An Australia-United States Free Trade Agreement: technological change and regulatory approaches

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Introduction

1. Let me start with an anecdote and then move to the harder stuff.

2. In the late 1980's, the unit cost of international telecommunications between Australia and the rest of the world fell sharply, as a result of the shift to fully electronic switching at international gateways, the availability of high capacity satellite links and the deployment of very high bandwidth fibre optic submarine cables. By my estimates, the combined effect was to more than halve unit costs in the space of 5 years.

3. Prices fell, but not as fast as costs. Particularly sticky were 'accounting rates' – the amounts international telecommunications carriers pay each other to terminate calls. As a result, it became very profitable for the Australian international carrier – at that time, OTC – to receive calls from overseas.

4. The implications of falling costs were not lost on some entrepreneurial young sparks at OTC. More specifically, they noted the opportunities created by cost reductions to expand Australia's exports of services. Within less than a year, a long established activity had been reshaped.

5. The activity I am referring to is that of heavy breathing – or more prosaically, sex by phone. Acting through distributors around the world, OTC emerged as a major supplier and exporter of dial-in sex lines. At its peak (so to speak) OTC may well have accounted for 50% or more of cross-border sex line traffic.

6. Now, to economists, this is not all that surprising. I rather doubt (though I admit I have no way of knowing) whether Australians are particularly good heavy breathers. But what we do have is an exceptionally diverse pool of potential heavy breathers to draw on. Need someone who can provide heavy breathing in Moldovian? You need look no further than the suburbs of Melbourne, and an appropriately worded classified ad in the Moldovian language paper will do the trick.

7. Equally, though we are a long way from the rest of the world, that is not necessarily a great disadvantage. The technological changes I mentioned above dramatically reduced the cost penalty distance implies. And the difference in time zones meant that our transmission and switching capacity was only very lightly utilised at the times when sex-line demand, notably in Europe, was greatest. To use the language of telecommunications engineering, our peaks were non-coincident.

8. We were therefore well-placed to exploit opportunity. But at least in sex line provision, success can be fleeting. OTC was too successful for its own good. Italian pensioners, in an old age home run by a religious order, discovered the service and were soon addicted. The bills they ran up virtually bankrupted the home and the order. In the resulting uproar, an Australian parliamentary inquiry made it plain that this was not an appropriate activity for an entity owned by the Australian government. Soon, regulatory constraints were imposed which made providing the service much less attractive. By the late 1990's, Australia was no longer a player in the international sex line market. OTC's bright sparks had moved on, to dot coms that first boomed and then went bust.

9. Several useful lessons can be learned from this anecdote. To begin with, comparative advantage moves in mysterious ways. Falls in telecommunications charges are like reductions in transport costs, and will create new patterns of specialisation. Just as Hecksher-Ohlin predicts, there was an increase in the value of a previously abundant resource – in this case, the pool of under-utilised potential heavy breathers. But it would be difficult for even the most prescient social planner to have called the precise area where the impact would the gains would flow.

10. A second point, which really accentuates the first, is that many of the new opportunities arise from **using** telecommunications and IT, rather than being directly in telecommunications and IT. Moreover, these opportunities involve changing the way existing products and processes activities are provided. Indeed, there is a great deal of research that shows that the largest productivity gains do not come from appending ICT to existing modes of production, but rather from using ICT as part of

a process of business transformation.[1] More recent research notes that the biggest gains from ICT have not come from its direct use, but its use in combination with product and process innovation.[2] This means that the trade gains from the development and diffusion of new information and communications technology are not in ICT narrowly defined, but rather affect a wide range of existing services.

11. A third point is that regulation is crucial to exploiting opportunity. I believe, though I cannot prove, that the speed and effectiveness with which OTC exploited the opportunity had a great deal to do with the telecommunications reforms of the mid to late 1980's. OTC, along with Telecom, was corporatised, and given a far more commercial mandate. It was also clear that competition was in the air. This was an environment which could encourage and reward risk-taking.

12. And just as regulatory reform helped create the initial response, so regulation helped kill it off. As the World Bank has emphasized, the policies necessary to benefit from electronic commerce are similar to those needed to take full advantage of trade, including an efficient services sector, especially with respect to telecommunications,

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1 Banks, G, "The drivers of Australia's productivity surge", Paper presented at *Outlook 2002*, hosted by the Department of Industry, Tourism and Resources and the Australian Bureau of Agriculture and Resource Economics (National Convention Centre, Canberra, 7 March 2002).

2 See Bresnahan, T, Brynjolfsson, E and Hitt, L, "Information Technology, Workplace Organization, and the Demand for Skilled Labour: Firm-level Evidence" (February 2002) *Quarterly Journal of Economic*s 339-376; Parham, D, Roberts, P and Sun, H, *Information Technology and Australia's Productivity Surge* (Productivity Commission Staff Research Paper, AusInfo, Canberra, 2001)..

and importantly, competitive markets without unnecessary constraints on how firms operate.[3]

13. These points are of obvious importance as we move forward. Australia has invested a great deal in ICT, with expenditure on related products and services in 1999 exceeding US$36 billion, placing Australia among the top ten countries in the world.[4] Given the relatively short life times of ICT assets, it is obvious that substantial further investment lies ahead. This investment, along with similar investment in the rest of the world, will create important opportunities for further gains from new ICT-induced patterns of trade.

14. The question then is whether and how an FTA can help ensure that these opportunities are promptly and fully taken up. More specifically, can an FTA help us secure policies that maximise the prospects for growth? This leads me to a discussion of the challenge ahead.

Challenges: Sins of commission and sins of omission

15. In considering this challenge, I would point in particular to the need to wrestle with potential differences in policy settings relating to what (continuing with my theme above!) can be best called sins of commission on the one hand and of omission on the other.

16. **Sins of commission** are the 'unfinished business' on the part of one country with respect to ensuring open and equal access of firms from other countries to their economies. These may, for instance, take the form of remaining tariffs and quotas in

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3 World Bank, *Global Economic Prospects and Developing Countries 2001* (unpublished proofs, Washington, Dec. 2001), Chapter 4, 1.

4 The Australian APEC Study Centre, *Issues and Implications: An Australia–USA Free Trade Agreement* (Monash University, Australia, August 2001) xiv, 64.

one country or subsidies that continue to discriminate in favour of local firms and against firms from the 'free trading' partner country. These issues are, comparatively speaking, easy to resolve as they go to the heart of what is needed in a free trade agreement--a mutual lifting of trade barriers.

17. One example of an outstanding issue relating to sins of commission is the policy of foreign ownership restrictions on telecommunications companies in Australia. However roughly symmetrical concerns would be raised by the policy contained in the Bill proposed by Congressman Ernest Hollings, which if implemented would mean that telecommunications companies that are more than 25% owned by foreign governments would not be able to buy US telecommunications companies. This is not to say, obviously, that the Hollings proposals are in any sense desirable – rather, it seems to me that the best solution would be to dismantle foreign ownership restrictions altogether.

18. Difficult as these issues are, even more difficult to resolve in the context of ironing out a FTA are **sins of omission**. This complication arises because what are fundamentally at issue are legitimate differences of opinion with respect to policy. For instance, the US firm Primus has alleged that the current Australian access regime unduly favours the incumbent player.

19. Differences in competition and regulatory policy between jurisdictions reflect differences not just in approach given the same ends but also different preferences for particular outcomes over others (such as different emphases placed on competition or efficiency, or on speed versus accuracy).

20. None of this is meant to suggest that there is little scope for harmonisation of competition and regulatory policy. Quite the opposite.

21. Rather, I propose that one useful and important element in an FTA could be a bilateral agreement on principles of sound competition policy and regulation. Such an agreement, covering keys areas where sins of omission arise, would not only enhance efficiency domestically, but it could also secure the gains of trade

liberalisation, most notably by preventing gains from opening markets to investment and trade from being undermined by harmful or unnecessarily restrictive domestic policies.

22. To achieve maximum benefit for the Australian economy, an important element in such a principles agreement should be the neutral, consistent, and universal application of competition policy. Of course, this does not mean that there cannot be exceptions in situations where public benefit concerns warrant. But it does mean that any exceptions should be rigorously and independently tested, and publicly so, on a regular and periodic basis.

23. Another key element of a FTA between Australia and the United States is that regulation, apart from competition policy, should be consistent with certain basic requirements. By "regulation" I mean policies that affirmatively tell firms what to do, in contrast to competition policy, which tells firms what they are prohibited from doing.

24. The regulatory policy that arises from an FTA should not constrain market processes any more than necessary to meet the objective of that regulation. Again, as is the case with competition policy, this approach should be reached through a joint process between Australia and the United States. As with competition policy, conformity to regulatory policies that introduce the minimum level of market interference is best reached through a process of rigorous, public and independent testing, on a regular and periodic basis.

Regulatory and competition policy differences

25. Is such an agreed set of principles possible? I believe it is. However, in considering what it might involve from a practical perspective, and why it would be useful, it is important to understand what the current underlying differences in approaches between the US and Australia are—in other words, we need to explore the potential 'sins of omission' that each trading partner may see in the other.

26. One noticeable difference between the US and Australia with respect to the **'architecture'** of combined regulatory policy and competition policy and their application to ICT industries is in the scope and location of enforcement powers.

27. In Australia, the regulator of the telecommunications industry, the Australian Competition and Consumer Commission (ACCC) has a very broad range of powers relating to not only consumer protection in this industry, but also the determination of access pricing and the administration of an industry-specific anti-competitive conduct regime.

28. The ACCC's equivalent on these matters, the Federal Communications Commission (FCC), is also responsible for the setting of access prices and has consumer protection powers. It is also responsible for rule-making on matters related to conduct (other than access) that come under the scope of the Telecommunications Act 1996 such as those governing entry of ILECs into particular markets. However there is no comparable power to administer a special anti-competitive conduct regime. In this important respect, the ACCC has – and has shown every willingness to use -- far greater powers than its US counterpart.

29. Additionally and importantly, the scope of the FCC's regulatory powers is circumscribed by judicial rulings in a manner not comparable to that faced by the ACCC. One example of this is the clear importance of the Supreme Court's decision in *Verizon Communications v. FCC*,[5] which put an end to nearly seven years of Regional Bell Operating Company ("RBOC")-driven litigation surrounding the Telecommunications Act of 1996. In contrast to US reliance on the Courts, in Australia, the Government has proposed to limit, quite drastically, the scope for appeal from comparable decisions by the ACCC.

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5 *Verizon Communications v. FCC,* No. 00-511 (S.Ct., May 13, 2002).

30. None of this is being pointed out to suggest that one approach is unambiguously better or worse than the other. Rather it is to highlight the clearly different traditions underlying the Australian and US regulatory approaches to telecommunications-specific legislation.

31. At the risk of over-generalisation it may be said that the Australian approach relies more on 'hands on' administration and direct intervention by the regulator into the industry. The benefits of this are possibly greater 'speed' and some certainty of rules ex ante.

32. By contrast, court rulings on specific provisions in the governing statute circumscribe the powers of the regulator in the US, making overall administration and intervention relatively more court-based and litigation centred. This may reflect a preference for a greater degree of overall accountability of regulatory practice. It may also reflect an implicit policy preference for reducing excessive permeability of the regulatory process to industry insiders' in order to avoid 'rent seeking' problems.

33. The contrast between US and Australia that is apparent in the area of regulation also finds its way into the **content** of competition policy.

34. Under the Australian approach to competition policy (and I am referring most notably to the provisions of Part IV of the TPA), specific practices are prohibited, unless they have been explicitly authorized. The relevant legislation seems aimed at specifying the conduct that may be caught in an exhaustive way. Examples of this approach are the specific *per se* prohibitions on exclusionary provisions, price fixing broadly defined, third-line forcing, and resale price maintenance.

35. In contrast, US competition laws are primarily set out in very general provisions, which are then interpreted and re-interpreted by the enforcement agencies and the courts. The generic terms in which the provisions are formulated allow for on-going adaptation to changing economic views. This approach has facilitated numerous shifts in doctrine by the courts to reflect changes in economic theory, and notably in our understanding of what is efficient.

36. For example, American courts have dramatically changed their stance towards vertical restraints since the 1970s. Equally, there is now no real equivalent in the US to the serious restrictions on joint ventures that can arise from the 'black letter law' approach our Courts adopt to the collective boycott provisions of our TPA.

37. Once again, each of these approaches has its own merits and demerits. The more 'specific' Australian approach provides greater ex-ante certainty in the law. At the same time it constrains the degree to which interpreters of that law can adjust the application of the law to changing conditions. Australian law is more dependent on constant revisions to the detail of legislative provisions by legislators themselves if the underlying policy behind the legislation is to adapt itself to new conditions.

38. Moreover, it needs to be recognised that the differing approaches are at least partly a reflection of different policy presumptions in the Australian and US system of governance. For instance, there are similarities between the more legislator-driven policy making in Australian competition law and the Australian approach to constitutional law which allows less scope for judicial policy making.

39. These differences must be accomodated in any consideration of greater harmonisation of competition and regulatory policy. But the common commitment to the principles of economic efficiency should allow Australia and the US to agree on the goals we will seek to pursue in this area, and to review and where necessary revise the means by which we do so.

40. This is especially important for the Australian ICT industries. The relatively prescriptive and detailed nature of Australian competition and regulation can and at times does create serious roadblocks to growth and change. For example, the way the price fixing provisions operate in the TPA substantially hinders efficient network joint ventures. Periodically testing provisions such as these and their enforcement, and our regulatory apparatus and its implementation, against US thinking and experience, can provide an important means of identifying areas where adaptation is needed.

Conclusion

41. A bilateral agreement on principles of sound competition policy and regulation is one of the most promising opportunities to come from a FTA between the US and Australia. This agreement would not only enhance efficiency domestically, but it could also secure the gains of trade liberalisation, most notably by preventing gains from opening markets to investment and trade from being undermined by harmful or unnecessarily restrictive domestic policies.

42. In order to pave the way for such an agreement, there must be a careful dialogue on and scrutiny of the respective traditions of competition and regulatory policy-making in Australia and the US. Irreconcilable differences will inevitably exist because of legitimate differences of opinion with respect to policy. However this does not rule out the possibility of some harmonization. The ever growing scope for gains from trade can make harmonization well worth pursuing.

43. Here, as ever, the insights of Nash and the concept of Nash equilibrium are especially relevant to the practicing economist. The Nash at issue, however, is not the mathematician John Nash but rather Ogden Nash the poet, who penned this worthy advice to youth:[6]

> Don't bother your head about the sins of commission because however sinful, they must at least be fun or else you wouldn't be committing them.
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> It is the sin of omission, the second kind of sin,
> That lays eggs under your skin.
> You didn't get a wicked forbidden thrill
> Every time you let a policy lapse or forget to pay a bill;

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6 Ogden Nash "Portrait of the Artist as a Prematurely Old Man" in *The Ogden Nash Pocket Book* (Pocket Books Inc., New York, 1944) at page 83 and follows.

No, you never get any fun
Out of things you haven't done.
The moral is that it is probably better not to sin at all, but if some kind of sin you must be pursuing,
Well, remember to do it by doing rather than by not doing.

44. Doing something about the things we don't do, or don't do right, should therefore be one more area where international agreement can contribute to advancing both our economies in the years ahead. For after all, even if Australia's role in the supply of international sex lines has all but disappeared, we can be sure that the world market for sins of commission will only ever grow. Providing greater and more effective scrutiny over our domestic competition and regulatory policies can only increase our prospects of competing not only in today's markets but also and most importantly in those we currently cannot even imagine.