benefits exceed the costs? If not, then the action should not take place, or should be significantly modified to maximise the net benefits. This proposition can hardly be controversial – nobody constructs an argument that suggests government action should impose net costs.

A systematic process is practical

The experience of NCP over the past ten years has demonstrated that systematic and nationally coordinated review is a practical part of good governance.

Systematic and ongoing review, particularly across many jurisdictions and portfolio areas, can be a daunting prospect. The scheduling of reviews and coordination of analysis requires careful attention and the selection of appropriate expertise. The NCP experience illustrates that this is achievable.

There is a growing body of expertise

The analytical and procedural requirements of NCP have been greatly assisted by a growing body of expertise in undertaking regulatory review and implementing reform within Australia. Some of this is within government agencies, but some is also present in a range of independent analysts who have been contracted on a case by case basis.

The analytical work of NCP reviews has been assisted by a number of early developments including:

- guidelines for undertaking reviews, including core analytical requirements; and
- careful specification of terms of reference for reviews.

Of course, it would not be correct to assert that all reviews have been done at the highest possible standard. The key point, however, is that the growing expertise with this kind of review continues to make the process practical. The growth of a body of expertise has been made possible by the national coordination and broad coverage of the reform. This has made it practical to draw together a wide variety of expertise.

Flexibility within a broad set of core principles

As the Productivity Commission noted in its review of NCP, flexibility within a set of core principles was a major strength of the NCP process. While agreeing to principle based reviews, jurisdictions were free to implement the process to suit their own needs within government.

Agreement to a broad set of principles is in fact a fundamentally important aspect of NCP, and of any broad based review and reform program. Were these principles not agreed to, it is unlikely that NCP could have taken place, or that it would have been as successful. With renewed understanding of the core principles and a common reference point, the success of future reviews will be considerably enhanced.

Given this, the continued clarification of underlying principles must be a key component of ongoing review.

Transparency and consultation are powerful disciplines

A number of NCP reviews involved public consultation and transparent publication of review findings. There are several advantages to this approach.

- Public consultation assists considerably in the task of identifying and measuring the costs and benefits of regulation. This identification is essentially an empirical or evidence based approach and casting the net broadly improves this process.
- Transparent exposure of review findings serves many purposes. In part, it helps ensure acceptance of the review process by various stakeholders – if they can see the logic and evidence that leads to a particular position, they are more likely to accept that position. In addition, transparent reviews have a shelf-life, regardless of the initial

outcome of the review. Even with the best of intentions, political pressures can often force inefficient regulatory outcomes. Transparent reviews ‘sitting on the shelf’ continue to do the work of exposing inefficient outcomes.

Common and independent oversight adds to the process

A central point for overseeing and commenting on reviews and reforms, as well as monitoring agreed progress and adhering to agreed principles provides a powerful catalyst and lubricant to the reform process.

In the context of NCP, the National Competition Council’s (NCC) annual assessment reports have provided an excellent resource for bringing together developments in regulatory review and reform. This adds considerably to the transparency of the review process.

Incentives can help overcome hurdles to reform

There is strong evidence that incentives have contributed to coordinated reform implementation. The NCC has argued that the national competition incentive payments made a significant difference to reform outcomes (NCC 2004), and this view was echoed in the Productivity Commission review of NCP where a number of participants endorsed the role of competition payments providing an incentive for progressing reform. The Productivity Commission concluded that ‘competition payments have played a pivotal role in maintaining reform momentum within the States and Territories’ (Productivity Commission 2005, p. 152).

The demonstrated success and importance of independent oversight, coupled with real incentives, is a major lesson from the NCP process, and one which is essential to take into account when considering a future reform program.

3

An ongoing process

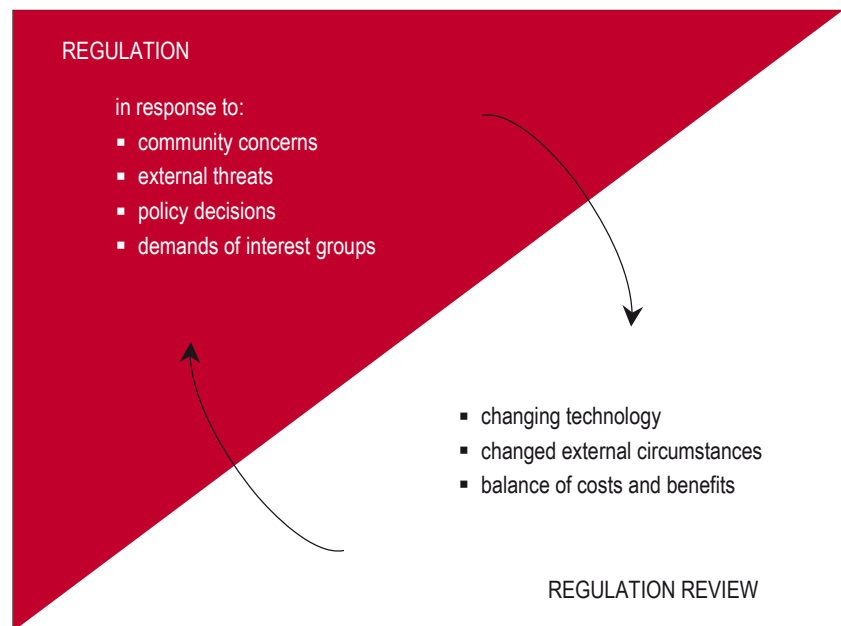
‘Adopt a dynamic approach to improve regulatory systems over time’

OECD

Unfinished reform

Despite the overall success of NCP to date, regulatory reform is always an unfinished process. Regulation and regulation review are two essential and complementary components of governance (chart 3.1).

3.1 Two core government activities



For the past ten years, NCP review has been about sorting out the now inappropriate regulations from a past era. The regulations that have been modified or removed in response to recent NCP reviews were originally established with good intent. But the world changed. Economic circumstances, technologies and community expectations all changed so that the original regulations were no longer appropriate. At the same time

as the reform, there were new demands for more and different forms of regulation.

Demand for new regulation ...

This dynamic is fundamental in modern economies. The demand for new regulation is continual (see, for example, BCA 2005a). Regulating, legislating and making rules is a fundamental activity of all governments. New legislative programs are a major focus of any government, certainly the parliamentary arms of government.

Governments respond to ongoing regulatory demands arising from:

- particular groups that seek government support or protection for their particular activities and concerns;
- public and social concerns over broad economic and social issues such as security and the environment; and
- the consequences of government decisions themselves: tax changes, for example, typically set in train a round of regulatory adjustments to administer, enforce and deal with ambiguities in the new system.

The degree of systematic and critical review of new regulations varies considerably, as does the extent of appreciation of the full economywide implications of particular changes.

... in a changing world

At the same time, the world is continually changing. External shocks and internal dynamics mean that the 'economy' that is being managed is never the same thing. Heraclitus said 'you can never step in the same stream twice', and the same sentiment is true for governance: governments never get to manage the same economy twice. Regulations appropriate in one era may no longer remain so.

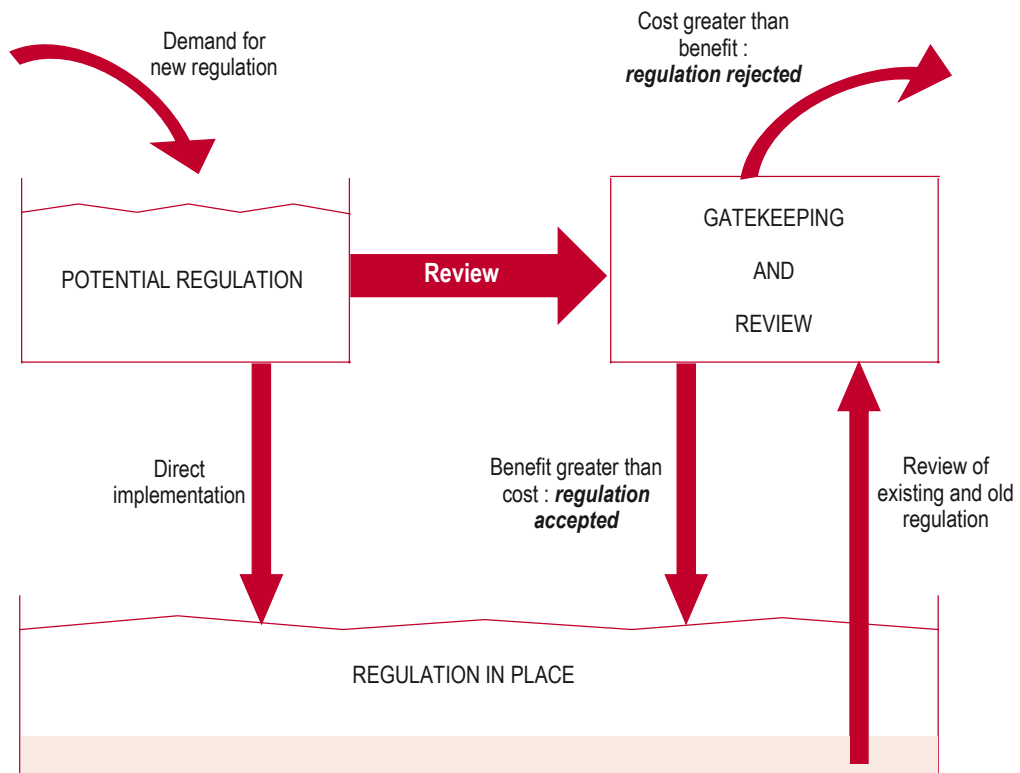
In our era, one of the most significant changes is the impact of rapid communications and information technology (see, for example, the Allen Consulting Group 2004). This has changed the landscape of economic activity, processes of government and community expectations about government performance.

Reviewing and reviewing again

It is extremely unlikely that we will ever be able to set in place the ideal set of regulations that will never need to be changed or reviewed again.

The NCP agreement on competition principles – particularly as it related to legislation review and reform – envisaged an ongoing process of regulatory modification (chart 3.2). New regulations would be checked before implementation, and would be accepted only if the benefits of restricting competition were greater than the costs. At the same time, existing ‘old’ regulations (those comfortably settled at the bottom of the regulatory pool) would be reviewed, and then reviewed again on an ongoing basis (the NCP agreements suggested every ten years). In this way, the regulatory pool would be constantly cleaned and renewed.

3.2 The dynamics of regulation review



‘Reform’ in this sense or ‘a national reform agenda’ is not so much a once off action – after which the economy could be considered to be ‘reformed’ – but an ongoing process of effective governance. Under such a view, nothing is ever exempt from review, or exempt from the process of checking that it continues to deliver benefits greater than costs.

That this ongoing process was already envisaged in the NCP agreements of a decade ago is of key importance. This fundamental insight into the nature of governance is a hard won finding, which governments cannot afford to lose sight of.

4

Maintaining a principle based approach

'Isolated efforts cannot take the place of a coherent, whole-of-government approach to create a regulatory environment favourable to the creation and growth of firms, productivity gains, competition, investment and international trade'

OECD

Core propositions of good governance

The lessons from NCP, international experience and the recent arguments of a number of business groups point to a number of core propositions for good regulatory practice in government. Six core propositions, plus the arguments in support of them, are summarised in table 4.1.

The propositions summarised in table 4.1 are not controversial. They result from both Australia's recent experience in regulation review as well as international experience embodied in organisations such as the OECD.

While not controversial, these propositions can sometimes be forgotten in the day to day running of government activities.

Importantly, the experience in good regulatory practice summarised above can in turn be converted into a set of principles for regulation reform and review, including nationally coordinated review and reform processes.

4.1 Core propositions of good governance

<i>Proposition</i>	<i>Evidence</i>
1. Regulations have both benefits and costs. The costs are often indirect and hidden. The costs and benefits are not necessarily borne by the same groups.	A large number of regulatory studies have estimated both the costs and benefits of a wide variety of regulations. Typically, many of the costs are an indirect consequence of the nature of the regulations. The incidence of both the benefits and costs of the regulations vary considerably.
2. Benefits and costs can be exposed through appropriate empirical economywide benefit–cost analysis combined with transparent consultation.	The techniques for empirical analysis of the benefits and costs of regulations have developed considerably in recent years. Advanced techniques are regularly used by a number of organisations in Australia (both government and non-government) and internationally (including agencies such as the OECD and the World Bank).
3. Governments should seek to discover the costs and benefits of their proposed and current actions, with a view to ensuring that benefits exceed costs.	This idea is in some ways self-evident, but is also indirectly demonstrated by national economic performance when the idea is heeded.
4. Regulations should not be put into place, or existing regulations should be modified, if it is found that the costs exceed the benefits.	As for proposition 3, this idea basically constitutes a definition of good governance, but is also supported by recent findings about the importance of ongoing reform for Australia’s economic performance.
5. Circumstances change and, as a result, so too does the balance of costs and benefits of various regulations	This proposition has been demonstrated time and again by examining Australian regulations in almost every area — from agricultural marketing to telecommunications to infrastructure provision.
6. There are continual pressures for new regulation, and some regulations remerge as a result of policy decisions of various kinds	This proposition is evident from examining government activity in almost any area. New regulations of various kinds are a constant feature of the economic landscape.

Principles for coordinated national review and reform

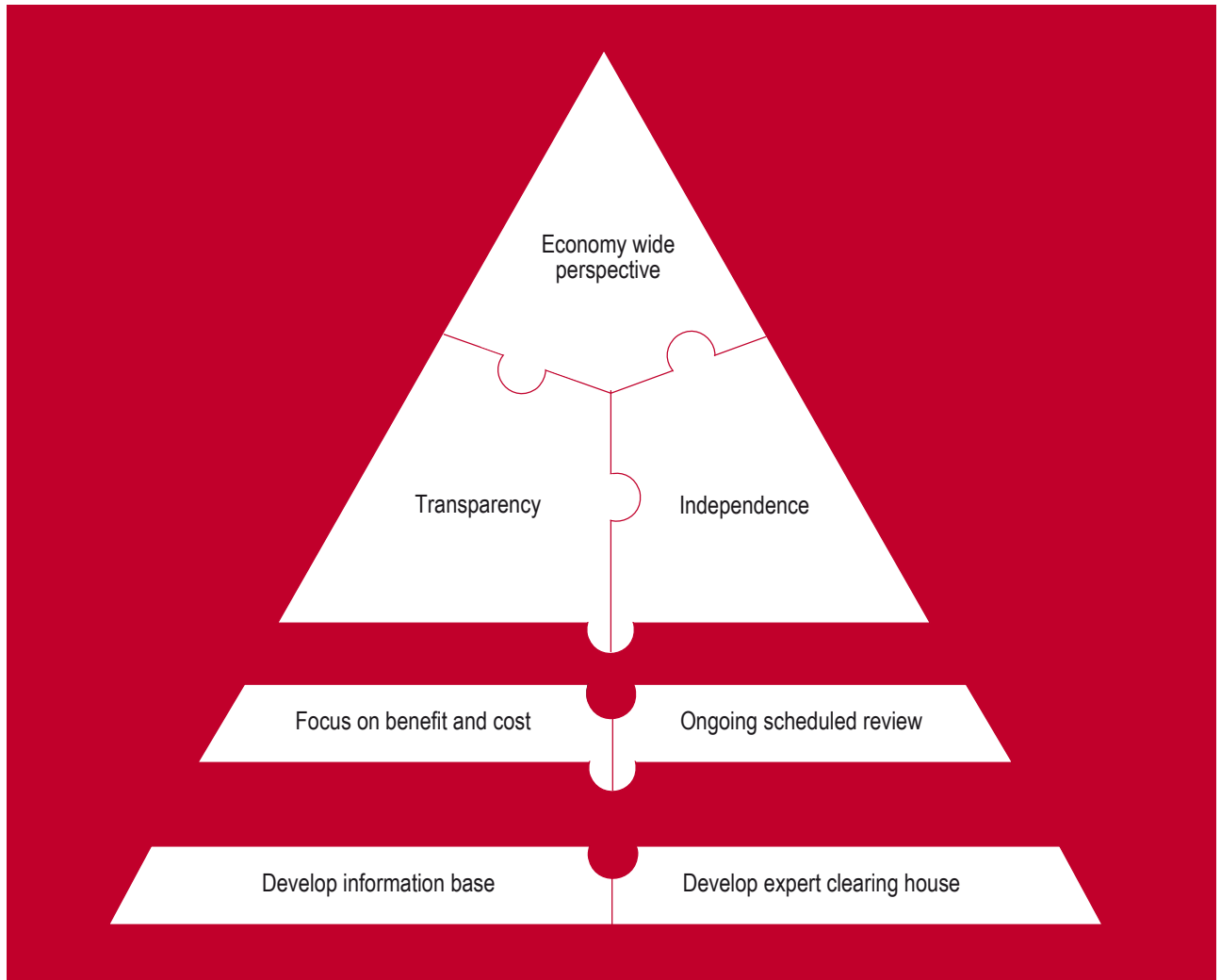
Some basic principles for regulatory review are summarised in chart 4.2. These principles consist of a fundamental three:

- economywide perspective
- transparency
- independence,

as well as some additional principles which support and provide a solid base to the first three.

As hinted in chart 4.2, the three core principles are interlocking and mutually reinforcing.

4.2 Principles for regulatory review

*An economywide perspective*

It is almost impossible to overstate the importance of an inclusive and economywide perspective to regulation review, ongoing reform and good governance in general. The importance of an economywide perspective arises at both an analytical level – understanding how regulations affect economic performance – and at a procedural level – working out the relationship between different reviews and reforms. In Australia, an economywide perspective is particularly important as major reform issues cross state and territory borders and so must be considered at all levels of government.

Cost and benefits are not borne by the same groups

The need for an economywide perspective is inherent in the nature of much regulation. Regulations in one area often affect outcomes in distant areas. Regulating downstream activities affects upstream activities. Businesses will seek to pass on the costs of regulation to the extent possible, so that the costs are often widely distributed.

Costs are often indirect and hidden

Without an economywide perspective, it is very easy to miss the costs of some regulations. Examining the impacts of telecommunications regulations on the telecommunications sector alone would completely miss the benefits of recent deregulation in Australia, where the benefits have accrued widely across the community.

All parts of the economy are linked

A feature of modern economies is the extraordinary level of interdependence between apparently distant activities. Economic changes are rapidly transmitted throughout the economy meaning that it is almost impossible to ring fence the effects of regulations to a single industry or activity.

Jurisdictions are linked

The interdependencies within the economy also hold for different levels of the economy – Commonwealth, state and local. These linkages were, of course, a major impetus for the original ideas of nationally coordinated reform. The strength of this original argument is even stronger today. Future reforms will require the cooperation of all levels of government.

Reforms are inevitably interlinked

Perhaps the most important implication of the economywide perspective is that there is an inevitable interaction between regulatory review and reform in different areas of the economy.

Reforms should not be put into silos or compartmentalised. Broad coverage is essential. The extent of interdependencies within the economy mean that divisions along industry or portfolio lines will not necessarily allow a full assessment of the need for, or implications of, reform. Broad consideration (as opposed to segmentation) also helps avoid disjointed and incremental approaches to policy.

Transparency

In all developed economies, transparency is recognised as a major component of good governance in its own right. It is also of fundamental importance in regulatory review and reform.

In the context of regulatory review, transparency has a number of key components including:

- a transparent process of review, such as, for example, the NCP process or the review and inquiry processes undertaken by the Productivity Commission;
- transparent analytical content to the review including the use of well established techniques and methods of research;
- a transparent process of consultation both with immediate stakeholders and those more distantly affected by particular regulations – this includes the opportunity for these groups to contribute to the review process;
- transparent and contestable procedures in moving from the analysis and consultation phases of the review to the ultimate conclusions; and
- transparent publication and dissemination of review findings and outcomes.

One of the implications of transparency is that reviews have a ‘shelf-life’. Often political circumstances prevent particular reforms taking place to the full extent recommended. The shelf-life of transparent reviews means that the collective knowledge in the review is not lost, but is able to be drawn on when circumstances permit.

Transparency combined with an economywide perspective also allows for the development of a growing body of knowledge about regulation and its impacts.

Independence

The fact that regulations have both costs and benefits means that a fair assessment of the balance requires independence from both the proponents and opponents of the regulation.

In many cases, government departments responsible for administering particular regulations are also responsible for reviewing them. In these cases, mechanisms for establishing and maintaining independent reviews are particularly important.

One way of maintaining independence across a wide range of reviews is for an independent agency to provide oversight to the ongoing review process. An agency with a role such as the National Competition Council (or the Office of Regulation Review at the Commonwealth level) helps provide confidence that someone is keeping a watch on the overall conduct of the reviews. The Business Council of Australia has recently supported the idea of independent oversight of regulations (BCA 2005a).

Independent oversight can also enhance the transparency of the review process by summarising in one place the review activities that have taken place over a particular period.

The notion of independence also intersects with the principle of an economywide perspective. When review is conceived as a series of isolated and one-off reforms, rather than as an economywide whole, it is much easier for the independence of the process to be compromised.

Focus on benefits and costs

Regulation review is not in itself anti-regulation. Regulations for which benefits exceed the costs, and which achieve their objective most efficiently, are appropriate. The point of regulation review is to compare the balance of the costs and benefits in order to understand the true effect of the regulation and whether it is really achieving its objectives.

Proponents of regulation often forget, however, that regulations can impose significant costs, with these costs often being in areas outside the proponents' fields of view. In the rush to implement particular regulatory programs, careful analysis of both costs and benefits can often be missed.

A focus on costs and benefits as an important principle of regulatory review provides something of a counterbalance to this tendency.

Ongoing scheduled review leading to reform where necessary

As noted above, the continual demand for new regulation combined with inevitable changes in economic circumstances means that *ongoing* review is essential.

As a principle, the need for ongoing review must be recognised as a reminder that the reform process is never finished.

As a matter of practicality, it is a good idea to schedule ongoing reviews to a degree. The key points, however, are that the review should be *ongoing*

rather than a once-off effort, and that the scheduling itself is an ongoing process.

Develop an information base and expertise

Undertaking regulation review and reform in accordance with the broad principles outlined above requires information and expertise.

A major advantage of nationally coordinated review, as well as reform with common oversight, is that it is possible to develop a common information base and expertise for undertaking review and analysis.

While many successful reviews of the costs and benefits of regulation have been undertaken in Australia, it is also true that the assessment of regulation can often be difficult, requiring careful and expert analysis.

Ongoing development of information and expertise for regulatory review is an important component of overall reform and should be kept in mind as an underlying principle.

Why focus on principles?

Why should any review process be supported by a set of commonly understood principles? Isn't it more important to simply get on with the job of reform?

As noted above, one of the major arguments in support of sound principles is that they work. The general principles underlying NCP contributed to its overall success. Indeed, it could be argued that the cases in which NCP was not entirely successful are those cases in which the principles were not fully adopted.

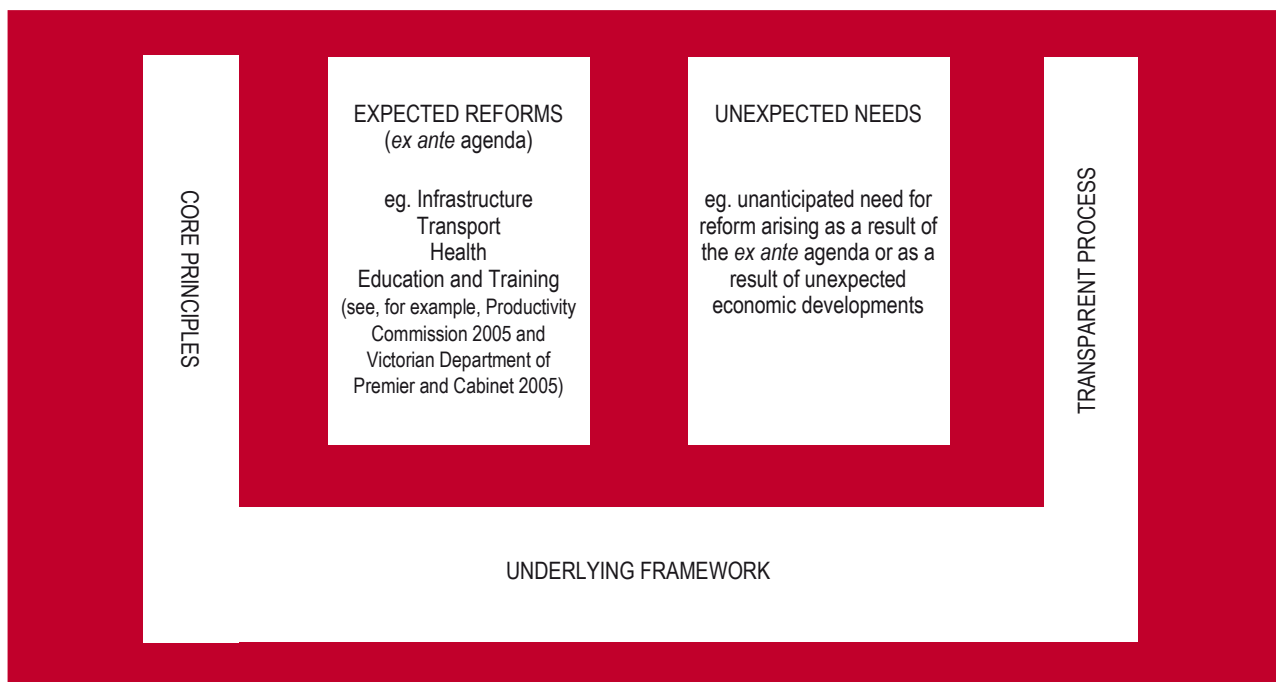
Regulation review and reform can often be a difficult process, requiring careful analysis and broad participation. A set of commonly understood principles provides a common reference to bring together different elements of the process.

A number of commentators have identified specific areas where reform effort should be focused in the near future. On the one hand, coming to a common understanding of where to focus reforms is extremely important. But on the other hand, the areas identified are not entirely surprising in the Australian context.

The expected (or *ex ante*) agenda is important and can be addressed via a principle based approach. But perhaps the greatest contribution of principle based reform is that it provides a framework for dealing with unexpected or unanticipated reform needs (needs that often become apparent only as the *ex ante* agenda proceeds). As chart 4.3 illustrates, both expected and unexpected reforms should be supported by the same core principles and underlying framework outlined above.

The application of a principle based approach will ensure that Australia can deal effectively with any reform needs that arise.

4.3 Expected and unanticipated reforms can be supported by the same principles



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