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Economic Policy for Rural and Regional Australia

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1. Introduction

Over the last decade or so there have been renewed and vociferous pressures at a minimum for special attention to, if not specific support for the needs of rural and regional Australia (RARA). Requests for special RARA policies arise from claims of falling relative incomes, higher unemployment, loss of access to private and public services, special difficulties in adjusting to structural changes, including changes in government policies, and loss of population, as well as the traditional concerns of droughts, floods and falling commodity prices (Kelty, 1993, and Productivity Commission, 1999). Of course, life for many in the cities of Australia also has been less than Utopia. However, it is RARA rather than the cities where political populism has been more apparent. This paper challenges arguments for special economic policies towards regions, industries and households in RARA if Australia is to meet national efficiency and equity goals.

The rest of the paper is structured as follows and the main results are noted. Section 2 provides a background description of economic outcomes and government policies affecting RARA relative to cities and Australia as a whole. In terms of averages, comparing RARA with the cities, the share of population has been fairly constant, the employment rate is about the same for males and lower for females and self employment is more common, education levels are lower, and household incomes are lower. But, these averages hide considerable diversity within different parts of RARA and different suburbs of the cities. Government industry assistance policies to particular industries have been phased down with microeconomic reform, with the dairy, sugar, TCF and automobile and car parts industries being the main outliers. RARA continues to be favoured relative to the cities by taxation and government spending policies and by community service obligations placed on the main utility suppliers. Section 3 evaluates efficiency arguments for special policies for RARA. Competitive markets and market failures are balanced, especially in assessing areas of commonality and areas of differences between RARA and the cities. Further microeconomic reform to reduce specific industry assistance and to reduce community service obligations is supported. Property rights for, and the use of, natural resources currently are unsatisfactory, and the solution is challenging because of the growing importance of public good type demands on land, water and forest resources. For most cases economy wide, rather than RARA specific, policy interventions towards external costs and benefits and the abuse of market power are supported. Section 4 reviews government taxation, social security and other expenditure policies of redistribution to achieve social equity goals. Available economy wide policies focusing on the needs of individuals and households are more direct and efficient redistributive instruments for alleviating both short term

temporary and longer term low incomes than are specific region or specific industry grants and assistance. A final section provides concluding comments.

2. Background

Although there is no precise or consistent definition of RARA, and any definition would vary with the specific analysis, the general idea is fairly clear (Productivity Commission, 1999, and Bray, 2000), and precision is not required for this paper. Most regard RARA as outside the main capital cities and other large coastal cities such as Newcastle, Wollongong, Geelong and the Gold Coast. Always included would be inland country towns and non-urban residents, and where natural resource industries including agriculture, mining, forestry, fishing and tourism are important. Contentious areas for inclusion in RARA are large country cities, such as Ballarat and Toowoomba, and coastal resort towns, such as Bateman's Bay and Lorne.

1996 Census

Data from the 1996 Population Census (and soon from the 2001 census) provide a comprehensive quantitative background for comparing different parts of Australia. The Productivity Commission (1999) and Bray (2000) have reported excellent assessments of RARA using the 1996 data. Table 1 draws on a much more detailed analysis by Bray. In Table 1 data is used to provide a background comparison of population, industry, labour force and income for Australia as a whole and for four components of RARA, namely towns with between 10,000 and 40,000 people, towns of between 2,000 and 10,000 people, towns of less than 2000 people and non-urban.

In 1996 there were 4.7 million persons, on 26.6 percent of the population, living in non-urban residences or in country towns of up to 40,000 people. Over the ten years to 1996 population growth in RARA exceeded the national average, with the exception of towns of less than 2000 persons where there was no aggregate population change. Clearly the averages hide considerable diversity of population growth with some areas growing fast and others losing population. For example, as noted by the Productivity Commission (1999), large country towns, so called 'sponge cities', have boomed at the expense of small towns in a 100 to 200 km periphery, especially in extensive cropping and grazing areas, and there has been a shift from the in-land to the coast. Again, some areas of extensive grazing and cropping have sharply reduced labour inputs and increased farm sizes, while other areas have increased labour inputs, especially in horticulture and tourism, and mines have opened and closed. While the average story of population growth in RARA as an aggregate has been positive, there are some places experiencing population decline and bleak prospects, and others areas are growing, some quite rapidly.

Labour market status and outcomes have a number of similarities and contrasts between RARA and city Australia. The employment to 15-64 age population ratio for males is about the same, and less for females, especially in small country towns where the ratio is about five percentage points lower. On average, and contrary to much populist political rhetoric, unemployment rates are comparable across RARA and city Australia. However, the averages in Table 1 hide pockets of double digit unemployment rates in particular suburbs of capital cities and in particular areas in RARA (see also Vinson, 1999). The workforce in RARA has much lower levels of

formal education, and moreso for those in small country towns. Self-employment at around 20 percent of the workforce in small country towns and in non-urban Australia is more than double the national average. After making allowance for differences in education, work experience and the factors affecting wage rates there is a consistent finding that wage rates are lower in non-metropolitan Australia (see, for example, Preston, 1997).

Agriculture, mining and other natural resource intensive industries are more important sources of employment in RARA than in the cities, however the tertiary or services sector is the dominant employer, including in non-urban Australia. Of course many of those in the tertiary and manufacturing sectors in RARA are either directly servicing the natural resource industries or providing consumption goods and services to families working in the primary sector. The dominance of tertiary sector employment in RARA means that government policies focussing on the agriculture and mining industries, or on farmers and miners, will miss the majority of people in RARA. Also, as Lim (2002) notes, about 30 percent of farm families have a member in non-farm employment and off-farm income is even more important for these households.

Household incomes on average are 15 percent lower in RARA than the Australian average. The gap is larger for those in small country towns than for those in larger towns and in non-urban areas. Similar patterns are found in the US (for example see Knutson, Perin and Flinchbough, 1995, chapter 16). In part, the lower incomes in RARA reflect the lower human capital levels and lower wage rates, a lower female workforce participation rate, and a higher dependence on government social security payments.

Importantly, the average income figures in Table 1 hide very considerable variations of income of families within RARA and within particular regions, towns and city suburbs. One indication of income variability is given by the gini coefficient in Table 1 (with a value of zero for complete equality and of unity for perfect inequality). Vinson (1999) finds pockets of low incomes, high unemployment and other measures of social disadvantage in both the major cities and RARA. In considering redistributive policies to meet equity goals of society, poverty and disadvantage are problems for both rural and city Australia. Also, because of the diversity within regions and industries the individual or household circumstances represent a more direct indicator of need for government support than does an industry or region.

Industry Assistance

Commonwealth and State governments still provide extensive assistance to particular industries via tariffs, price regulations, direct budgetary assistance, and tax concessions (or tax expenditures). Extensive microeconomic reform over the past twenty years has significantly reduced the importance of selective industry assistance especially via tariff reductions and phasing out of agricultural marketing schemes, although there remain important exceptions for the textile, clothing and footwear (TCF), car and car parts, dairy and sugar industries.

Estimates of selected industry assistance for the broad industry sectors primary, mining, manufacturing and services for 2001-02 compiled by the Productivity

Commission (2002) are shown in Table 2. Tariffs provide significant net assistance to the TCF (at 27 percent) and car and car parts industries (at 10 percent), but very little to other manufacturing industries, and tariffs impose net costs on the primary, mining and services sectors. The dairy industry and (from 2003) the sugar industry receive significant assistance by effective taxes on domestic consumption of 11 cents a litre on fluid milk and of 3 cents a kilogram of sugar (Productivity Commission, 2002, and Edwards, 2003). There are some regulations of services not shown in Table 2 which provide selective industry assistance to the tertiary industries, for example quotas on domestic TV programs, non-recognition of many overseas professional qualifications, and quotas on taxi licenses.

Commonwealth budget assistance to selected industries shown in Table 2 of \$3.9 billion in 2001-02 includes direct payments for industry specific programs and tax expenditures. Assistance to primary industry includes budget payments for R & D, for adjustment assistance, including for dairy farmers and for relief for exceptional circumstances (currently for drought), and tax expenditures include income tax averaging and accelerated depreciation for horticulture. In manufacturing, motor vehicles are the largest recipient of direct budgetary assistance, with other important recipients being the petroleum, coal, chemicals and pharmaceutical industries. The development allowances, as a tax expenditure, is the most important source of special assistance to mining.

State and Territory governments also provide budgetary assistance to particular industries. A partial list compiled by the Productivity Commission (2002) is for \$3.3 billion, and this measure excludes tax expenditures associated with the payroll tax exemption for small business and the land tax exemption for primary production and for most owned occupied homes. The agricultural sector is a significant beneficiary of State and Territory budgetary grants.

Overall, the Productivity Commission data on specific industry assistance points to a favourable bias to industries located in RARA. The assistance rate to primary industry is not much below that for manufacturing, and the high rate of assistance to the TCF goes partly to factories in RARA.

Tax and Spending Programs

Taxation and expenditure programs of the Commonwealth, States and Local governments have significant effects on incentives facing individuals and businesses and they redistribute private spending capacity. The majority of programs do not distinguish between geographic areas of the country, but a significant number explicitly, or in effect, favour RARA.

Commonwealth income tax and social security systems have the largest direct effects on individuals and households. With a few minor exceptions, such as the remote area allowance, these universal systems focus on individual or family circumstances and not on region. The combination of a progressive personal income tax system and a system of means tested social security pensions and benefits results in disposable incomes with less variation than pre-tax or market incomes (see, for example, ABS, 2001, and Harding et al., 2002). An indirect outcome is that the income tax and social security systems redistribute income from people in the cities where pre-tax incomes

on average are higher to people in RARA where on average incomes are lower and there is a higher proportion of social security recipients (as shown in Table 1).

Commonwealth excise on petroleum products provides exemptions for fuel used off-road and for diesel used in long distance transport. These concessions favour industry in RARA. Other Commonwealth and State indirect taxes, including the GST, other excise taxes and stamp duties, do not explicitly distinguish between expenditures by geographic area.

Governments fund, and in many cases also supply, some goods and services to businesses and households. Outlays on pure public goods, such as defence and law and order, provide identical services to all Australians, but individually we place different values on these public goods. The location incentive effects and the redistributive effects of government funded private goods, including education and health, and local public goods, such as local policing and roads, are more complex, particularly because of the important effects of considerations grouped under the heading of horizontal fiscal equalisation (HFE).

The general idea of HFE is that the Commonwealth in redistributing some of its tax revenue to the States (and Territories), and the Commonwealth and States in redistributing some of their revenues to the Locals, follow formulae based not on relative population or relative revenue collected, but formulae seeking to provide each lower level jurisdiction with funds to provide a comparable capacity to deliver government services given estimates of differences in costs of providing services and differences in own revenue raising opportunities (Morris, 2002). An independent body, the Commonwealth Grants Commission, is charged with making recommendations for the distribution of Commonwealth General Purpose Grants (mostly GST revenue) of about \$32 billion a year to the States, and States have similar bodies to assist in distributing Commonwealth and State funds to Locals.

In applying HFE the grants commissions consider a number of criteria in assessing relative capacity. An important subcomponent of the criteria is population, population density and distances; other criteria include age distribution, incomes and natural resource base (see, for example, Garnaut and Fitzgerald, 2002). Population sparseness and greater distances through HFE result in the Commonwealth redistributing revenue collected from residents of the higher population density States of NSW and Victoria to the other States. The Productivity Commission (1999) quotes markedly higher per capital grants by the States to Locals in country shires, and then regional cities, compared with city municipalities. Overall, HFE redistributes revenue collected in the large cities to RARA with the aim of State, Territory and Local governments providing comparable levels of education, health and other services to all Australians, regardless of location.

Community Service Obligations

Commonwealth and State governments in the pursuit of equity objectives have directed some government business enterprises, and now privatised utilities, to meet a number of community service obligations (CSOs). CSOs include standard rates for letters, telephone calls, electricity and gas regardless of different costs of supply, and prices for transport and water below costs of supply. The Industry Commission

(1997) estimated CSOs had an annual cost of around \$3 billion a year. While some of the CSOs are explicitly targeted at the capital cities especially subsidies for public transport, and others have benefits for those in the cities as well as RARA, most of the CSOs provide households and businesses in RARA with utility services at prices below cost (Thompson and Walsh, 1981, Kolson, 1983, and Lloyd, 1986).

Conclusions

This background provides mixed evidence that RARA is disadvantaged relative to city Australia. Most tangibly, income levels are lower, but there are many high income people in RARA and there are many areas and people in the cities who have low incomes. Some areas of RARA are experiencing population growth and new opportunities, and male employment and overall unemployment rates are comparable in RARA and the cities. Government policies on taxation, expenditure, industry assistance and community service obligations on balance have a slight bias in favour of RARA.

Tertiary industries, and in the larger country towns secondary industries, are more important sources of employment than the natural resource intensive primary and mining industries in RARA. Economic policy for people in RARA has to be very much more than agricultural and mining industry policy.

In fact, economy-wide government policies on taxation, social security, government expenditure on goods and services and regulations have a larger effect on the incentives and outcomes for RARA than industry or regional policies. For these programs, much of the focus is on individual and family circumstances rather than on regional average conditions and outcomes.

3. Efficiency Issues.

Choices about the allocation of labour and capital to different industries and locations, and choices about the growth and decline of population and economic activity in different geographical parts of Australia, including RARA, are really just a part of the general economic problem of allocation scarce resources among competing and generally unlimited ends. Further, changes in tastes, technology and world markets mean that these location choices also change and evolve over time.

Efficiency Criteria and Instruments

Economic efficiency requires application of the simple principle of equating marginal social benefits and costs in choosing products, production methods and location. For example, scarce capital and labour would be allocated between industries and between locations. whether it be wheat production, tourism, education and health, or between capital cities, country towns or non-urban Australia, to the point where marginal social benefits in one activity or location equals the marginal social benefit, or opportunity cost, in other activities or locations. This simple principle underlies such reports as the 1974 Green Paper on agricultural policy (Harris, et al., 1974), Lloyd (1986) the Hilmer Report (Hilmer, et al., 1993), and advice by the Industry Assistance Commission/Industry Commission/Productivity Commission and conventional economic analyses.

For many of the decisions affecting the location of people, resources and economic activity in RARA market forces of price coordination will achieve an efficient allocation, both in a static sense and most importantly in making dynamic responses to changes in tastes, technology, policies, and so forth. Favourable outcomes with competitive markets require good property rights, minimal relevant external benefits and costs, the absence of sustained market power, and good, or at least symmetrical, information. Then, private benefits and costs approximate social benefits and costs.

Clearly, reality includes important areas of the economy where there is demonstrable market failure. In such situations government intervention has the potential to improve allocative efficiency. However, market failure is a necessary but not a sufficient condition for intervention. This is because government failure associated with the limited information available to politicians and bureaucrats, and with private interest regulating objectives and behaviour, has to be balanced against market failures, usually on a case by case assessment.

Market Outcomes

Several observations about the operation of, and outcomes, from markets allocating resources, people and economic activity in RARA are worthy of emphasis. First, the firm profit motive and household utility maximisation leads private decisions to equate marginal private benefits and costs. In the absence of market failures these equate with social benefits and costs yielding an efficient outcome, including geographical location. The market system is an efficient processor of new, and often difficult to anticipate, information about changes in technology, tastes, prices and so forth which continuously drive change and reallocations of scarce resources required for efficiency.

Second, successful and enduring private decisions in competitive markets recognise the realities of the choice options and constraints. For example, the vagaries of climate and market prices facing agriculture, mining and tourism are taken into account for longer term investment decisions and in choosing strategies to accommodate short term difficulties.

Some rural lobbyists point to special difficulties faced by RARA, and then sometimes proceed to argue that such problems justify special assistance and subsidies to RARA. Alleged difficulties include remoteness with higher transport and communications costs, dependence on climate variability and its unpredictability, and so forth. Of course, city Australia could, and some do, point to their location difficulties with congestion, uncertain and fickle product demand, and so forth. National economic efficiency, and private market decisions, need to accept as givens the different difficulties and opportunities when measuring benefits and costs. Private market decision makers require and seek extra compensation to offset the extra costs of difficult industries, occupations and locations. Then, in terms of locating in RARA areas with higher private and social costs, businesses and households in an efficient market outcome would receive extra compensation to provide an offset for higher costs associated with remoteness, limited access to cultural life, and other disadvantages of a RARA location.

Changing technology as it affects costs of transport and communications, and scale economies in production in all types of industries, clearly are driving much structural change in RARA in particular and the economy in general. These and other structural changes are certain to adversely affect many small country towns, and of course rural people often drive past their 'local' village or town to a larger country town or city for supermarkets, health care and recreation. Government has little special information, entrepreneurship or skills to assess which towns will grow and which will decline. Market forces are better suited to collecting, evaluating and utilising the information required in making decisions to pick the future 'sponge cities', tourist centres, new or expanded mines, niche manufacturers, and areas of more labour intensive agriculture..

Third, with a market system to allocate scarce resources, the return on quasi fixed natural resources, not just agricultural land, forests, fisheries and ore bodies but also land in the cities, essentially is a residual return or rent. By contrast, the more mobile labour and capital inputs receive returns to reflect marginal opportunity costs of employment in different activities and geographical parts of the economy. From an efficiency perspective, so long as the rental return exceeds zero a market system will continue to operate with natural resources in RARA.

Fourth, with no significant market failures there is no case on efficiency grounds for subsidies to natural resource intensive industries or to RARA. For example, tariffs and other trade restrictions, marketing boards practicing price discrimination, assistance to businesses for exceptional circumstances such as drought, cross subsidies in the provision of utility services, such as telephones and water, and special assistance to regions with specific disadvantages (as proposed in the Kelty Report, 1983) would result in too many resources, activities and people locating in the subsidised industry and region. In terms of distribution, most of the subsidies augment the residual return on the quasi-fixed natural resources and become capitalised into higher asset values for the owners of these resources.

The foregoing rosy assessment of the virtues of competitive markets in allocating resources, economic activity and people in RARA is conditional on well defined property rights and no significant market failures. We turn now to discuss some of the challenges in contemporary RARA with these important conditions.

Property Rights

Agriculture, forestry, fishing, mining and tourism are key industries in RARA. Secure property rights over natural resource inputs are important if private decisions in a competitive market over investment, employment and production in these industries are to be productive. Secure property rights include clear, unambiguous and transparent ownership over the rights to use natural resource inputs, the owner reaps all of the benefits and meets all of the costs of different uses, and there is a right to freely change ownership for mutual gain between buyer and seller. Currently there are areas of ambiguity and uncertainty with the property rights over land, water, forests, fisheries, mineral bodies and biodiversity. A particular area of difficulty is that some of the more recent claims on the natural resources associated with environmental and heritage values have public good properties. Markets alone are not well suited for allocating scarce natural resources between commercial uses and public good uses.

Property rights over land use for some agricultural development and for some new mining leases are areas of debate and uncertainty. The Mabo case of 1992 and the 1996 Wik case have given new but uncertain rights to claims of indigenous Australians over crown land. Environmental concerns about water, biodiversity, salinity and land degradation have been expressed as political opposition to, and in more and more cases regulation of, current land owners' rights to clear native vegetation, build dams and other structural earth works.

Debate over property rights for the uses of forests for commercial logging versus the environment, tourism, water catchment and other uses still has some way to go before property rights for commercial use or for other uses will be considered secure. In the mean time, commercial decisions are adversely affected by poor property rights, the environment movement and others are dissatisfied, and resources are wasted in lobbying and other rent seeking activities.

Natural fish resources are the classic example of a common property resource where market forces lead to over exploitation (Wills, 1998). With the oceans international cooperation as well as national policy intervention will be required.

Water

Achieving an efficient allocation of water is one of the most challenging issues facing Australia, and water illustrates most of the difficulties in specifying clear property rights for natural resources. Water is important not only for irrigators, miners, manufacturers, households and other commercial users in RARA, but also for commercial users in the cities, and in many cases city and country via for the same water resources. For commercial uses water has private good properties of rival consumption and low costs of exclusion. In recent decades, especially as Australia has moved into a mature water economy stage (Randall, 1981), the political and social demand for more water for environmental purposes has grown. Because of the non rival consumption and high costs of exclusive public good properties of many of the environmental resource, amenity and waste disposal uses of water, market allocations will fail efficiency criteria. In particular, commercial users will gain too high a share of the scarce water.

History also is important to the water debate, particularly as it defines the perceived assignment of water property rights. Since the arrival of Europeans, water has been regarded as a common property free good. Riparian rights combined land and water rights together, but since the mid-1980s land and water rights have been separated in more and more cases. Commercial users, and here irrigators are the most important in terms of water volume, consider the property rights have been allocated to them, and, further, with low usage fees. Recent buyers have paid asset prices reflecting these assumptions. By contrast, environment users, as relatively late entrants to the market, have had to argue for water rights. There is considerable evidence that the current allocation of water does not approach the efficient one whereby marginal social benefits are equated across the alternative uses of water, even within agriculture (e.g. Hall, Poulter and Currtatle, 1993; Taff and McClintock, 1998, Quiggin, 2001 and Goesch and Hanna, 2002) and between rural and urban commercial users, aside from the more controversial comparison between commercial and environmental uses.

Future policy has to confront the serious market failure associated with the public good properties of most environmental uses and the historically small allocation of water rights for these uses. Some mix of quotas, regulations, taxes on commercial usage, or allocation of water property rights to a “representative” environmental player will be required to increase water allocated for environmental uses. The desired allocation should seek to equate the marginal social benefits of more water for bio-diversity, stream integrity and other payoffs with the marginal social benefits of water diverted from commercial uses. A benefit cost framework built on physical and biological data quantifying the marginal gains in environmental services, and choice modelling and contingent value techniques for placing dollar values on the incremental non-market environmental services, provide a formal framework for collecting information on marginal social benefits.

It is likely, but not inevitable, that the social optimum allocation of water will require moving water from current commercial uses, in particular for irrigation, to greater environmental flows. Not surprisingly, farmers will seek compensation for what they perceive will be a loss of historical property rights. In part the claim is an equity one for the loss of asset values due to a change in government policy. Also, equity could reflect that the public good benefits of greater environmental services will be enjoyed by all Australians (and also some overseas). Even on efficiency grounds, caution seems to be necessary in involving the Coase theorem that the initial allocation of property rights is not relevant to efficiency. Requiring government to pay compensation likely will strengthen the need for formal justification of net social gains, whereas regulations appear to involve no costs in the political debate. Government buying of water property rights for environmental flows effectively compensates current right holders. Such a strategy reduces the actual and perceived sovereign risk faced by current water property right holders and gives them confidence to follow socially optimum uses of their more secure private property rights.

For the water allocated for commercial purposes, competitive markets provide the basis for an effective way to allocate scarce water between grapes, rice and other crops, urban households, manufacturers and so forth. To a very large extent these uses have private good properties. Where particular uses incur external costs associated with, for example, downstream salinity there is a case for taxes on these particular externalities, or as a second best feasible instrument a tax on the water input, set at the marginal external cost. Prices of traded rights effectively summarise the information on private marginal benefits of water in different uses and they also signal returns to investments to increase effective water supply. Further, markets are far quicker in coordinating changes in market circumstances than centralised command and control methods of allocating water. Government policy now accepts the desirability of markets for tradable water rights in allocating scarce water between different commercial uses, with Committee of Australian Government meetings in the mid-1990s being especially pivotal.

However, the actual trading of water rights for commercial purposes has been slow to develop and in part there remain problems with the current system of property rights (Brennan and Scoccimarro, 1999 and Crane, O’Reilly and Dollery, 2000). There is uncertainty about the volume, reliability and delivered price of water and about the

conditions of transferability. These uncertainties are greater for permanent versus temporary right transfers, and for transfers between regions versus within irrigation districts. In part uncertainty about volumes is associated with the already discussed debate on commercial versus environmental uses of water. The extreme variability of catchment flows in Australia, and to a lesser extent the variability of demand, requires more creativity in distinguishing water rights by probability (or reliability) of supply so that individual private buyers can choose their own portfolio of water right types. At a minimum, water rights should include the incremental or marginal supply costs. Whether delivery costs should include a component for sunk costs on dams and water delivery investments is largely a distributional issue because the water right market price reflecting opportunity returns would be discounted \$ for \$ for higher delivery costs. Current command and control regulations for externalities, and the way they are administered, add to transaction costs.

Externalities

External benefits and costs, or spillovers to third parties not involved in a market exchange, are found throughout the economy. Externalities result in market failures which may provide a cause for government intervention. Many externalities are common to all geographical parts of an economy. Examples of external benefits affecting country and city alike include education and individual firms R&D, and examples of common external costs include the burning of fossil fuels for transport and energy generation. Our interest is whether there are significant externalities which could justify policy intervention favouring RARA versus the capital cities.

Congestion in cities, together with market failures associated with congestion, sometimes is advanced as an argument for public subsidies to decentralise economic activity and population. The first part of the argument is that beyond a threshold larger and larger cities incur rising per unit costs of transporting people and products, handling waste and from pollution. It is less clear whether there are diseconomies in the delivery of telecommunications, electricity, water, gas and other services. The second part of the argument is that while individuals face the rising average cost (AC) of large city expansion, the relevant social marginal cost (MC) for efficiency is higher as illustrated in Figure 1. Then, in RARA with its low population and economic density demand D_{country} cuts the cost curves at Q_R where there is little difference between MC and AC and no market failure. By contrast, in the large capital cities with demand at D_{city} there is a large gap of AB between MC and AC. In this model, private markets ignoring the city congestion externality would have too many people and businesses in the city and too few in RARA for economic efficiency.

Several questions about the relevance and policy implications of the congestion externality argument for subsidising RARA can be made. First, the empirical magnitude of the externality is important. Further, planning and investment in infrastructure can mitigate some to all of size diseconomies. Of course, for many economic activities cities are required to capture economies of scale and scope in the provision of physical infrastructure and large urban conglomerations are required to capture network externalities for many businesses. Comparison of Australian capital cities with many overseas cities with whom we compete shows our capital cities are relatively small. That is, it is not clear that the empirical magnitude of the congestion externality is large.

Second, if in net there are substantial external costs with Australian cities, the first best policy intervention is to tax households and businesses in the congested cities. Subsidising RARA is a second best instrument. Third, even if this second best policy strategy is followed, current assistance to RARA described in Section 2 above of subsidies on particular inputs, such as CSOs for electricity and telecommunications, or subsidies for particular industries, such as dairy and tourism, have their own respective input mix and output mix distortions.

In Europe multifunctionality has been advanced as an externality argument for special assistance to agriculture and to rural areas (Jones, 2002), but so far this line of argument has little currency in Australia. It is claimed that farmers and country villages provide social, cultural and environmental benefits, largely in the form of public goods, to all of society but that they are unable to capture payment for the services provided. The supposed public goods include neat countryside scenery with leisure access, protection of the environment, and knowing that rural lifestyles are being sustained. Jones and others are critical of the supposed external benefits. For example, they state that farmers often deny access and they point to the fact that European farming incurs substantial environmental degradation. Finally, the price enhancement mechanisms of the Common Agricultural Policy are a very crude way of assisting an increased output of multifunctionality public goods.

Multifunctionality would seem to be an even weaker argument for special assistance to RARA than is the case in Europe. Any externalities are likely to be relatively smaller because of the greater geographical separation of urban Australia and agriculture, the greater commercial focus of Australian agriculture, and the greater sparseness of RARA. Again, selected output and input subsidies currently used in Australia are poorly targeted and expensive ways to sustain the image of rustic rural Australia.

Market Power

Efficiency losses and redistributive effects from the abuse of market power can be found in all and any parts of the economy. Market power may be a greater concern in RARA than in city Australia for two reasons. First, the sparse population, remoteness, and expensive travel and communication costs can both reduce the number of potential suppliers and exaggerate the incidence of natural monopoly. Thin markets and local monopoly often are given as the underlying structural reasons for relative high prices in RARA for fuel, groceries and spare parts. Smaller turnover in local markets mean it is more likely that quantity demanded occurs at levels where average costs are still falling to exploit economies of size. Here a single seller is required for technical efficiency, but at the same time this seller has the opportunity to set higher prices to exploit local monopoly power. Second, the greater share of self employed and small businesses in RARA, not just farming but also in manufacturing and services, can place RARA producers against more concentrated industries supplying inputs and buyers of their outputs. Falling real prices for transport and communications, and new information technology, are likely to have lessened the opportunities for abuse of market power in sparse and low populated country regions in recent decades.

The general economy pro-competitive regulatory processes, especially the ACCC, have a mandate to intervene against adverse abuse of market power in all parts of the economy, including RARA. Current discussion about the operation of the ACCC, including the Dawson Inquiry due to report in February 2003 (with some of the issues discussed in King, 2002; Jones, 2002, Kates, 2002 and Smith, 2002), has not drawn attention to special needs or claims of deficiencies specific to RARA (see also Productivity Commission, 1999).

Some community service obligations might be seen as a crude way of constraining prices where natural monopoly is relevant, particularly with the utilities, in RARA. However, where there are obvious differences in supply costs, not only between city and country but also between different parts of RARA, a policy of uniform prices distorts and results in efficiency losses. First best policy instruments would directly target the behaviour of firms abusing market power.

Conclusions

A mix of government intervention and competitive markets has been and will continue to be used to decide on the efficient allocation of economic activity and population in RARA. With the important natural resources the public good properties of most of the environmental and heritage uses require some form of government imposed quantities that aim to equate marginal social benefits across different uses. For most commercial uses of natural resources there are private good properties where competitive markets work well, but ambiguities in property rights need to be clarified.

For the main part, alleged disadvantages of remoteness, sparse population and long distances or other special characteristics of RARA do not warrant different and special economic policy approaches to RARA to achieve an efficient allocation of resources. Difficulties are given components of the available choice sets for both society and private decision makers. Claims for special subsidies to RARA because of externalities associated with congestion in cities and multifunctionality of agriculture and rural life are not supported. It is concluded that economy wide pro-competitive policies are appropriate for RARA, even though it may experience more opportunities for the abuse of market power.

Subsidies to RARA, whether to natural resource intensive industries or to inputs used by RARA, in the end provide incentives for too many resources, economic activity and people to locate in RARA.

4. Equity and Redistribution

Much of the discussion of economic policy for RARA is about equity and welfare, rather than about efficiency, and equity is a fundamental objective of Australian economic, social and political policies. Equity in Australia takes into account available income and consumption capacity, and equity includes opportunities for access to education, health and other services. The focus of equity primarily is on individuals and households and less so on regions and industries. The background discussion of Section 2, and Table 1 in particular, indicated lower incomes, less education and poorer health in RARA than in the capital cities providing some

evidence of inequity, but also, there is much variation within both RARA and the cities. Key questions for this section are the adequacy of existing redistributive policy instruments for meeting equity goals of people in RARA *viz a viz* the cities, and if there are policy gaps what form should complementary measures take?

Income Taxation and Social Security

Australia wide programs of progressive income taxation and means tested social security pensions, benefits and allowances are the most important and effective policy instruments for achieving greater equity of disposable incomes. These redistributive instruments focus on the income and asset circumstances of individuals or households, and they apply equally across different regions. An outcome flowing from lower average incomes in RARA relative to city Australia is that on average less income tax is paid by people in RARA and they receive more social security payments (Table 1 and Bray, 2000, for more details).

The adequacy of economy wide determined common social security rates for those living in RARA have been subject to ongoing debate. For the case for deficiency it is argued that because of transport costs many prices are higher for products sold in the country. On the other side, housing costs are much lower in RARA than in the capital cities. Overall, the higher share of social security recipients in the population in RARA relative to the cities suggests that clients find overall living costs lower in RARA.

Provision of social security support for the self employed and their families, whether to meet temporary (or emergency) needs or to provide longer term income support because of structural problems, is a greater issue for RARA because the self employed are more important, not only farmers but other small business people. A general principle with Australian social security is that unemployment, sickness, disability and other benefits are for employees or for the self employed willing to meet work tests, but that there is no general scheme of formal support for the self employed or for capital in the event of temporary or longer term income shortfalls. The Green Paper (Harris et al., 1974), the Henderson Poverty Inquiry (Henderson, 1975), Musgrave (1983) and others have pointed to gaps in the social security system for the self employed who need to devote time and resources to maintaining their business and so fail the work test and/or have difficulty converting assets into income. Arguments against specific welfare schemes for the self employed include opportunities for income spreading available in modern finance markets, better risk management strategies, moral hazard, and the difficulties of measuring poverty for the self employed, and even opportunistic decision making and accounting to exploit special benefits.

Special payments to farmers for income support under equity criteria have been made under various Rural Reconstruction Schemes and more recently the Exceptional Circumstances Relief Payments Scheme. For the 2002/03 drought the latter scheme was made available also to non-farm business in RARA. Neither efficiency or equity arguments support special poverty support instruments for self employed farmers versus other self employed business persons in RARA or the cities (a point made by Musgrave, 1983).

Government Services

Providing equitable access to education, health, cultural and other services to those in RARA represents a contentious challenge (see, for example, Morris, 2002). While governments via horizontal fiscal equalization and other measures appear to spend more per person in RARA, at least partly to compensate for lack of economies of size and other cost disadvantages, on some measures the resulting outcomes are less in RARA versus city Australia. Consider education as an example.

The observation from Table 1 that the education achievements of those currently residing in RARA is less than their city cousins does not necessarily imply lesser education opportunities especially for the young. More well educated youth move to the city for careers than *vice versa*. Further, such education and migration almost certainly is important for necessary structural adjustment in a rapidly evolving economy. Network economies of scale and production economies of scale and scope tend to favour location in large urban markets for many of the high education intensive activities. In a similar vein, size economies mean the wide choice of secondary and tertiary education will be available only in the cities. Inevitably those in remote and sparsely populated areas will have to incur additional transport and other private costs to access some services available in large urban areas, and, as argued in Section 3, above average returns to people locating in remote areas will be required to compensate for these types of cost disadvantages.

Nevertheless, the provision of comparable education opportunities for those in RARA and all suburbs of the cities must be a key part of equity and of efficiency in future Australia. The likelihood of multiple careers, a rapidly evolving economy and society, and inter-regional migration points to general education and life long learning skills as key parts of the curriculum.

Industry and Regional Policies

Where the focus of equity and redistribution is on individuals or households, subsidies to particular industries, inputs or regions are blunt redistributive instruments relative to the tax, social security and expenditure instruments already discussed. Within a particular industry or region there are individuals who span the low, middle income to rich. Then, subsidies to industries or the regions increase incomes of the middle income and the rich as well as the equity targeted few. Further, since the subsidies are for unit of output or input, the larger sellers and buyers gain more subsidy dollars, and generally the smaller players dominate the group society aims to assist.

Much of the need for welfare support is short term and temporary. The social security system in particular, but to a lesser extent also the tax system, are flexible in adjusting government support to individual and household current needs. By contrast, industry, input and regional subsidies lack this temporal flexibility even for the industry or region, let alone the different circumstances of particular individuals within an industry or region.

Conclusions

Most of the equity concerns for individuals and households in RARA, as in the cities, are met effectively by existing general government programs of social security, taxation and provision of key opportunity services at zero or below cost. Requests for additional formal support programs for the self employed are questionable, and there is no horizontal equity argument for singling out farmers for special measures but not other self employed persons.

5. Concluding Comments

Many of the complaints that RARA has been disadvantaged by government economic policies and that the economic outcomes in RARA compare unfavourably with the cities are not supported by the facts. Macroeconomic and microeconomic reform policies apply across the economy and all citizens, regardless of region, are supported by general government expenditure programs. Certainly there are particular regions and particular times when the going has been difficult in RARA, but this also has been the case for particular suburbs and times in the capital cities.

A mix of competitive market forces and government intervention will decide on the allocation of resources, economic activity and people, both between RARA and the cities but also within RARA. Markets have the advantage of making effective use of information on wants and constraints, and especially in coordinating the efficient reallocations of resources in response to changes. However, market failures are important reasons for government intervention. Economic efficiency is not enhanced by continuation of special assistance and subsidies to selected industries or services, many of which are in RARA. There is a growing need for and available options to improve the systems of property rights for natural resources, including water, land use and forests.

Society equity concerns are best addressed by instruments which focus on the circumstances of individuals and households, rather than on industries and regions. Current taxation, social security and other expenditure programs are important redistributive tools for those in RARA as well as the cities.

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Table 1 Some Characteristics of Rural and Regional Australia Relative to Australia, 1996 Census

	Rural Australia				Australia
	Towns of 10,000 - 40,000	Towns of 2,000 - 10,000	Towns < 2000	Non- Urban	
Population:					
1996 (million)	1.589	1.317	.318	1.489	17.750
1996 (% of total)	9.0	7.4	1.8	8.4	100.0
Growth 1986-1996 (%)	18.2	12.7	0.0	18.8	13.9
Labour Force:					
Employment/pop. Ratio					
Males (%)	70.4	72.2	73.6	73.3	73.4
Females (%)	57.1	56.4	55.2	58.0	60.7
Self-employed (%)	10.3	14.3	20.0	19.7	9.4
Unemployment (%)	11.6	9.9	8.4	8.9	9.2
Education					
Left school \leq 15 (%)	44.7	46.5	47.0	45.4	38.2
Degree or higher (%)	7.3	6.7	6.1	7.3	11.7
Industry composition					
Primary (%)	7.9	17.2	35.0	24.6	6.6
Secondary (%)	10.8	10.8	6.5	10.3	13.1
Tertiary (%)	81.3	72.0	58.5	65.1	80.3
Income:					
Average household					
Income (\$/week)	692.6	680.3	674.7	692.7	815.1
Distribution of					
household income					
(gini coefficient)	.393	.393	.400	.388	.402
Proportion of adults					
benefiting from					
social security					
transfers (%)	34.9	33.1	31.3	30.9	29.5

Sources: From J. Rob Bray, Social Indicators for Rural Australia, Department of Family and Community Services, 2000

Table 2 Productivity Commission Estimates of Selected Industry Assistance by Broad Industry Category, 2001-02

	Assistance via in \$million			Selected Industry Assistance as share of Sector GDP in %
	Tariffs and Price Regulations	Commonwealth Budget	State Budget	
Primary	211	663	971	6.8
Mining	-176	212	136	0.5
Manufacturing	4431	1863	93	8.5
Services	-2299	893	1438	0.0

Source: Assistance via tariffs and regulations, commonwealth budget and selected State and Territories budgets from Productivity Commission (2002), Trade and Assistance Review 2001-02, AusInfo, Canberra, Last column computed as sum of preceding three columns as share of sector GDP

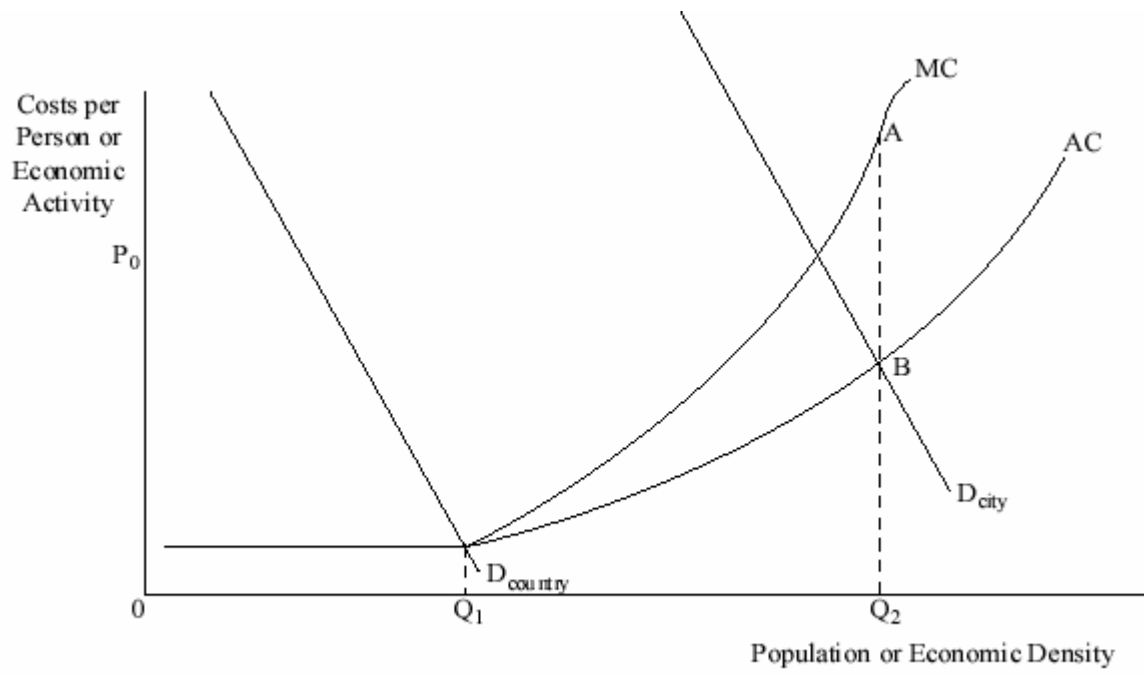


Figure 1 Marginal and Average Costs of Congestion