

Privatised Failure:

Submission to the Productivity Commission's National Competition Policy Analysis inquiry

For many years competition has been enshrined as a goal of economic policy. However, over the last three decades initiatives to deliver competition and contestability to public services through privatisation, outsourcing and deregulation, have repeatedly failed both economically and socially. This submission demonstrates how each failed attempt to add 'competition' and 'contestability' to a traditionally public service could have been predicted and avoided.

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Contents

Summary.....	1
Introduction.....	2
Privatised failure, inefficiency and waste.....	4
What is needed for markets to promote economic welfare?.....	6
Benefits of competition.....	6
Deviations from the competitive ideal.....	7
The theory of the second best.....	8
Australian deviations from competition.....	9
Economic criterion for a well-functioning market.....	12
1 Numerous small suppliers and customers.....	13
‘Thin markets’.....	13
2 Freedom of entry and exit.....	14
3 Homogeneity of product.....	15
Measurement issues.....	16
4 Perfect information.....	17
Vocational education.....	18
The caring economy.....	19
5 No transactions costs.....	20
6 Absence of externalities.....	21
7 Exogenous tastes.....	22
The Conditions Grid.....	23
Conclusion.....	24

Summary

For many years competition has been enshrined as a goal of economic policy. Among many landmarks was the 1995 establishment of the National Competition Council (NCC) by the Commonwealth and states and territories. At this time there was broad consensus between these governments that more competitive markets would benefit Australia and its citizens. In the words of the Hilmer review, seminal in the establishment of the NCC:

If Australia is to prosper as a nation, and maintain and improve living standards and opportunities for its people, it has no choice but to improve the productivity and international competitiveness of its firms and institutions. Australian organisations, irrespective of their size, location or ownership, must become more efficient, more innovative and more flexible. Over the last decade or so, there has been a growing recognition, not only in Australia but around the world, of the role that competition plays in meeting these challenges.

This principle was extended to services traditionally provided by the government such as utilities and transport. A major component of the NCP was that the provision of these services would be more productive, higher quality and lower cost if government monopolies over services were broken up and replaced with 'competitive' or 'contestable' markets.

Over the last three decades initiatives to deliver competition and contestability to public services, namely through privatisation, outsourcing and deregulation, have repeatedly failed both economically and socially. This submission, using a framework built on neoclassical economic principles, demonstrates how each failed attempt to add 'competition' and 'contestability' to a traditionally public service could have been predicted and avoided.

Introduction

The Australia Institute is pleased to respond to the Productivity Commission's call for submissions on its inquiry, "National Competition Policy analysis".

The Australia Institute has written many submissions and research papers over the last 30 years on the topic of competition policy. While some, like our research highlighting the costs to taxpayers of privatising the ACT's electricity and water supply, have been highly influential most of our submissions have been ignored to the detriment of consumers, the economy, and the environment.

This submission provides an overview of some of these previous submissions and draws attention to their main points. However, it is our wish that these documents be considered as part of the Institute's submission.

For many years competition has been enshrined as a goal of economic policy. Among many landmarks was the 1995 establishment of the National Competition Policy (NCP) and the National Competition Council (NCC) by the Commonwealth and states and territories. And according to the Hilmer report,¹ the Productivity Commission² and numerous state and Commonwealth treasurers,³ increasing competition in and for the provision of public services would deliver, among a myriad of other benefits, greater productivity.

Despite repeated forecasts and assurances that greater productivity would inevitably flow from privatising, outsourcing and or deregulating the provision of a wide range of government services, there is little evidence to support such a conclusion. Indeed, since the Productivity Commission was created in 1998 and Australia doubled down on its neoliberal policy experiment, the rate of growth of GDP per hour worked has continued to decline.

The present submission focuses on one major component of the NCP, and related initiatives: the claim that the replacement of traditional public provision of certain goods and services with market mechanisms would increase productivity. These initiatives reflected the neoliberal assumption that public provision was inefficient and wasteful, and

¹ Hilmer, Rayner and Taperell (1993) *National Competition Policy Review*, <http://ncp.ncc.gov.au/docs/National%20Competition%20Policy%20Review%20report,%20The%20Hilmer%20Report,%20August%201993.pdf>

² Productivity Commission (2017) *Introducing Competition and Informed User Choice into Human Services: Reforms to Human Services*, <https://www.pc.gov.au/inquiries/completed/human-services/reforms/report/human-services-reforms.pdf>; Harper et al (2015) *Competition Policy Review: Final Report*, https://treasury.gov.au/sites/default/files/2019-03/Competition-policy-review-report_online.pdf

³ Morrison (2016) *Productivity Commission inquiry into introducing competition and informed user choice into human services*, <https://ministers.treasury.gov.au/ministers/scott-morrison-2015/media-releases/productivity-commission-inquiry-introducing>

that private (market) provision was inevitably more efficient. No doubt the proponents of decades of reforms to the way that Australia provided essential public services would not have thought so crudely, and no doubt many involved genuinely believed that their actions would improve the welfare of the Australian people. However, in practice, the rollout of privatisation, deregulation and outsourcing of public services in Australia was clearly based more on ideology than strong evidence or sound theory.

Put simply, after decades of experimentation with the provision of essential services in Australia there is no strong evidence to support the foundational assumption of NCP: that market provision of once publicly provided services is superior to continued public provisions unless it can be demonstrated, first, that there are serious market imperfections and, second, that government action is better than government inaction.

The idea that private provision of public services is superior to public provision is based on assumptions that market outcomes will approximate the 'efficient outcome' of the perfectly competitive market described in economic textbooks, even though no public service even closely approximates the market conditions required for 'perfect competition' to exist.

For example, this assumption allowed the Productivity Commission among others to believe that Sydney airport operated in a competitive market given competition from other domestic airports and that market forces were preventing the appearance and exercise of market power.⁴ At the time of course, Sydney airport was generating massive monopoly profits.

The privatisations and deregulations of Russia were among the worst applications of neoliberalism the world has ever seen. But Australia and other countries inspired by neoliberalism have failed as systematically, if not as spectacularly. After decades of 'competition policy' the Australian market is highly concentrated especially in sectors where privatisation and outsourcing occurred.

Economic theory does not support any general conclusion that private ownership will deliver lower costs, higher quality, or greater productivity growth than public sector provision of services. Indeed, when compared to Australia, a number of countries with a significantly larger public sector share of the economy have higher levels of GDP per capita, along with lower levels of income inequality, longer life expectancy, significantly better education systems and higher measured levels of happiness.⁵

Neoclassical economic theory does however provide a rudimentary framework for evaluating the circumstances in which private or public provision may be superior and sets

⁴ Productivity Commission (2019) *Economic regulation of airports*,
<https://www.pc.gov.au/inquiries/completed/airports-2019/report>

⁵ Grudnoff (2020) *Tax and wellbeing: the impact of taxation on economic wellbeing*,
<https://australiainstitute.org.au/wp-content/uploads/2020/12/Tax-and-wellbeing-updated.pdf>

out. the conditions that must be satisfied for the competitive or market solution to make the nation better off.

Despite the fact that neoclassical theory provides a clear (albeit imperfect) set of criteria for evaluating the likelihood that market provision of services may be appropriate, and the nature and extent of regulation and oversight that might be required if this is the preferred solution, Australian policy makers and other advocates of privatisation, deregulation and outsourcing have paid little attention to those criteria.

The Australian Government Guide to Policy Impact Analysis, the central guide for considerations in policy making, does not recommend that such an evaluation be undertaken for potential market-based solutions.

The ideology of privatisation, deregulation and outsourcing progressed to such an extent that David Jull, Minister for Administrative Services under the first Howard Government, went so far as to invoke the so-called yellow page test—if you can find a similar service in the phone book then the government should not be in that business.⁶

Privatised failure, inefficiency and waste

Examples of the failures of privatisation, deregulation and outsourcing, are numerous and many will be provided throughout this submission. However, a few are worth highlighting due to their clear inefficient, wasteful and unproductive results.

Electricity generation

Following reforms of privatisation and deregulation, electricity now employs an army of sales and marketing and other workers who do not actually make electricity. The reforms also seem to have encouraged profit gouging from companies in the industry who are able to inflate the asset base used in calculating the permitted return on assets. More than half the asset base appears to be 'goodwill' and retained earnings. There is a weird circular process in which high rates of return are capitalised in 'goodwill' and other fictitious or notional items while high profits guarantee high retained earnings which also feed into the asset base. In that way the unproductive capital base is allowed to increase, and we are charged for capital that has no real function in producing electricity.⁷

By failing to take account of the obvious problems of market solutions the governments concerned have created a mess. This market simply failed the conditions necessary for competition to work well. There have been a small number of players with barriers to entry. That encouraged the electricity providers to anticipate monopoly profits which were

⁶ Koutsoukis (2007) 'Small' service keeps on growing', *The Age*, <https://www.theage.com.au/national/small-service-keeps-on-growing-20070729-ge5gke.html>

⁷ Richardson (2013) *Electricity and privatisation: what happened to those promises?*, <https://australiainstitute.org.au/report/electricity-and-privatisation-what-happened-to-those-promises/>

capitalised as “goodwill” and other intangibles on their balance sheets which effectively put a high price floor under any subsequent developments.⁸

Advertising and administrative spending in the caring economy

Another sector of likely, though under quantified, inefficiency and waste is the caring economy. For instance, aged care, childcare and disability support services are all largely provided by private and non-government providers. These providers all incur significant costs in advertising their services to prospective customers. Much of this advertising focuses on alleged quality differences between providers, directly contrary to a requirement for perfect competition (homogenous products), which will be detailed further in the following sections. Additionally, all these providers must incur costs in complying with relevant (and highly necessary) regulatory frameworks. These costs are then duplicated across numerous providers.

We round off the present submission with a brief examination of the Zingales critique of financial markets in the belief that this is a critique that any discussion of competitive markets must confront. If fraud is as endemic as Zingales suggests then any pro-market reform must be especially careful.

⁸ Richardson (2013) *Electricity and privatisation: what happened to those promises?*

What is needed for markets to promote economic welfare?

BENEFITS OF COMPETITION

Economists often refer to “perfect competition”, “pure competition”, or “perfect markets” to describe a situation in which resources are being allocated as efficiently as possible. Just as understanding the movement of a cannonball in a vacuum can help students understand the principles of Newtonian physics, textbook models of perfect competition can help students understand how economic forces may work in a highly abstract, indeed imaginary, economy. But just as an understanding of how a cannonball moves in a vacuum is of virtually no use in predicting how well a paper airplane will fly, an understanding of perfect completion is of virtually no use in predicting how elderly patients will be treated in a privatised aged care system.

The following sections provide evidence of how far away from the assumptions of perfect competition are most of the government services that have been privatised, outsourced and deregulated. Importantly, this submission also discusses the lack of theoretical or empirical evidence to support the widely held view that it is desirable to privatise public services when only some of the conditions of perfect competition are present.

The International Monetary Fund (IMF) emphasises the role of perfect markets in balancing supply and demand. It says:

In perfect competition, no one has the ability to affect prices. Both sides take the market price as a given, and the market-clearing price is the one at which there is neither excess supply nor excess demand. Suppliers will keep producing as long as they can sell the good for a price that exceeds their cost of making one more (the marginal cost of production). Buyers will go on purchasing as long as the satisfaction they derive from consuming is greater than the price they pay (the marginal utility of consumption).⁹

Market adjustments can ensure no excess demand or supply will persist for very long.

⁹ Asmundson I (no date) “Supply and demand: Why markets tick”, IMF Finance and Development, at <https://www.imf.org/en/Publications/fandd/issues/Series/Back-to-Basics/Supply-and-Demand>

If prices rise, additional suppliers will be enticed to enter the market. Supply will increase until a market-clearing price is reached again. If prices fall, suppliers who are unable to cover their costs will drop out.¹⁰

Additionally, perfectly competitive markets reduce costs of production, as Morris writes in a textbook on the subject:

As an institution for making decisions, markets operate best or most efficiently when they are free or purely competitive. Perfect competition involves rivalry between many firms in a particular market where each seller tries to undercut the price and exceed the product quality of other firms.¹¹

Putting all this together means that, in theory, perfect competition meets society's needs efficiently and at least cost. It also implies consumers are getting the maximum satisfaction that the nation's existing resource endowment will allow.

These are powerful results, and it is easy to see why people have been enchanted by the propensity of the market to produce the best possible outcome, at least in theory. This model of perfect competition is central to economics' focus on efficiency. As Abelson says in a popular economics textbook:

What kind of economy achieves the three necessary conditions for economic efficiency: production, consumption and product mix efficiency? The answer is a perfectly competitive economy ... if there are markets for all goods and all markets are perfectly competitive, an economy achieves ... [an] efficient outcome.¹²

DEVIATIONS FROM THE COMPETITIVE IDEAL

Perfect competition is appealing in theory, but the efficiency claims attributed to perfect competition rely on various assumptions or pre-conditions that cannot be taken for granted in the real world.¹³ As stated in an Australian version of the best-selling economics textbook of all-time, Economics by Paul Samuelson:

The advantages claimed for free enterprise are fully realised only when the complete checks and balances of "perfect competition" are present.¹⁴

As discussed below, it is hard to overstate the importance of Samuelson's use of the phrase 'the complete checks and balances'. Neoclassical economic theory makes clear that *all* the

¹⁰ Asmundson I (no date) "Supply and demand: Why markets tick", IMF Finance and Development

¹¹ Morris (2011) *Economics Down Under*, Brisbane: John Wiley & Sons

¹² Abelson (2003) *Public Economics: Principles and Practice*, Sydney: Southwood Press

¹³ Samuelson PA, Hancock K and Wallace R (1970) *Economics: Australian Edition*, Sydney: McGraw-Hill.

¹⁴ Abelson (2003) *Public Economics: Principles and Practice*, Sydney: Southwood Press

assumptions of perfect competition are required for markets to deliver the efficiency benefits claimed by advocates of privatisation, deregulation and outsourcing of public services. That is the assumptions of perfect competition are like ingredients for an intricate recipe rather than a menu from which policy makers can select. Just as you cannot make tomato sauce without tomatoes, no matter how much salt, sugar, onion or bottles you have, you cannot have a perfectly competitive market without all the essential ingredients. The consequences of this need for 'all the ingredients' was spelt out, using orthodox neo-classical theory, by Richard Lipsey and Kelvin Lancaster in 1956 in what economists call 'the theory of the second best'.¹⁵

The theory of the second best

Under the conditions of perfect competition, where all resources are being efficiently allocated, it is impossible to make anyone else better off without making someone else worse-off: economists call this state of 'perfection' Pareto Optimality.

In their seminal paper Lipsey and Lancaster state the conditions for Pareto Optimality (the same conditions alluded to by Samuelson and Abelson) and the implications of any deviation from the conditions of perfect companion as follows:

It is well known that the attainment of a Paretian optimum requires the simultaneous fulfillment of all the optimum conditions. The general theorem for the second best optimum states that if there is introduced into a general equilibrium system a constraint which prevents the attainment of one of the Paretian conditions, the other Paretian conditions, although still attainable, are, in general, no longer desirable. In other words, given that one of the Paretian optimum conditions cannot be fulfilled, then an optimum situation can be achieved only by departing from all the other Paretian conditions. The optimum situation finally attained may be termed a second best optimum because it is achieved subject to a constraint which, by definition, prevents the attainment of a Paretian optimum.

To be clear, the theory of second best does not just say that markets might not always be efficient, it says that if there is one form of market failure in one market, economists should not assume that removing other forms of market failure in the same or other markets will inevitably lead to an increase in economic efficiency. Put another way, market failures are sometimes desirable to counter the existence of unavoidable market failures somewhere else.

In explaining the significance of their conclusion for policy makers Lipsey and Lancaster state (emphasis added):

¹⁵ Lipsey and Lancaster (1956) 'The General Theory of the Second Best', *The Review of Economic Studies*, <https://doi.org/10.2307/2296233>

There is an important basic similarity underlying a number of recent works in apparently widely separated fields of economic theory. Upon examination, it would appear that the authors have been rediscovering, in some of the many guises given it by various specific problems, a single general theorem. This theorem forms the core of what may be called The General Theory of Second Best. Although the main principles of the theory of second best have undoubtedly gained wide acceptance, no general statement of them seems to exist. **Furthermore, the principles often seem to be forgotten in the context of specific problems and, when they are rediscovered and stated in the form pertinent to some problem, this seems to evoke expressions of surprise and doubt rather than of immediate agreement and satisfaction at the discovery of yet another application of the already accepted generalizations.**¹⁶

As discussed in the sections below, nearly 70 years after the formalisation of the theory of the second best, and 30 years into its experiment with the default assumption that private markets were more efficient than public service delivery, Australian policy makers still seem to exhibit the surprise referred to by Lipsey and Lancaster.

While economics textbooks carefully outline the conditions that must be met for the market to “work” effectively, such as numerous buyers and sellers, no barriers to entry and the absence of externality there is virtually no discussion of how policy makers should respond when one, or most, of these assumptions are clearly inappropriate for describing a real-world market. In the following section we outline each criterion that must be met in order to claim the benefits of perfect competition.

AUSTRALIAN DEVIATIONS FROM COMPETITION

Where it works well, competition protects the community from extortion and price gouging on the part of providers of essential goods and services. But in practice, competition is often ineffective, leads to reductions in hard to measure elements of quality, or creates perverse incentives or opportunities for fraud. Private Vocational Education and Training (VET) providers offering free iPads to induce young Australians to enrol in inappropriate courses was, arguably, one of the low points in the ability of Australian policy makers to predict how profit maximising companies might exploit vulnerable people.¹⁷ But given the ongoing exploitation of people by private providers of National Disability Insurance Scheme (NDIS) and aged care services, it would seem that no amount of evidence can protect some Australian policy makers from the ‘surprise’ of market failure.

¹⁶ Lipsey and Lancaster (1956) 'The General Theory of the Second Best', *The Review of Economic Studies*

¹⁷ Dodd (2015) 'Free iPads banned as a student 'inducement'', *Australian Financial Review*,

<https://www.afr.com/policy/health-and-education/free-ipads-banned-as-a-student-inducement-20150311-1411rz>

In Australia the term ‘competitive market’ has been so debased that it has no actual economic meaning. While the textbook definition is clear, and real-world examples are hard to find, it is far easier to find the textbook definition of other forms of market, such as in the real-world. However, even though neoclassical economics defines a competitive market as having many buyers and many sellers, none of which have any price setting power, in Australia, industries such as banking and airlines that clearly have ‘few’ suppliers with clear market power are widely referred to as ‘competitive’. To be clear, while such descriptions are solely based on the political power of these industries, and the fear of offending such industries, in a genuinely competitive market no supplier would have enough power (market or political) to exert such influence over the way they are described. In a well-functioning democracy, describing a market as an oligopoly should be as uncontroversial as describing subsidies for products with negative externalities, such as fossil fuels and large four-wheel drive vehicles, as ‘inefficient’. Needless to say, Australia is not such a democracy.

Consider, for example, that the CEO of the Australian Bankers Association recently claimed that the Australian banking sector is “a very competitive market”.¹⁸ The Australian market is dominated by the ‘Big 4’ banks which have a combined market share of over three quarters of the market,¹⁹ and rarely diverge significantly in their price offerings. They also make very large profits.²⁰ Competition between the banks is largely concerned with advertising that emphasises brand image and other marketing initiatives.

In other industries non-price competition can also include product differentiation, in-store promotions, free delivery, and related services. We expect that while some aspects of non-price competition may be valued, consumers would much prefer lower prices, especially for products like credit cards and mortgages. Advertising does have a role in providing information in imperfect markets (as perfectly competitive markets are based on the assumptions that consumers already have perfect information and that all products in the market have identical features). That said, the fact that the ‘Big 4’ banks regularly collectively spend more than \$1 billion per year on advertising is further proof that the Australian banking industry cannot meaningfully be described as ‘competitive’.²¹

Similarly, if investors in the ‘Big 4’ banks believed that they were in a ‘competitive market’ then they would assume that the profit margins would fall steadily towards the profit margins of their smallest competitors and, in turn this belief would be reflected in the share price of the ‘Big 4’ banks. The stock market valuation of the ‘Big 4’ banks is further proof

¹⁸ Australian Banking Association (2024) *Anna Bligh Interview Sky News, discussing financial hardship and what banks can do to help*, <https://www.ausbanking.org.au/anna-bligh-interview-sky-news/>

¹⁹ Bullock (2017) *Big Banks and Financial Stability*, <https://www.rba.gov.au/speeches/2017/sp-ag-2017-07-21.html>

²⁰ Fear, Denniss and Richardson (2010) *Money and power: The case for better regulation in banking*, https://australiainstitute.org.au/wp-content/uploads/2020/12/IP-4-Money-and-Power_4.pdf

²¹ Fear, Denniss and Richardson (2010) *Money and power: The case for better regulation in banking*

that claims the banking industry is 'competitive' are absurd. Indeed, the fact that such absurd claims are so rarely contested, even by regulators, is proof of just how much market power, and political power, the 'Big 4' banks have in Australia.

Economic criterion for a well-functioning market

The conditions required for perfect competition have been clearly identified by economists and, until recently, have been spelt out in virtually all introductory economics textbooks. That said, in recent years some textbooks have begun to limit the assumptions required for perfect competition to exist. One popular economics textbook now only lists two requirements for perfect competition.²² It is not clear if this trend is to speed up the teaching of economics, conceal the inappropriateness of the perfectly competitive model for policy purposes, or both.

As mentioned in the previous section, *all* the conditions of perfect completion must be met to support a conclusion that a market will efficiently allocate scarce resources. The absence of any single condition means that we cannot assume that a market will be effective and functional. These conditions are often detailed in economics textbooks and include the following:

1. many small firms and customers (no market participant has market power)
2. freedom of entry and exit (no legal, physical or other barriers to entry or exist)
3. homogeneity of product (no product differentiation, quality differences, need for advertising)
4. perfect information (all participants know all about all the features of each product and its substitutes)
5. no transaction costs (it is easy to swap banks, insurance companies and there are zero transport costs)
6. no externalities (no costs to others such as pollution or benefits to others such as immunisation)
7. exogenous preferences (individual's choices are entirely their own, fashion, culture, habit and advertising play no role in consumer choices).²³

²² Mankiw (2016) *Principles of Economics (Eighth Edition)*, Boston: Cengage Learning

²³ One such textbook is Baumol WJ and Blinder AS (2007) *Economics: Principles and Policy, Tenth Ed 2007 Update*, Mason, OH: Thompson South-Western. They outline four conditions that must be satisfied in order that the market will work. These are as set out; however, we add three more categories that are implied by Baumol and Blinder or are commonly understood causes of market failure and are worth treating separately because of their importance.

1 NUMEROUS SMALL SUPPLIERS AND CUSTOMERS

Competitive markets contain so many small buyers and sellers that each one constitutes a negligible portion of the whole - so small that each player's decisions have no effect on price. This means that both suppliers and customers must take the price offered by the market and have no ability to set their own prices, as trying to charge a price above the market price would cost a supplier all of their customers. This requirement also rules out trade associations or other collusive arrangements in which firms work together to influence price or regulation. For instance, with many suppliers, collusion becomes much harder and, even if a cartel was formed, a large number of suppliers would make it easier for suppliers to break away from any industry agreement.

This assumption of many buyers and sellers has not been met for a wide range of goods and services that have been privatised and outsourced by past Australian governments, most notably the privatisation of the publicly-owned telecommunications provider Telecom, now known as Telstra.

We have previously provided a submission relating to Telstra's performance since privatisation, the conclusions from this submission can be simply stated.²⁴ Telstra is a monopolist that exploits its monopoly power to make huge profits at the expense of ordinary Australians and, disproportionately, at the expense of lower income groups. A conservative estimate was that Telstra's pre-tax profit was at least \$4.4 billion greater than would have been possible if it were operating in a competitive market in telephones.²⁵ Such excess profits simply should not exist in a competitive market, and represent both a transfer of welfare from consumers to the owners of Telstra as well as providing clear evidence of the inefficiency of the privatised market for telecommunications. Efficient markets do not generate large profits over any significant period of time as they would be competed away by new entrants.

'Thin markets'

Another place where ignoring this condition for efficient markets has regularly led to failures in privatised, outsourced, or deregulated services are in 'thin markets'. A thin market occurs when there are insufficient transactions, and therefore small numbers of buyers and sellers, to create a functional market. This is a common problem in areas with lower population densities, such as regional, rural, and remote communities. Another factor that may create 'thin markets' are the incomes of residents; if a population does not have the resources to pay for a service, no robust market will arise. Additionally, divergent needs and preferences

²⁴ Richardson (2010) *Telstra's price control arrangements*, <https://australiainstitute.org.au/report/submission-to-the-accs-on-telstras-price-control-arrangements/>

²⁵ Richardson (2010) *Telstra's price control arrangements*

can contribute to a thin market. For instance, a community might need various types of disability support providers but not need any single type sufficiently to create a market for this service; another example may be divergent cultural needs of a community.

Unsurprisingly, ‘thin markets’ have consistently been identified as a problem throughout privatised and outsourced services such as disability,²⁶ aged care,²⁷ and childcare.²⁸ While it seems obvious in hindsight that smaller population centres, for instance a town of 2,000 people, may be unable to create a thriving market with numerous disability, aged care and childcare service providers; it is unfortunate that this is not sufficiently acknowledged and accounted for in foresight.

2 FREEDOM OF ENTRY AND EXIT

Competitive markets allow new firms to enter and exit markets freely. The existence of free entry to a market is essential to the conclusion that markets efficiently allocate scarce resources, including capital, land and labour as in the absence of free entry incumbent firms will be able to charge high prices and make high profits over a sustained period. If new entrants are prevented from entering and establishing themselves in high profit industries, then the market will under allocate resources to the production of goods and services that are clearly of high value to consumers, resulting in inefficiently high prices and inefficiently low levels of investment and production. In turn, such barriers to entry, by definition, reduce productivity growth by keeping resources out of their highest value uses.

Freedom of entry and exit is usually assessed by determining whether the market has any ‘barriers to entry’ and ‘barriers to exit’. Barriers to entry are things that make it more difficult for a seller to enter the market, this includes economic barriers (such as the upfront cost of establishing a new firm), physical barriers (such as the amount of land suitable for producing certain crops or providing port services), and legal barriers (such as laws preventing people copying a product or copyright and patents processes which are, by design, anticompetitive). Barriers to exit include factors such as ongoing contractual obligations to staff and suppliers and sunk costs in the current market (for instance a firm might have assets that are only relevant to this sector and cannot be sold).

²⁶ Aged Care Taskforce (2024) *Final report of the Aged Care Taskforce*,
https://www.health.gov.au/sites/default/files/2024-03/final-report-of-the-aged-care-taskforce_0.pdf

²⁷ National Disability Insurance Scheme (2023) *Thin Market Trials: Final Evaluation*,
<https://www.ndis.gov.au/about-us/research-and-evaluation/market-stewardship-and-employment/evaluation-ndia-thin-market-trials>

²⁸ Productivity Commission (2023) *A path to universal early childhood education and care: draft report*,
<https://www.pc.gov.au/inquiries/current/childhood/draft/childhood-draft.pdf>

While a fully functional market requires low barriers to entry and exit, Australian governments have privatised and outsourced services with significant barriers, including privatising various airports. Airports have high barriers to entry, namely:

- high initial investment costs such as buying sufficient land and building all necessary infrastructure including terminals and runways requires significant access to capital
- high regulatory costs to ensure airport safety and security, which also discourages entry from firms unable to become aware of or comply with regulations
- physical and legal constraints as airports require significant land and only certain locations are geographically suitable for their placement, they are also politically and legally sensitive, this inevitably creates further barriers to entry for new firms.

Despite airports violating this necessary condition for a functional market, they have been privatised across Australia, including Sydney and Melbourne. Our previous work has demonstrated that these now privatised airports have unsurprisingly made excessive profits.²⁹

As a result of the barriers to entry the cost of using airport services is higher than that required to operate an airport. This in turn imposes costs, and distorts the behaviour, of both consumers and other firms (for example airlines) in ways that transfer welfare to the owner of the airport and reduce the productivity of the economy as a whole.

3 HOMOGENEITY OF PRODUCT

The assumption that for markets to work well the products must be homogenous plays a particularly important role in understanding both the conditions of an efficient market and the risks of privatising or outsourcing government services. When products are identical consumers are free to focus solely on price, at the same time this helps ensure the condition of perfect information is met. When all products in a market have identical attributes, there are no quality differences between products and consumers can easily identify the best value product as, by definition, it is the lowest price product.

The existence of homogenous goods (along with the assumption discussed below that individual preferences are endogenous) also means there is no role for advertising of any non-price features. Similarly, the assumption of perfect information means there is no role for advertising of either price or non-price features. In turn, the existence of a significant amount of advertising in a market is proof that the market is not fully competitive. Large expenditures on advertising are evidence of inefficiency in a market and further, if privatised markets for aged care, childcare, NDIS or other services require significant expenditure on advertising then the result is, by definition, a reduction in productivity as the

²⁹ Richardson (2019) *Airports: What the Productivity Commission missed*, https://australiainstitute.org.au/wp-content/uploads/2020/12/Airports-What-the-Productivity-Commission-missed_.pdf

resources dedicated to advertising are resources that could be used to produce more valuable goods and services.

While neoclassical economic theory relies heavily on the assumptions that homogenous goods and perfect information help ensure markets will efficiently allocate society's resources, there is also academic evidence that more complex products have higher mark-ups and are sold to less sophisticated customers of financial services.³⁰ Moreover, complexity seems to be a deliberate strategy used by the finance industry to prevent consumers shopping around, a strategy sometimes dubbed 'confusopoly'. People cannot shop around if they do not understand the products they are buying or if the related transaction costs (see below) are high.

It seems obvious that there are significant benefits to consumers and the economy from the government acting as a buyer of a wide range of services including disability support services and regional health services. However, in practice the belief that 'markets are more efficient' has led to the creation of private markets for once public services where differences in quality, or perceived differences in quality, play a major role in the decision making of consumers and producers. This has been especially wasteful where advertising claims are inaccurate, for example it is rare to see an advertisement admitting that quality is low but the product is cheap in health, education, aged care, childcare or NDIS services.

Measurement issues

Imperfect measurement refers to the difficulty in perfectly observing the output of the supplier, especially when the quality of the service is hard to quantify. *The Economist* says that in some industries complex contracts with multiple indicators have proved easy to game and that the "NAO [National Audit Office] politely observes that 'we rarely see performance management measures...working as intended'".³¹ Problems can also arise when some of the information is described as "commercial-in-confidence". Paul Barrett once observed:

Virtually all traditional accountability mechanisms rely on the availability of reliable and timely information. As a result of contracting out to the private sector, the flow of information available to assess performance and satisfy accountability requirements has on the whole been reduced. This situation has arisen where performance data is held exclusively by the private sector or through claims of commercial confidentiality that seek to limit or exclude data in agency hands from

³⁰ Celerier C and Vallee B (2013) 'What drives financial complexity? A look into the retail market for structured products, A Look into the Retail Market for Structured Products' cited in Zingales *op cit*.

³¹ The Economist (2018) "Britain's outsourcing model, copied around the world, is in trouble", *The Economist*, 28 June.

wider parliamentary scrutiny. Thus accountability can be impaired where outsourcing reduces openness and transparency in public administration.³²

All of this raises the “residual rights of intervention”:³³ if a contract is silent on a problem that appears in practice, the provider can easily evade responsibility and the government must fix the problem. When problems arise because of a private business’ failure to deliver it behoves the government to pick up the pieces.

In practice there is always incentive for the private provider to under-perform and cut corners which becomes easier the harder it is to measure and quantify output. Quality is difficult to define but is an area where a supplier can cut costs. In the absence of watertight specifications there is the risk that the winning supplier will be the one most prepared to cut corners.

This difficulty in defining and measuring the quality of privatised and outsourced non-homogenous goods has been starkly apparent through various failures. For instance, the controversies involving engagement of consultancy agencies (such as PwC) to provide advice on and manage traditionally public service responsibilities, or reported failures for outsourced employment.³⁴ As reported in the Australian Government’s Employment White Paper:

Since the shift in Australia’s employment services model to fully outsourced delivery, there has been less personalised servicing, and less qualified and experienced frontline consultants.³⁵

4 PERFECT INFORMATION

This condition requires consumers to have full knowledge of all information relevant to their purchases, such as full knowledge of all available product options and providers including the qualities of the products, any prices and other costs, and any changes to prices and qualities; and full knowledge of their own preferences and needs. Importantly, in addition to having access to this information the consumer must also be able to properly understand and process the information to make rational decisions. For example, in a perfectly competitive market a person who was sick and seeking medical attention would know

³² Barrett P (2001) “Managing and monitoring privatisation and outsourcing initiatives – Challenges in maintaining accountability”, *Presentation to Global Working Group Meeting*, Washington, 11 January

³³ Sappington DEM and Stiglitz JE (1987) “Privatisation, information and incentives”, *NBER Working Paper No 2196*

³⁴ For example Wedesweiler (2023) ‘Is the government relying too much on its ‘shadow public service’ of consultants?’, *SBS News* <https://www.sbs.com.au/news/article/is-the-government-relying-too-much-on-its-shadow-public-service-of-consultants/a0kognmuk>

³⁵ Treasury (2023) *Working Future: The Australian Government’s White Paper on Jobs and Opportunities*, <https://treasury.gov.au/sites/default/files/2023-10/p2023-447996-working-future.pdf>

exactly what was wrong with them, all the alternative treatment options, the skill of each medical practitioner and the relative cost and waiting time of each medical service provider.

Using the model of a perfectly competitive market with assumptions of homogenous products and perfect information is particularly absurd when it comes to the provision of services that require 'customers' to obtain significant amounts of advice and weigh up different options with access to information that is expensive to obtain, partial in its completeness and highly subjective. Similar issues arise when students are 'buying' an education service which, if they were perfectly well informed, they would not need. Universities and private colleges spend billions of dollars per year on advertising making claims about quality which, if true, highlight that the market is not competitive and, if false, are an enormous and misleading waste of scarce resources which reduce productivity and consumer welfare.

Vocational education

The vocational education sector was opened to private suppliers in the expectation that students buying a service and the government providing a loan or subsidy, would know the content of the course. Of course, this assumption is illogical in that if the student knew the content of a course, then they would not need to undertake the course in the first place.

Not only did the vocational education and training case fall foul of the lack of information problem there was another issue involved that we have not yet discussed: perverse incentives. The incentive for the student is to get the qualification with as little effort as possible, whilst the incentive for the training provider is to provide the training and the certification with as little effort and expense as possible. Neither party have a strong incentive to ensure the quality of the certificate. However, third parties such as potential employers and clients certainly do have concerns about quality. The problem for third parties is that they do not have information about the quality of the certifications issued by dodgy education and training providers.

The experiment with privately provided VET failed because there was a race to the bottom in terms of quality and the above noted incentive issues. The following was reported in a Senate inquiry which followed revelations of the scandal:

2.53 Throughout this inquiry, the committee heard that a fundamental problem with private provision of VET courses is that educational priorities are sometimes at odds with the profitability considerations central to the operation of a business.

...

2.95 Given the numerous concerns expressed to the committee and in the national media about the quality and relevance of the education and training students

accessing the scheme are receiving there are grounds to conclude that much of this additional investment in vocational education that VET FEE-HELP represents is currently being wasted, or milked for profit. This is a tragedy not just for the Australian taxpayer, but for individual students, many of whom are left without a qualification – or worse a useless qualification – and a debt to the Commonwealth.³⁶

This sort of problem can only be solved by government action of some sort, including government provision of education and training which had been the long-standing arrangement.

The caring economy

Aged care

Informational problems are also likely to be significant in the aged care sector. Firstly, it may be difficult for the potential aged care resident (or their family members who may be acting on their behalf) to determine whether the aged care is likely to suit them (quality, compatibility etc) without first signing a contract to purchase the service.

This information asymmetry is exacerbated by the holistic and interpersonal nature of the service and heterogeneity of aged resident needs. Relatedly, aged care residents are not easily able to gather information through repeated purchases and comparisons between different providers as it is complex and costly to switch residential home providers. That is, while a consumer who is unhappy with the service at a café can easily choose a different café the next day, an aged care resident who is unhappy with their care not only finds it very difficult and expensive to switch, but they also have no ability to determine whether the care would be better or worse at an alternative aged care provider.

Of even greater concern is that many residents are likely to have significant difficulty gathering and processing information due to physical factors such as illnesses and disabilities associated with aging. Some potential residents may receive assistance from family, however not all will, and family members may not be fully aware of the potential residents' needs and preference, or in the worst cases may use this as an opportunity for abuse.

³⁶ Senate Education and Employment References Committee (2015) *Getting our money's worth: the operation, regulation and funding of private vocational education and training (VET) providers in Australia*, https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Education_and_Employment/vocational/~/media/Committees/eet_ctte/vocational/Final_Report/report.pdf

There is clear evidence of abuse and malnutrition in Australian aged care institutions, outcomes that no 'rational' consumer would subject themselves to in a competitive market.³⁷

Childcare

The childcare sector experiences similar problems to the aged care industry. Importantly, the purchaser of the service (the parent) does not directly consume the service but does so via their child who may not be able to judge the quality of service provided. Therefore, the purchaser will have to rely on impressions based on other characteristics, such as the appearance of the facilities and indications from the child.

There is extensive advertising in the childcare industry, widespread claims of quality and product differentiation, and often queuing for access. All these features of the childcare market make clear that the market cannot be considered efficient. The childcare sector is currently undergoing a review by the Australian Competition and Consumer Commission.³⁸

5 NO TRANSACTIONS COSTS

Transaction costs are costs associated with agreeing and enforcing an economic transaction, for instance drafting a contract or changing service providers.

Transaction costs help to protect incumbent firms from new entrants and/or trap consumers with providers who they dislike (an impossibility when products are homogenous) because of the time and monetary costs of switching.

Transaction costs also create barriers to entry, for instance costs incurred in establishing a business, negotiating contracts with suppliers, and complying with regulations are all transaction costs that may discourage a firm from entering a market.

While market efficiency may be based on the ability of customers to rapidly switch providers without additional cost, few users of childcare or aged care would consider such regular switching to be a virtue of an efficient market. In turn, if regulators assume that switching is easy and desirable for children, people with disabilities and those in aged care then the result will be markets where vulnerable consumers are exploited, profits excessive and productivity reduced.

³⁷ Royal Commission into Aged Care Quality & Safety (2021) *Final Report: Care, Dignity and Respect (Volume 2: The current system)* <https://www.royalcommission.gov.au/system/files/2021-03/final-report-volume-2.pdf>

³⁸ Australian Competition & Consumer Commission (2023) *Childcare inquiry: Final report*, <https://www.accc.gov.au/system/files/ACCC%20Childcare%20Inquiry-final%20report%20December%202023.pdf?ref=0&download=y>

6 ABSENCE OF EXTERNALITIES

Externalities are costs, or benefits, arising from an activity that affect an unrelated party. The classic 'negative externality' is air pollution from a factory where the producer does not need to compensate those adversely affected by their production and, in turn, the price of bricks does not reflect the full cost of manufacturing the brick as it leaves out the costs imposed on the neighbours. A positive externality may be the case of a beekeeper whose bees pollinate the local orchard and thereby provide an uncompensated benefit to the orchardist. Another example is educating a citizen so that they can meaningfully participate in their democracy.

Significant positive and negative externalities have been involved in markets that have been privatised and outsourced by Australian governments, one notable example is the electricity system.

Electricity generation has historically involved burning fossil fuels such as coal and gas, which has resulted in significant emissions of carbon dioxide into the atmosphere. These emissions are a negative externality as they contribute to climate change, which will deliver significant costs for people all around the world. The attempt to create an 'efficient market' in this sector, for instance through privatisation and corporatisation, has created significant problems. An earlier Australia Institute submission to the Productivity Commission demonstrated that implementation of 'competition policy' to the electricity sector was responsible for a rapid growth in emissions due to the impact on a falling price of wholesale electricity and a rise in the carbon dioxide intensity of electricity generation.³⁹ This analysis indicated that the environmental damage caused by excess emissions would cost Australia almost \$1.5 billion for the period over 1998-2005. These costs have likely mounted significantly since this time.

To be clear, it was obvious at the time that the electricity market was privatised that there were negative externalities associated with the production of coal and gas fired electricity. It was obvious also that policies designed to reduce the wholesale price of electricity would lead to an increase in the production and consumption of a product with negative externalities which would, by definition, lead to a reduction in community wellbeing. But despite the obvious consequences, Australian policy makers were clearly determined to ignore the existence of negative externalities when expressing their support for the 'efficiency' of their preferred private market structure. The consequences for the climate, and Australia's productivity growth were simply ignored in favour of simplistic ideology.

³⁹ Hamilton and Denniss (2000) 'Impact of microeconomic reform on greenhouse gas emissions from the electricity sector' in Productivity Commission *Microeconomic Reform and the Environment: Workshop Proceedings* <https://www.pc.gov.au/research/supporting/environment-macroeconomic-reform>

7 EXOGENOUS TASTES

This condition requires that individuals' tastes and preferences exist independently of the market itself. For instance, if someone buys a snack, they must have always wanted a snack of that precise nature and have always been willing to pay its price, being uninfluenced by the preferences of others or marketing campaigns.

This condition does not appear to be present in most markets, including those privatised by Australian governments. If consumers had exogenous tastes and perfect information then advertising campaigns would not be necessary for aged care, childcare, NDIS, VET or other markets as consumers would already know what they wanted, and the assumption of perfect information means they would know where to get it. However, advertising, including for numerous privatised government goods and services, is ubiquitous, indicating either perfect information, exogenous tastes or both conditions are not present in these markets. The costs of these advertising campaigns are borne either by the consumer of a good or service or by the public through taxation.

Players in the market will often use marketing and advertising to whip up demand for their products. The economic welfare of society is hardly advanced if people are induced to spend money on something they had not realised they wanted until the businesses concerned were able to manufacture a need for the product.

The Conditions Grid

With the benefit of hindsight, we can point to several policy areas and show why they should never have been privatised, commercialised or subject to market forces. We can use the requirements of a perfectly competitive market to inform a table that summarises the conditions and for each policy area, assesses whether the conditions were valid or not.

Table 1: Conditions of perfect competition

	Assessment
Numerous small buyers	<input type="checkbox"/>
Numerous small sellers	<input type="checkbox"/>
No barriers to entry or exit	<input type="checkbox"/>
Homogenous product	<input type="checkbox"/>
Perfect information	<input type="checkbox"/>
No transaction costs	<input type="checkbox"/>
No externalities	<input type="checkbox"/>
Exogenous tastes	<input type="checkbox"/>

This table allows us to predict, from straightforward neoclassical economic principles, the failures of initiatives to outsource, privatise and deregulate the provision of government services.

Conclusion

Much of our work on competition has drawn on the work of Luigi Zingales, especially his address as President of the American Finance Association. The discussion in Australia has been fairly mild compared with the message from Zingales who feared “that in the financial sector fraud has become a feature and not a bug”,⁴⁰ also noting:

From Libor fixing to exchange rate manipulation, from gold price rigging to outright fraud in subprime mortgages, not a day passes without a news of a fresh financial scandal.⁴¹

Zingales makes it clear that “[i]f the most profitable line of business is to dupe investors with complex financial products, competitive pressure will induce financial firms to innovate along that dimension’. The Hayne Royal Commission stopped far short of the severity of this language, although recent conduct in the market for so called ‘carbon offsets’ highlights the risks that Australian policy makers face when large profits can be derived from poorly regulated markets.

Zingales makes the point that economists and especially finance economists are prone to the “belief in our profession...that all that we observe is efficient”,⁴² but without any evidence to justify that belief. By contrast Zingales argues that “market forces cannot bring [the finance sector] in check”.⁴³ However, it must be stressed that the critique is not confined to the finance sector. As is evident in the daily activities of the Australian Competition and Consumer Commission, the critique identified by Zingales extends more broadly across the economy.

Zingales discusses specific problems with the finance sector as a whole beginning with ‘duping unsophisticated investors’, to which we now turn. Zingales says there are two types of ‘duping’:

- ‘straight’ duping: “where investors are sold a product they do not understand and would have never wanted had they understood it”⁴⁴
- ‘indirect’ duping: “where investors are attracted to product bundles that are very convenient for sophisticated investors (who buy the cheap part and disregard the expensive one) but turns out to be extremely costly for unsophisticated ones, who

⁴⁰ Zingales (2015) ‘Does finance benefit society?’ *2015 American Finance Association Presidential Address*, p 19, at https://www.nber.org/system/files/working_papers/w20894/w20894.pdf

⁴¹ Zingales (2015) ‘Does finance benefit society?’ *2015 American Finance Association Presidential Address*, p 2

⁴² Zingales (2015) ‘Does finance benefit society?’ *2015 American Finance Association Presidential Address*, p 9

⁴³ Zingales (2015) ‘Does finance benefit society?’ *2015 American Finance Association Presidential Address*, p 4

⁴⁴ Zingales (2015) ‘Does finance benefit society?’ *2015 American Finance Association Presidential Address*, p 14

buy the whole bundle”.⁴⁵

Most of the Australian examples seem to be of the first type – straight duping in which unsophisticated investors are sold complex investment products that are not understood until they fail, and often not even then. There is evidence that more complex products have higher mark-ups and are sold to less sophisticated investors.⁴⁶

Similarly, as several Royal Commissions and other inquiries have found, consumers and indeed governments, seem to be regularly ‘duped’ by providers of a wide range of once publicly provided services.

The virtues of competition assume everyone obeys the rules of the game. Zingales, in his Presidential Address to the American Finance Association, chided his members for not concerning themselves more with fraud. He pointed out that “If the most profitable line of business is to dupe investors with complex financial products, competitive pressure will induce financial firms to innovate along that dimension”.⁴⁷

The Hayne Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry showed what can happen when self-interest is not held in check. Hayne said fraud and scandals are motivated by “greed – the pursuit of short term profit at the expense of basic standards of honesty... From the executive suite to the front line, staff were measured and rewarded by reference to profit and sales”.⁴⁸

Fraud of this type is hardly limited to finance. We are all prone to drive over the speed limit or park illegally when it suits us. Most people will admit to an occasion when they allowed a shopkeeper to undercharge them. It should not be a surprise in the course of business, people stray into fraudulent or untruthful behaviour.

In perfect competition, with perfect information and homogenous goods, fraud and exploitation of consumers are impossible. But in complicated markets like childcare, aged care and disability services almost every feature of the market differs from the competitive ‘ideal’. It is, therefore, highly likely that the market will be inefficient, productivity growth lower, and fraud almost inevitable.

⁴⁵ Zingales (2015) ‘Does finance benefit society?’ *2015 American Finance Association Presidential Address*, p 14

⁴⁶ Celerier C and Vallee B (2013) ‘What drives financial complexity? A look into the retail market for structured products, A Look into the Retail Market for Structured Products’ cited in Zingales

⁴⁷ Zingales (2015) ‘Does finance benefit society?’ *2015 American Finance Association Presidential Address*, p 22

⁴⁸ Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (2018) *Interim Report Executive Summary*, <https://www.royalcommission.gov.au/system/files/2020-09/executive-summary.pdf>

In order to protect consumers and governments from fraud, significant resources must be invested in oversight, regulation and compliance, all resources which could be used to produce higher value products and boost national productivity.

An assumption that markets will work efficiency, and that few if any resources will be dedicated to advertising, marketing, or purchasing advice to navigate complicate systems and detect and protect against fraud, has been the cornerstone of NCP in Australia for decades. As outlined above, there is no evidence to support that assumption.

If Australian governments are serious about maximising community wellbeing, maximising productivity growth and minimising fraud they should undertake a wide-ranging inquiry into the performance of privatised and outsourced government services with a particular focus on the costs to consumers and governments of unnecessary administration, product differentiation, advertising, and fraud. Such an inquiry should focus on the time spent navigating such systems as well as the financial cost of their administration and regulation.