Chapter One

Introduction

In 1998, the Audit Office undertook a performance audit of the Department of State and Regional Development (DSRD). The aim of these audits is to determine whether an agency is carrying out its activities effectively, economically, efficiently and in compliance with all relevant laws. The audit report was tabled in the Legislative Assembly by the Auditor General in December that year.

The report made recommendations in the following areas:

- DSRD should try to prioritise assistance by comparing projects against each other to find the best, rather than assessing them individually on a case by case basis.
- DSRD should improve the guidance given to staff in evaluating projects.
- DSRD should improve its management controls such as information systems and its assessment procedures.
- DSRD should report assistance made to individual businesses and improve its monitoring of projects that have received assistance.

The Auditor General's report is covered in more detail in chapter three.

Under section 57 of the *Public Finance and Audit Act 1983*, the Public Accounts Committee is given the power to examine any report of the Auditor General laid before the Legislative Assembly and to report to the Assembly upon any item connected with such reports (sub-sections (1)(c1) and (1)(d)). The Committee is not able to examine Government policy, unless the matter has been specifically referred to the Committee by the Legislative Assembly or a Minister (sub-section (2)).

The terms of reference for the inquiry were:

- a consideration of issues relating to the provision of industry assistance provided by the NSW Government;
- a consideration of accountability and transparency matters relating to industry assistance provided by the NSW Government;
- the procedures currently employed by the NSW Government in allocating and distributing industry assistance and whether these can be improved;
- how the NSW Government's program of industry assistance compares with other jurisdictions in terms of transparency, accountability and efficiency;
- consequences of industry assistance; and
- any other relevant matters.

Chapter Two

Activities of the Department of State and Regional Development

The Department of State and Regional Development aims to advance the economic development of New South Wales and bring new business to the State. The objectives by which it seeks to do this are to secure sustainable economic growth in regional and metropolitan areas through:

- securing investment;
- boosting exports;
- developing enterprise;
- increasing the size of the domestic market;
- promoting innovation; and
- shaping the business environment.

The Department's Structure

As at 30 April 2000, the Department's total staff was approximately 260, most of whom were employed in its five core divisions: Policy and Resources, Investment, Small Business, Regional Development and Industry Development. The Department also has a Communications Unit employing 10 people, a Retail Tenancies Dispute Unit that mediates disputes over shop leases (five staff) and an Executive Support Unit with 12 staff. The roles of the five Divisions are as follows.

<u>Investment Division</u>

This Division attempts to attract investment to NSW and at 30 April 2000 employed 25 staff. It targets industries it considers play key roles in the development of the NSW economy. The sectors it currently targets include finance, information technology and telecoms, call centres, manufacturing, light metals, chemicals, bioscience, defence and aerospace, regional headquarters, agribusiness and regional operating centres.

<u>Small Business Development Division</u>

The Division's role is to help small and medium enterprises become more competitive through business advice, including an emphasis on exports once firms reach a particular size. It employed 54 staff in April 2000 and targets businesses at three critical stages:

- *Start-up*: Providing basic business planning and skills may reduce failure rates.

- *Transition to Employing Staff*: To prevent a lack of information from deterring businesses from further growth.
- *Expansion to International Markets*: To prevent small and medium enterprises being deterred from entering export trade by a lack of information about business practices and market needs.

Industry Development Division

The Industry Division's main roles are to research local comparative advantages to identify new business opportunities and to examine how to better develop current industries in NSW. It also promotes innovation within the State. It had 29 staff in April 2000.

Regional Development Division

This Division undertakes many of the same roles of the previous three Divisions, but concentrates on regional NSW. Its two main roles are: 1) recruiting new businesses and growing existing businesses in regional NSW, and 2) improving the leadership and capacity of regional communities.

In April 2000, it employed 88 staff across DSRD's head office and 18 regional offices.

Policy and Resources Division

The Division's three main roles are to:

- carry out DSRD's policy work;
- independently analyse larger project proposals; and
- manage the internal administration of the Department.

In April 2000, this division comprised 38 staff.

The Department's Activities

Although DSRD is divided into a number of divisions, there is a large amount of overlap in what they do. For ease of analysis, the Committee has divided the Department's work into eight activities, in addition to general policy work:

- financial incentives for economic activity;
- networking;
- business advice;
- promoting NSW;
- regulation;

- funding research and development;
- providing information to business; and
- community growth strategies.

Financial Incentives for Economic Activity

The Investment and Regional Divisions provide the bulk of the financial assistance. Assistance is typically provided through payroll tax rebates (after paying payroll tax, the firm gets a certain percentage of the amount back from the Department). There is a number of schemes through which assistance can be provided.

- *Regional Economic Transition Scheme:* $5 million pa is allocated to attracting projects in towns suffering from economic shocks.
- *Hunter and Illawarra Advantage Funds:* Both funds have a once-off allocation of $10 million to attract projects to their respective regions.
- *Regional Business Development Scheme (RBDS):* $7.5 million pa for projects that expand or locate in regional NSW.
- *Regional Headquarters:* $2 million pa to attract regional headquarters of multinational firms.
- *Industry Assistance Fund:* Historically has been $3 million pa to attract projects to NSW. Where the net present value of assistance for a project is over $1 million, DSRD can apply for extra funds from Treasury. The total amount in a financial year could be up to $17.5 million. Funds can be spent on regional projects (54% in 1999/00). Changes to this program are discussed in chapter ten.
- *Country Industries (Payroll Tax Rebates) Act:* Manufacturing firms that establish in most regional locations are legally entitled to rebates for the first five years after they locate. Rarely used – DSRD prefers to assist firms through the RBDS.

Advisory Services

The Small Business Division provides most of DSRD's advisory services. The key programs are:

- *Small Business Service Centres:* These provide basic advice and business planning to firms at start up. DSRD helps subsidise the cost of running 50 centres across NSW.
- *Small Business Expansion Program:* Partially subsidises the cost of consultancy advice (up to $5,000 per firm) to businesses employing three or more full-time people.
- *High Growth Business Program:* Export, e-commerce and business systems advice to firms identified with a strong growth potential.
- *Regional Export Advisers:* Five advisers are employed across regional NSW to provide export advice.

- *Women in Business Mentoring Program:* Links emerging and experienced business women to share knowledge and boost confidence.
- *Aboriginal Business Development:* Start up advice to Aboriginals. Business guidebook published in 1999.

Promotion of Sydney and New South Wales

All five Divisions participate in promotion duties. Examples are:

- *Competitiveness Report:* Uses comparisons of lifestyle and business conditions to favourably present NSW and Sydney as a place to do business compared with overseas locations.
- *Overseas Offices:* DSRD operates small offices in London and Tokyo.
- *Country Lifestyles Program:* The lifestyle of regional NSW is promoted to attract skilled labour to the regions.
- *Import Replacement*: DSRD provides $1 million pa to the Industrial Supplies Office to encourage domestic industries to source their supplies locally.

Regulation

This activity is spread across the Department. The main examples are:

- DSRD helps attracts investment by assisting firms through planning procedures, including the fast tracking of approvals.
- It has helped improve planning approvals for particular industries. An example is its work with other agencies to streamline approvals for aquaculture facilities.
- DSRD has carriage of the *Retail Leases Act 1994* and helps mediate retail tenancy disputes through its Retail Tenancies Unit.

Information to Business

The Small Business, Industry, and Investment Divisions are the most active in supplying information to business. Examples are:

- *Small Business Website:* Information on planning tools, programs, and links to regulatory agencies.
- *Innovation Website:* Bulletin board, development software, news line, and recent developments. Done in partnership with the University of Wollongong.
- *Export Seminars:* Provide practical knowledge about exporting.
- *NSW Air and Sea Freight Councils:* Provide information on the technicalities of exporting.
- *Olympics Business Information Service:* Provided information on Olympics contracts.

- *Investment Attraction:* Potential investors are given information on doing business in New South Wales, including the labour market, office rents, IT support capabilities, taxes, training subsidies, and visa applications.

Networking

The Department introduces local firms to potential overseas clients. The Small Business and Industry Divisions participate in this activity. Key programs are:

- *Investment Missions:* DSRD representatives and local firms travel overseas to attract investment and meet potential clients.
- *Foreign Government Relations:* NSW has five sister states (eg Tokyo and Seoul) and five memoranda of understanding with foreign governments (eg Colorado and Lebanon).
- *Incoming Buying Missions:* DSRD introduces missions from overseas to local firms.
- *Business Club Australia:* Used the Olympics to introduce international business representatives to local firms.

Community Growth Strategies

The Regional Division runs a number of programs to encourage regional communities to take leadership in developing their economies:

- *Regional Development Boards:* DSRD funds Boards for each of NSW's 13 regions. They draw up a strategic framework for growth in their region and develop local leadership.
- *Business Retention and Expansion Program:* Local communities are funded to analyse their economy to develop future growth strategies.
- *Main Street Programs:* Local communities are funded to plan and improve their business districts.
- *Developing Regional Resources Program:* DSRD offsets the cost of consultants to develop local plans to promote investment, increase exports and encourage innovation.

Research and Development

Although the Department provides information to agencies on R&D, promotes NSW as a centre for R&D and helps R&D firms network, it does not generally provide support to firms to undertake R&D. This may be because the Commonwealth already provides hundreds of millions of dollars annually for R&D.

However, R&D can be undertaken as part of DSRD's programs. For example, under the Agribusiness Alternatives Program, the Department has helped a firm increase its productivity by funding new drying and cutting technology with aridzone hardwoods. Timber that would have otherwise been destroyed can now be used for fine furniture.

The Department's Expenditure

The table below sets out the Department's expenditure from the 2000/2001 Budget Papers. The key findings from the table are:

- 22% of the Department's costs are on staff.
- 21% of its costs cover overheads and other operating expenses.
- The remainder of DSRD's expenditure (57% of its total) is on business and regional assistance.
- The Department's largest area of assistance is regional development (24% of its budget), followed by general assistance to industry (11%) and small business (9%). However, these last two categories would also include regional clients.

Table 1: Expenditure by the Department of State and Regional Development

Item	1999/00	2000/01
	($'000)	($'000)
Operating Expenses		
Employees	20,041	21,251
Other (rent, publications etc)	17,674	16,184
Maintenance	200	88
Depreciation etc	1,500	1,500
Total Operating Expenses	39,415	39,023
Payments to Other Bodies		
Regional Headquarters Scheme	1,119	1,179
Hunter Advantage Fund	7,960	2,000
Illawarra Advantage Fund	210	4,000
Assistance to Industry	10,366	11,580
Small Business Programs	8,101	8,591
Regional Development Assistance	13,664	14,334
Others	9,629	22,685
Total Payments to Other Bodies	51,049	64,369
Total	90,464	103,392

Source is 2000/01 Budget Papers. "Others" in Payments to Other Bodies for 2000/01 includes an abnormal item of $12 million. This is a capital payment to Gosford City Council for repayment of an advance from the Crown.

During evidence, the Committee asked the Department about how its scale of operations compared with other State agencies:

> **Ms ALLAN:** How does our performance compare with Queensland's performance in these areas that we are interested in as a Committee?
>
> **Mr HARRIS:**[1] The operation in Queensland is bigger. Do you want me to talk about numbers?
>
> **Ms ALLAN:** Yes.
>
> **Mr HARRIS:** These are ballpark numbers… In Queensland there are probably somewhere in the region of 600 people working in the area of State development, business development, economic development issues. In Victoria it is, I believe, somewhere around 430. In New South Wales it is about 240. The gross budget figures for those departments, trying as best one can to compare apples with apples, in New South Wales it is a figure of about $90 million as a gross budget.
>
> That constitutes about $50 million or so in captured items, items that have already been committed to in previous years and are thus just administered by the budget. So we have probably about a $30 million to $40 million discretionary budget. In Queensland the budget is in the high $130 million and in Victoria it is in the high $130 million.

Given NSW has a larger population than Victoria or Queensland, DSRD is spending less on assistance on a per capita basis than the other two states. This appears to be the position in relation to other States as well. For example, the 1998/99 Annual Report of the Western Australian agency Commerce and Trade lists its total expenses at $60 million, including total grants of $24.6 million. On a per capita basis, this is significantly higher than DSRD.

Procedures for Providing Financial Assistance

DSRD's procedures are given in the figure overleaf. Its main features are:

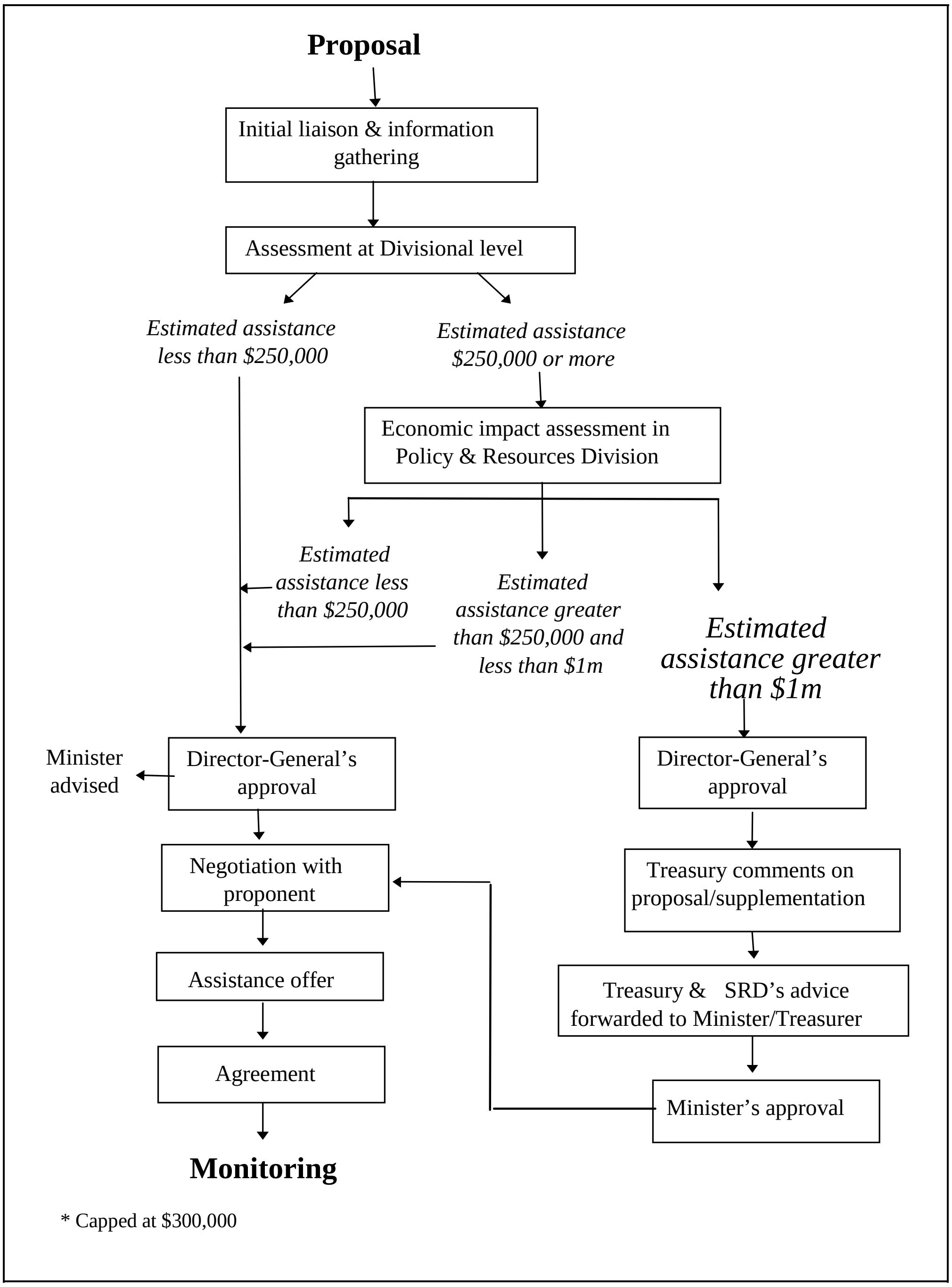
- If the estimated value of assistance is less than $250,000, the package can be approved by the Division involved.
- Amounts greater than $250,000 must be independently assessed by the Department's Policy and Resources Division.
- If the estimated assistance is greater than $1 million, the package requires the Treasurer's approval, following advice from Treasury.
- The Treasurer need not follow Treasury's advice.

The Investment, Regional Development and Industry Divisions all attempt to discover investment leads. There is no advertising of assistance. The Department

[1] Director General, DSRD, transcript of hearing, 3 May 2000, p 112

promotes New South Wales as a place to invest, not a place to receive assistance. Staff in the Investment Division are required to obtain a certain number of investment leads every month. In many cases, firms seek out DSRD.

Fig 1: Key Steps in the Provision of Assistance under the IAF, RHQ* and RBDS



Source: Auditor General's report on the Department (1998)

Businesses seeking assistance must fill out an application form and provide detailed data of their operations, including forecast financial operations statements for at least five years, employment data, and business plans. Officers from the Department often personally guide firms through this process, especially for regional assistance.

The procedures and criteria used by DSRD to provide financial incentives for economic activity are not published. The Department advised this was by design, as it was competing against other countries and considered this secrecy allowed it to attract investment for the least cost. One of the criteria is usually whether there is a real risk a project will locate outside New South Wales ("footloose"). As will be discussed in chapter five, this criterion is difficult to determine and define.

Financial assistance given by the Small Busines Division is more structured and the criteria are more rigid. The amount of assistance involved is usually a specific amount based on a payment made by the business, eg for consultant advice.

Chapter Three

Australian Literature Review

Industry Commission: Research and Development (1995)

The Commission's report covered a wide range of R&D issues, given R&D is done by many different types of organisations in both the public and private sectors. By making international comparisons, it made the following findings about Australian R&D:

- low gross expenditure on R&D relative to GDP, reflecting relatively low R&D spending by business;
- high public relative to private expenditure on R&D; and
- middle ranking performance in terms of publications and patents.

However, in the 10 to 15 years prior to the report, the Commission found significant changes in the R&D system. The ratio of gross spending on R&D to GDP grew much faster in Australia in the early 1990s compared with most other countries. This was due to business R&D, which was growing by 13% annually and as a proportion of GDP rose from 0.3% in 1981 to 0.7% in 1992/93.

The Commission found that opening up the Australian economy to international competition helped spur innovation. The Commission did not consider the gap between the levels of Australian business R&D and those overseas to be caused by a lack of government assistance. The Commission found business R&D to be more highly supported than in most other countries. It thought Australia's low business R&D spending was due to the following factors:

- The long-standing protection of manufacturing and Australia's traditionally low participation in world trade.
- The small size of Australia's manfuacturing sector. In all countries, manufacturing industries perform a high proportion of business R&D.
- Different manufacturing industries have different R&D intensities. Compared with the OECD, Australia manufacturing has a bias to low and medium R&D intensive industries.
- Within most manufacturing industries, Australian companies tend to be less R&D intensive than their overseas counterparts.

Finally, the Commission examined the Commonwealth's R&D programs. Its main recommendation was to retain the 150% tax concession for R&D. The Howard Government, however, cancelled the concession in 1996.

Victorian Auditor General's Office: Promoting Industry Development, Assistance by Government (1995)

This report was largely aimed at monitoring the claims and performance of the Victorian Department of Business and Employment and suggesting improvements to its operations. The report also discussed bidding wars between States and Territories in competing for investment.

Between 1993/94 and 1994/95, the number of projects approved to receive only non-financial facilitation had fallen from 41 to 15. However, there was an increase from 25 to 38 in the number of projects approved to receive financial assistance in the same period. The report noted the value of facilitation services in securing investment and recommended the Government maintain a suitable balance over time between direct financial assistance and non-financial services.

WA Public Accounts and Expenditure Review Committee: Western Australian Government Financial Assistance to Industry (1996)

The Committee found that many forms of business assistance were activities business could best do for itself. Governments should instead concentrate on their unique role in creating a good business environment through sound fiscal management, fair pricing of government services and an appropriate level of regulation. Its other comments were:

- Competitive or second bidding imposes a significant cost to the State and the Government should not employ this practice in order to attract industry to Western Australia.
- The question of whether or not a project will locate in the State without assistance cannot be objectively tested.
- The threat of locating to another state or country should not be considered a valid reason for granting financial assistance.

The Committee also analysed the process in which financial assistance packages were approved and determined. It recommended the Department of Commerce and Trade establish criteria that must be satisfied before any organisation is granted or offered financial assistance. Further, evaluation must take place after the project has been operational as well as before.

Finally, the Committee argued the public's right to know substantially outweighs any claims to conceal relevant information on the basis of commercial confidentiality. If an organisation does not wish to disclose relevant information then it should forego financial assistance.

The Industry Commission: State, Territory and Local Government Assistance to Industry (1996)

The Industry Commission analysed government assistance that discriminates between activities, firms or industries. It was critical of this selective assistance:

- As discretion in industry assistance increases, so does secrecy. Public reporting of this type of assistance is very limited. Secrecy raises suspicions of corruption and can create a conflict of interest for public officials who are publicly accountable for their actions.
- Selective assistance has high administrative costs. Delivery costs of state assistance averaged 28% of the assistance provided.
- Attempts to buy development can divert governments from addressing business fundamentals such as tax, infrastructure and education.
- There can be small gains in terms of state output and jobs, but only in the unlikely event that only one state is providing assistance.
- There is little net effect on unemployment and the risks to government are high.
- While formal evaluations are often undertaken before assistance is given, few evaluations are done afterwards.

The Commission found there are three main reasons why state, territory and local governments provide this assistance:

- the need to be seen to be doing something about problems such as unemployment;
- the use of flawed evaluation techniques which overstate the benefits of the assistance; and
- a fear the state, territory or council will lose if it does not participate while others do.

The Commission distinguished bidding wars and competition for individual firms (types of selective assistance) from more general types of competition between States such as better infrastructure, social services, appropriate regulation and less taxes. This general competition between States on the business climate is healthy because it encourages governments to set favourable conditions for *all* businesses in that jurisdiction.

The Commission noted Canada has addressed selective assistance through an internal trade agreement between the Canadian Government and the Provinces which prevents incentives being used to encourage firms to relocate within Canada. The agreement provides for regular monitoring and enforcement mechanisms. A similar agreement could be implemented in Australia.

The Mortimer Report: Going for Growth (1997)

The Commonwealth commissioned a review of its business programs in November 1996. The review's key findings of business programs at that time were:

- programs did not operate within a clear policy framework;
- program objectives were often poorly specified; and
- programs appear *ad hoc* or too small for the specified task.

The report recommended a number of key principles for business programs. These included:

- requiring programs to illustrate a net economic benefit and address a market imperfection;
- programs must have measurable objectives and be assessed against measurable performance indicators;
- clear eligibility criteria;
- governments should fund activities, not providers;
- adopt cost recovery; and
- programs must be regularly evaluated, avoiding *ad hoc* reviews.

The review also noted further coordination was required between governments to reduce bidding wars. The review found they undercut Australia's competitive position and its ability to win investment. In addition, they also add to the overall cost of investment attraction. It recommended Invest Australia should negotiate formal agreements between the States and the Commonwealth and develop guiding principles on the roles of the Commonwealth and States in investment promotion, attraction and facilitation.

Finally, the report stated Australia should not actively encourage particular industries. The industries chosen by government may miss changing trends and may not be well suited to Australia. We should fund generic issues such as innovation, not particular sectors or industries.

Audit Office of NSW: Department of State and Regional Development, Provision of Industry Assistance (1998)

The audit assessed the efficiency and effectiveness of three of the Department's main industry assistance programs, which provided $26 million in direct financial assistance to businesses in 1997/98. The schemes were the Industries Assistance Fund, the Regional Business Development Scheme and the Regional Headquarters Scheme.

Prioritisation of Assistance

DSRD assesses projects to see whether they offer economic benefits to NSW, but it does not compare projects to determine which of them offer the best value for money. Instead, assistance is approved on a case by case basis. DSRD judges its performance on jobs and investment where it has intervened, instead of whether it got the best value for money in its intervention. It is not encouraged to prioritise assistance.

The Audit Office argued a case by case approach means firms are not required to compete amongst themselves for a limited pool of funds. This reduces DSRD's negotiating power with firms. Some form of competitive bidding (tendering is an example) would help DSRD get better value for money.

Guidance Provided to Staff to Assess and Evaluate Proposals

DSRD provides guidance to staff on evaluating proposals, but this needs to be improved, especially in relation to the financial viability of projects and whether a project is truly footloose. Projects are footloose when the project proponents have genuine choices regarding the location of a project, meaning government assistance might improve the chances of influencing its location.

In addition, the report found guidelines were sometimes ignored. An example was competitive neutrality, where assistance should not be given to a firm if this would disadvantage its competitors. DSRD sometimes breached competitive neutrality on the grounds it would lose the project because other States would be prepared to provide assistance and breach competitive neutrality.

Management Controls

If the level of assistance envisaged is above $1 million, and the Treasurer approves the assistance, then DSRD receives extra funds. This could encourage over-estimation of assistance, because the Department gets extra funds to handle big projects.

Although DSRD attempts to model the net benefit to the economy of providing assistance, the review found DSRD's analysis is not complete because it does not fully assess the costs involved in the assistance:

- DSRD's assistance packages and the staff to administer them are financed by taxes. If the taxes were not levied, the market would probably direct the money to a more valuable use.
- If a firm expands through the assistance it receives, it may take business from other competing firms.
- It costs the Government money to collect the taxes.

The audit found DSRD could improve its information systems as it was difficult to retrieve relevant data. For example, the Department could not determine the costs of non-financial assistance, such as the cost of staff time.

Documentation, Reporting and Monitoring

The Department does not publish the names of the firms that have received assistance, nor the amounts involved. The review found the need for commercial confidentiality in providing assistance is overstated and prevents transparency and public accountability. Although some information may need to be withheld at certain times, confidentiality should generally only apply before a decision about assistance is made. The onus for arguing confidentiality should be placed on the recipient of assistance.

Confidentiality of assistance reduces the incentive for DSRD to demonstrate it has bargained well. Further, firms adversely affected by assistance to their competitors are unaware of government actions affecting their profitability.

Recommendations and Department's Response

The report made 21 specific recommendations. In response, DSRD stated it supported three, eight recommendations were already being implemented, three were deferred, and seven were rejected. A full listing of the recommendations and DSRD's response is given in the Appendices. The 10 recommendations it rejected or deferred are in the table overleaf.

Economic and Finance Committee: South Australian Government Assistance to Industry (1999)

The Committee supported many of the findings of previous reports on this topic. For example:

- The significant assistance packages provided by the Government to individual firms to outbid other States were wasteful. The Government should instead support skill development, infrastructure, industry networks, clusters and R&D.
- Government assistance would be more efficient if proponents were required to compete for a limited pool of funds.
- Information concerning individual assistance packages should be classified as commercial in confidence only until a contractual agreement is signed off.
- All agreements involving more than $200,000 in assistance should include claw back provisions that require full or partial repayment of assistance if the recipient fails to honour its original commitments.

Table 2: Auditor General's Recommendations Rejected or Deferred by DSRD

Rec No	**Recommendation**	**DSRD Response**
1.3	Develop options for the reform of the Country Industries Payroll Tax Rebate Act (1966).	DSRD is considering this matter in the light of other developments.
1.4	Develop protocols to cover circumstances where DSRD and Strategic Projects (Premier's) are both involved in projects.	The Premier's Department publication "Working Together" provides guidelines for collaboration in the public sector.
1.5	Introduce competitive tendering to prioritise assistance proposals.	Requests for assistance arise on an ad hoc basis, rather than having a group of projects "on the table." However, negotiating officers have an upper limit of assistance following DSRD analysis.
2.1	Expedite the introduction of systems to monitor and manage the expenditure and commitment of funds more effectively.	Commitment database development has continued within DSRD.
2.3	Reconsider the assessment model so that it reflects the full costs and consequences of assistance in the decision making process.	The model is already highly refined. It is being continually updated.
2.4	Consider ways of reducing the footlooseness of firms that accept assistance (eg, require them to make infrastructure investment or that assistance is recouped if a certain number of jobs are not sustained).	DSRD only assists firms where the fundamental attributes of the NSW economy are attractive. Recently, assistance in some cases has been linked to investment in fixed assets.
2.5	Consider having all economic assessments being undertaken centrally by the Policy and Resources Division (it may be appropriate for smaller projects to be less rigorously assessed).	The Industry and Regional Development Divisions use economic analysis parameters in assessing small projects (less than $250,000).
3.1	Do not define information as commercial in confidence, unless it is demonstrably so.	All development agencies have commercial relationships with their clients that are of a commercial nature. An assurance of confidentiality is fundamentally important to investors. Audit Office showed no evidence to support its view.
3.2	Report assistance provided as suggested by the Industry Commission in its 1996 report.	See above.
3.3	Establish a mechanism to act as a proxy for public scrutiny for decisions regarding assistance where information is not published (eg, an operations review committee).	Further scrutiny is not needed, given DSRD is already scrutinised by a number of agencies (eg, Treasury, Council on the Cost and Quality of Government, Audit Office, etc).

Source: Auditor General's report on DSRD.

- The Department of Industry and Trade should improve its application and approval procedures, develop program evaluation guidelines and ensure regular post assistance monitoring.

The Committee argued South Australia had a potential competitive advantage in biotechnology, and recommended that the Government, the private sector and universities jointly fund incubators to develop this industry.

Productivity Commission: Inquiry into the Impact of Competition Policy Reforms on Rural and Regional Australia (1999)

This report also discussed regional development. The Commission gave a brief history of recent regional development policies and argued regional development policies have not been successful because:

- The decentralisation policies of the 1970s (eg, Albury-Wodonga and Monarto in South Australia) were overly ambitious and wasteful.
- Some programs (eg, the Commonwealth's Regional Development Organisations, 1994-96) only involved meetings, travelling, studies and consultancies, with no measurable benefits.
- Governments do not have sufficient resources to counteract the effects of long term economic changes. Properly resourced attempts would take funds from other services (eg, health).

The Commission suggested a number of general regional development programs governments could usefully implement. Typically, they involve instances of filling in gaps left by the free market and include:

- Governments can provide accurate information to businesses and individuals on regional areas. Information on lifestyle, expertise, skills and locations can help overcome preconceptions about regional communities.
- Self help can be encouraged. An example is the setting up of community banks in response to closures by major banks.
- Governments can remove impediments to development such as red tape and restrictions in the labour market.
- Governments should concentrate on policies helping all regions across all industries.

In terms of specific assistance, the Commission found adjustment assistance might be warranted on a case by case basis. The following would be relevant:

- the scale of shock relative to the size of the region, ie its ability to adjust;
- whether or not redundancy payments have been made available to all employees;
- the job readiness of those affected (language and other skills);

- employment prospects within the region; and
- the mix of existing adjustment mechanisms.

The Commission recommended where governments decide specific adjustment assistance is warranted to address any large, regionally concentrated costs, the assistance should:

- facilitate, rather than hinder, the necessary change;
- be targeted to those groups where adjustment pressures are most acutely felt;
- be transparent, simple to administer, and of limited duration; and
- be compatible with general safety net arrangements.

Innovation Summit Implementation Group: Innovation, Unlocking the Future (2000)

The National Innovation Summit, jointly hosted by the Business Council of Australia and the Commonwealth Government, was held in Melbourne in February 2000. Business and government combined to develop a package of recommendations. An Implementation Group was established to refine the Summit's work, provide concrete actions, and consult with stakeholders. The Group's report covered three broad areas:

- creating an ideas culture through a public relations campaign, innovation scholarships for teachers and other strategies;
- generating ideas through increased tax concessions and grants; and
- acting on ideas through a national technology incubator program, pre-seed funding for universities and international R&D collaboration.

Summary

There have been a number of common findings between these reports. These include:

- Bidding between States to secure investment is wasteful. Some form of agreement could be reached to stop it.
- Treating selective industry assistance as commercial-in-confidence is not necessary.
- Standard government procedures (eg eligibility criteria, monitoring and evaluation) should be used for all business programs.
- Selective business programs can distract governments from their unique function of improving the business conditions for all firms in their jurisdiction (eg lower taxes and better infrastructure).

- The first priority of business programs should be on correcting market failure (see next chapter). Economic transition programs are also appropriate in special circumstances.

Chapter Four

The Economic Efficiency of State Government Programs

The primary role of businesses in society is to improve the material wealth of the community. Accordingly, the first criterion in assessing industry programs must be to what extent they improve the efficiency of the economy, ie increase output of goods and services the community wants.

When is an Economy Efficient?

A basic test for whether an economy is efficient is whether it is impossible to make someone better off without making anyone else worse off. If so, the economy is Pareto optimal.

The First Fundamental Welfare Theorem provides the conditions for Pareto optimality:

- every relevant good is traded;
- at publicly known prices; and
- households and firms operate in perfectly competitive markets.

These conditions usually do not fully apply in the real world. This is called market failure. The four types of market failure are:

- market power;
- information asymmetry;
- externalities; and
- public goods.

How Can Governments Address Market Failure?

<u>Market Power</u>

This term is defined as follows:

> The ability of a single economic unit to influence the prices at which particular goods, services and resources are bought and sold. It is, in effect, a measure of the extent to which any individual buyer or seller can interfere with the free functioning of the price mechanism.[2]

[2] Collier and Batty (1995), p 307

Table 3: Examples of Market Power and Government Response

Market Power	Government Response
A group of firms may secretly agree to put up prices and not compete against each other.	Banned by the Commonwealth Government. Monitored by the ACCC.
Large firms and unions have considerable bargaining power over wages.	Industrial relations systems set award rates.
Shopping centres have more bargaining power than small business tenants.	The Retail Tenancies Unit in DSRD mediates these disputes.

<u>Information Asymmetry</u>

This occurs when one party to a transaction knows more about the goods or services than the other party. If the second party isn't aware of it, this inherently places the first party at an advantage.

Table 4: Examples of Information Asymmetry and Government Response

Information Asymmetry	Government Response
Buyers of used cars know little about mechanics or the history of a car, but car dealers do.	In NSW, used car dealers are required to give a three-month warranty for most used cars.
Prospective employees know more about their skills than potential employers.	Provides education and accredits other education providers. Applicants' success gives an indication of their abilities.
Insider trading.	Banned.

<u>Externalities</u>

These can be defined as follows:

> Externalities refer to those indirect costs and benefits associated with the production and consumption of certain goods and services which the price mechanism fails to take into account.[3]

Externalities are also called spill-over effects. They may be beneficial (positive) or harmful (negative).

Table 5: Examples of Externalities and Government Response

Externality	Government Response
Airborne pollution from a factory affects	Limits placed on emissions.

[3] Id, p 466

nearby residents (negative).	
Basic research can be copied by other firms, reducing the incentive for a business to do it (positive).	Public funding for R&D.
Roads congestion at Olympics if spectators attempt to drive to events (negative).	Spectators encouraged to take public transport. Limits placed on car parking at venues.
Large numbers of children are vaccinated against diseases and do not pass them on to un-vaccinated. Other parents see no need to vaccinate their own children (positive).	Free vaccination services. Extra child payments made if vaccination schedule completed.

Since the externality is not captured by the price mechanism, the production and consumption of the goods and services in question is either higher (in the case of a negative externality) or lower (for a positive externality) than is optimal. For example, if controls were not placed on water extraction from the Murray-Darling basin, downstream users may not have access to water.

<u>Public Goods</u>

This is a special case of a positive externality. A public good occurs where the consumption or use of a good does not preclude its consumption or use by others. Where this is the case, government more efficiently provides these goods or services. Examples include flood control, defence and lighthouses.

Do the Department's Programs improve the Efficiency of the Economy?

This is equivalent to asking whether DSRD's programs address market failure. Each of its activities will be assessed to see whether they do this.

<u>Financial Incentives to Attract and Retain Economic Activity</u>

The Industry Commission (1996) found governments sometimes claim this selective purchasing of investment addresses the externality of multiplier effects. Multipliers are the numbers of extra jobs created outside a new project by that project's demand for inputs from other companies. For example, in addition to the 100 direct jobs an aluminium smelter might create on site, it might create another 200 indirect jobs in other companies by purchasing ore and electricity.

The indirect jobs are said to be the externality. However, this argument is fallacious as these indirect jobs are generated through normal market transactions. Externalities happen outside the market, generally because certain property rights (eg to clean air) are not recognised.

A project cannot be assessed just by comparing the value of the assistance against the direct and indirect jobs. Any alternative uses of the resources involved must also be considered. For example, if other companies were interested in using the land for a business park, also creating 300 direct and indirect jobs, then there is probably no need for the government to provide assistance to either project.

Determining alternate uses would usually depend on the circumstances on each case. However, some generalisations can be made. Projects located in areas of low unemployment (eg Sydney) are more likely to have high-value alternate uses than projects in areas of high unemployment (eg some regional areas).

Attracting or retaining specific economic activity does not improve the efficiency of the economy, does not address market failure and should be discouraged.

<u>Business Advice</u>

Education is traditionally seen as a positive externality. Not only do children have a better chance of getting a job by going to school, but society is better off through having better citizens, better leaders, less unemployed and less of the social consequences of unemployment.

However, the extent to which government should intervene to support an activity that has positive externalities depends on whether the activity would take place anyway without the intervention. If the benefits to the recipient are large compared with the externality, government action probably would not be required.

Business advice directly leads to increased profits for the recipient. The Committee considers the externality in this case to be relatively small. The Committee does not support government providing these services in-principle.

<u>Promotion of Sydney and NSW</u>

This is a kind of public good. For example, if a motel in the Blue Mountains promoted that area as a holiday destination, all the other motels, restaurants and tour firms in the Blue Mountains would freely benefit from the promotion. This discourages an individual business from promoting the area. There could be a role for government here.

<u>Regulation</u>

Much government regulation is designed to overcome market failure. For example, most environmental and planning regulations address negative externalities. Industrial regulations address the bargaining power of big business and unions. When governments reform their regulations, they are often working out how to better address market failure. The Committee gives in-principle support to this activity.

<u>Information to Business</u>

The provision of general information is similar in nature to general education and addresses market failure. This activity is supported in principle.

Networking

This does not address market failure. The benefits of these business introductions remain with the firms involved. Businesses are expected to establish their own clients.

Community Growth Strategies

The main aim of these programs is to improve local leadership in regional economies. This is motivated by a perception regional areas are the losers from better communications, open markets, competition policy, and other structural changes in the economy. However, producing strategies does not counter market failure and is not supported by the Committee.

Research and Development

This is a classic externality. If a firm develops a new product, technology, or system, it is often difficult to stop other firms copying the innovation, despite patent laws. Therefore, less R&D is undertaken than is optimal for the community. The Committee gives in-principle support to R&D programs.

Summary

The Department's programs should be initially judged on the basis of whether they improve the efficiency of the economy. Of the eight types of industry programs identified, the following four have the capacity to bring efficiency benefits:

- promotion of NSW and Sydney;
- regulatory reform;
- information to business; and
- training.

The remaining four cannot be supported on efficiency grounds:

- attracting and retaining economic activity;
- advice to firms;
- networking; and
- community growth strategies.

Chapter Five

The Realities of Attracting and Retaining Economic Activity

With improvements to communications, transport and data handling, companies now have more choices where to make physical investments or hold special events (eg the Bledisloe Cup). Increased options imply greater bargaining power and these companies have used the threat of locating their investment elsewhere to extract financial and other concessions from all levels of government.

These incentives can be very large. The Industry Commission (1996) stated incentives of between $16 million and $30 million were reputedly offered by South Australia to attract Westpac's National Loans Centre to Adelaide (900 jobs). The South Australian Economic and Finance Committee (1999) gave the example of Indiana, which reputedly offered incentives of $US 451 million to attract a United Airlines investment (6,300 jobs).

These high profile investments often assume an importance well beyond what is warranted. As Treasury noted in evidence:

> **Mr JORDAN:**[4] … I would say that the amount of investment that we lure as a result of this scheme [the Industry Assistance Fund] in New South Wales at the moment is reasonably small. We are talking about an economy of close to $200 billion in which we get about $20 billion to $30 billion worth of investment each year. That investment comes along because of the fundamentals. Most of this does not go through this process, and we are happy it does not, to be honest. Most of it comes here because of the fundamentals.

What Factors does a Company Consider for Locating Investment?

Preston (1994) lists the main factors, commencing with the most important:

- taking a stake in regional markets to preserve or expand global market share;
- access to raw materials;
- access to a low cost, skilled workforce;
- a well developed local infrastructure;
- an efficient and honest public sector; and
- political stability.

[4] Director Economic Strategy, NSW Treasury, transcript of hearing, 24 May 2000, p 6

Tax, which for a firm is roughly equivalent to financial incentives, is less important as a location factor. In Australia, Preston notes most business costs are predetermined, given labour (25%) and materials inputs (45%) make up 70% of firms' costs. Players in investment attraction recognise incentives are not the most important factors in location decisions:

> **Mr SCOTT:**[5] I guess the only other point I would like to make is that to some extent it is not just a battle for financial inducement from one State or the other. That may swing it at the margin, but in my view it is often a case of responding in a very timely manner to the enquiry, and being able to harness all the agencies you need to supply all those inputs that particular company would want. For me, that is really as important as it is to offer, for instance, some financial benefit such as a payroll concession. That may come later in the negotiations, but initially I think it is an ability to really draw the agencies together, and that is an area where I think we have got to do some more work.

DSRD commented it downplays the importance of financial incentives:

> **Mr HARRIS:**[6] … when a firm does talk to us or we do find a firm that we are discussing, we very often - I probably do it almost every time - start off by pointing out that if the investment is going to be driven by an incentive, then probably we are not the place for it because they will get a better incentive in other locations. We work very hard to try to be better at providing in-kind support, and that, I have got to say, has been a position we have taken routinely.

The Committee took evidence from the Department that a key factor in attracting investment is the response time by government agencies:

> **Mr GLACHAN:** We heard from people here earlier today the view that although on a local level State Development work very hard but they were sometimes locally let down by a slow reaction from head office in Sydney, do you think that is the case? Do you find that yourself?
>
> **Mr GRANT:**[7] Again I could not give you a yes/no answer. I could give you an example of a company that has just gone into Howlong, a company called Melban, who were footloose, were looking at both Victoria and New South Wales sites, they were looking at Howlong and at Rutherglen and having talked to the local government people informally on the Victorian side they believed that the reason that it went to Howlong was because New South Wales moved faster than Victoria.

In summary, the Committee was able to confirm during hearings financial incentives are not the drivers of investment.

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[5] Chief Executive Officer, Investment Albury Wodonga, transcript of hearing, 27 April 2000, p 39

[6] Director General, DSRD, transcript of hearing, 3 May 2000, p 120

[7] Mr James Grant, Regional Manager Southern, DSRD, transcript of hearing, 27 April 2000, p 67

The Australian Advertising Industry

Sydney has become a popular location for international television advertisements. estimates probably a quarter of the advertisements made in Sydney are for the international market. Overseas firms are attracted by the Euro-American cityscapes, our small crews and our production skills. As Jake Scott (son of Ridley Scott) put it:

"I like to film in Sydney for three reasons. Maximum value, maximum efficiency, minimum fuss. To me the Australian dollar is the cream on the cake, but not my motivation for shooting here. Sydney, its crews and its go-for-it attitude is what brings me back."[8]

Why do Governments offer Assistance?

The reasons why governments participate are:

- they fear they will miss investments because other governments offer assistance (game theory); and
- they can promote this as "winning" something for people (public sector failure).

<u>Game Theory</u>

It appears the benefit to a state government of providing assistance is limited:

- There is no objective data on whether the assistance swings location decisions.
- The more assistance offered, the more likely it would be to affect a location decision. However, the state involved will have traded away more of the benefits of the investment back to the company.
- Most projects have specific requirements, so cannot be considered "footloose." At hearings the Department acknowledged firms usually decide on a location in one State and then go interstate to get offers of assistance to put pressure on the first State to give assistance.
- Where a project does not have specific requirements, it is more likely to be footloose and to be bought with incentives. However, once the incentives have finished, it is more likely to be poached by other governments.
- Industry Commission (1996) modelling suggested specific incentives would only be of significant benefit to a state if it were the only one providing them.

Yet despite these reasons, governments fear if they do not provide assistance, they will miss out. This fear is best explained through an example. Suppose $20 million in investment in either NSW or Victoria is proposed by several companies, both

[8] Tabakoff, "Perfect Pitch" *Sydney Morning Herald, The Guide*, 23-29 October 2000, p 4

states provide $2 million in incentives, and the investment is evenly split between the two. Both states have a net gain of $8 million.

Assume without intervention, the investments would still be evenly split, then NSW and Victoria would receive a net benefit of $10 million each. However, neither state is prepared not to offer incentives, because both fear if the other state offers them, they would receive less investment, say $6 million. This is despite the points made earlier that most investments are not footloose, and if they are, the investment can just as easily be lost again. The fears of state governments can be represented as:

Figure 2: Strategic Interaction in Bidding Wars

		Victoria	
		No Assistance	Offer Assistance
NSW	No Assistance	NSW: $10 M Vic: $10 M	NSW: $6 M Vic: $12 M
	Offer Assistance	NSW: $12 M Vic: $6 M	NSW: $8 M Vic: $8 M

If NSW thinks Victoria will probably offer assistance, then it should also offer assistance, as it will be $2 million better off. However, if NSW thinks Victoria will instead not offer assistance, then NSW will also be $2 million better off by offering assistance. So either way, NSW will be better off by offering assistance. The same applies to Victoria, so both states offer assistance and have a net benefit of $8 million. Regardless of what the other state will do, the first state is always better off by offering assistance.

These bidding wars are very much a reality. Take the recent example of the closure of the Arnott's plant in Melbourne:

> The Victorian Treasurer, Mr John Brumby … offered a package of financial incentives to the company nine months ago to stay in Victoria. Queensland also conceded it offered funds to secure its share of an extra 160 jobs expected to be created by expanding Arnott's facilities in Queensland and NSW.[9]

The tragedy of these battles is nothing has changed, except for a transfer of funds from the governments to the investing companies. Although companies are expected to make profits, they should do it by making goods and services people want, rather than playing governments off against each other. As the Industry

[9] Field, "Talks aim to save Arnott's plant" *Australian Financial Review*, 7 May 2001, p 8

Commission (1996) noted, what is required to stop these bidding wars is some sort of agreement between the states.

This approach by state governments also fails to incorporate alternative uses of assistance funds (the $2 million in the example). For example, they could be used instead to support R&D or fast-track approvals processes. These alternative uses could lead to increased productivity and generate real benefits for New South Wales.

Public Sector Failure

Jackson (1980) lists a number of inherent shortcomings in the public sector which limit governments' ability to promote economic efficiency. One of these is the visibility of the costs and benefits of government programs. For example:

- governments might reject good programs which have up front costs but benefits which will only become apparent in the long term; and
- governments might accept poor programs that have clear benefits but hidden costs.

Gittins (1996) noted investment attraction allowed governments to promote their achievements, without having to take responsibility for the hidden costs of discriminating against existing firms. In addition, it takes governments' focus off more mundane but effective projects such as regulatory reform and cutting red tape, which have hidden benefits.

Have Industry Agencies "Won" Investment?

A common scenario is, after working with a company that builds a $50 million facility and employs 100 people, the relevant industry department claims it "won a $50 million investment generating 100 jobs." Such statements imply the entire economic benefit of the project was the work of the agency. This is not the case:

- Many companies have specific requirements for staff, location, raw materials and infrastructure. These requirements usually limit their options. In some cases, regardless of what the investor firm may state, it may only have one viable investment location.
- In many cases, the resources the company will use (the staff, site and raw materials) could have been used on other projects by other firms. That is especially true in Sydney, which currently has low unemployment.
- Companies have often already drawn up a short list of investment locations before they themselves contact the local investment agencies.

At the Committee's hearings, DSRD said most investors find NSW, rather than the other way around.

> **CHAIR:** The 1998-99 Annual Report, your Director-General's Report, "The Year in Review", states:

> Projects representing $XXX billion in investment were attracted . . . by the Department during the year . . . There were 28 major projects and 9 international regional headquarters and regional operations centres.

How were these investors identified?

Mr HARRIS:[10] I would have to look at the list to be able to tell you, but, in general, some of them would have been brought to our notice through the investment commissioners; they would have fed through the Commonwealth Investment Commissioner program; some of them would have found us. The majority, I think, would have found us.

Given these factors, one must be sceptical about the claims made by industry agencies in relation to attracting jobs and investment.

Fiscal Policy Institute, New York

"Throughout our nation's history, state and local governments have done much to facilitate the growth and development of the American economy. They built an impressive physical infrastructure and developed the nation's human capital without which our private sector economy could not have prospered. In fact, almost everything that state and local governments did over the last 200-plus years served, either directly or indirectly, to make the development of the private-sector economy possible. But we did not call these activities 'economic development.' We called them internal improvements or public works or education or public safety, but economic development is what they accomplished."

"In contrast, most government activities undertaken in the last 30 years in the name of 'economic development' have little to do with the development of the economy. Rather, they involve, in one way or another, the use of public resources to either convince businesses to move from where they were located to someplace else OR, in response to such entreaties – either real or purported, to convince them to stay where they are. Economic developers persist in referring to the first of those two activities as job creation, even though the jobs already existed somewhere else."

Frank J Mauro
Executive Director

Is Assistance given through Payroll Tax Rebates made at no Cost to New South Wales?

Both Treasury and DSRD stated payroll tax rebates given as an incentive to encourage firms to locate here were made at no cost to the State. They argued the tax would not have been received in the first place if the firm had not located here.

For this argument to succeed, however, the following must apply:

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[10] Director General, DSRD, transcript of hearing, 3 May 2000, p 72

- Each assisted project did not crowd out payroll tax liable investment.
- Each assisted project did not take labour away from other payroll tax liable employers.
- Each project would not have located in New South Wales if the assistance wasn't given.

The Committee does not accept these assumptions apply universally across all assistance packages. For example, in May 2000 the Australian Bureau of Statistics estimated the unemployment rate in Sydney was 4.6%. With skilled labour constraints, it is highly unlikely assisted projects at this time did not take labour away from other payroll tax liable employers.

How does the International Business Community view Australia?

The following excerpt from an interview with Jack Welch (Chairman of General Electric) by Michael Pascoe of Business Sunday is instructive.

> **WELCH:** …I don't see us making big acquisitions here.
>
> **PASCOE:** Why not?
>
> **WELCH:** Well, I don't see the opportunity. I don't see with the size of the country…there are just bigger opportunities elsewhere.
>
> **PASCOE:** In terms of Australia as a base for growth elsewhere, or companies that are already multinational from Australia?
>
> **WELCH:** Well, I think Australia's a market. It's 18 million people. You've got to be realistic about what Australia is going to be for a multinational. And for us it will not be a major, major country although it will be a great source of intellectual talent…and I think it's in many ways a laboratory. I mean, I think people are doing great things here and best practices are here. And one can learn a lot here. But when you have 18 million people, the limitations of growth, and a healthy economy, and a good wage structure… Multinationals have very often better places to invest.
>
> **PASCOE:** Is there any way we can change that to attract investment capital here?
>
> **WELCH:** No. I think the more intellectual capital you have here the better the bet. Better educational system, more software development, more incubator work, more ideas. You've got great educated people, you've got a great spirit, you've got a great country, you've got natural resources. You've got a lot of things going for you but I'm just saying, as a company with our product mix, we're focused in certain areas. Aircraft engines will be a big player here. We'll be a big player hopefully in your power expansion. We wouldn't build a power plant here. We wouldn't build a jet engine plant here. But we would create a real software company here, a real financial services enterprise here.

Jack Welch confirms investment attraction programs are of limited use and Australia should concentrate on its comparative advantage of its highly educated workforce.

The investment possibilities in Australia for General Electric are in services such as software and finance, rather than in manufacturing. This is probably because our domestic market is too small to allow the economies of scale found overseas.