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Dear Ian,

This letter represents our private, professional opinions, which are not necessarily those of the Pharmacy Guild of Australia.

We came away from the meeting in Melbourne on 3 December believing that you and the other Review members present had not understood the main analytical arguments put in the PGA submission to which we contributed.

The Draft Review made certain recommendations concerning the regulation of pharmacies. In our opinion, the published bases for these recommendations are deficient and defective. The PGA submission lays out the argument and evidence.

A fundamental deficiency of the Draft Report lies in the competition principles it enunciates and which are claimed to underpin all the recommendations. According to those principles, restrictions on competition should only be accepted if they are the 'only' way of achieving public policy objectives.

This formulation leads to the absurd result that restrictions on competition should be rejected even when they are a more efficient means of achieving public policy objectives than the relevant alternatives.

The correct public policy criterion to be met before policy X (say, scrapping the location and ownership rules) displaces existing policy Y (the current rules) is that the responsible authority needs to be convinced that X is feasible, and better than policy Y, in the sense that it more fully achieves policy objectives. Equivalently, existing policy Y should only be rejected if a properly specified and evaluated policy X is superior to it. This is the criterion we proposed, and which we suggested should be implemented in terms of assessments of social welfare.

At the meeting of 3 December, you seemed to propose a different criterion, namely, that policy Y should be rejected unless it can be shown to be the best of all possible policies. There was the added implication that even were the current rules shown to 'work', in the sense of achieving public policy objectives, they should be rejected unless it is shown that they are the optimum in the full set of possible policies.

We believe this formulation is no less absurd than that set out in the draft report. Indeed, analytically, it is closely related to it, at least in the sense of requiring the analyst to evaluate the full set of possible options. Public policy does not require such 'existence' proofs—that there exists no policy superior to policy Y. Despite many years of experience in public policy, we are unaware of any instance in which the test for policy evaluation has been framed in those terms.

The standard methods recommended and used in public policy decision-making are Cost-Benefit Analysis or Cost-Effectiveness (in their many varieties). As has been recognised in successive Commonwealth guidance, these compare a discrete number of candidate policies, not all imaginable, feasible policies. This is what was done in the PGA submission.

There is a second element of principle, which you seemed to reject at the 3 December meeting. This is that the onus of proof lies with the decision-maker (government or its agents) and not with others, to show that existing policy Y is superior to proposed policy X. As the submission noted, collective self-interest gives the affected parties an incentive to attempt to show that a change, from policy Y to policy X, would be detrimental. Nonetheless, the responsibility for the decision lies with government; and government would be remiss in its duties if it were to jettison existing policy Y in favour of policy X, without first reassuring itself that such a change would be beneficial. Naturally, in arriving at a state of reassurance, government (and its advisory agencies) cannot be content merely with the submissions made by interested parties. But that does not excuse it from the need to properly specify the alternative it has in mind and subject that alternative to transparent, rigorous testing.

At the meeting, Michael O'Bryan asked whether deregulation would not maximize consumer surplus. The implication was that because long-term consumer welfare was the objective of competition policy, deregulation was a candidate policy to replace the existing arrangements (or an element in such a replacement policy). Because this question was posed more than once, evidently the responses were not accepted.

Our responses were three-fold. First, economic theory tells us that strict conditions are needed to ensure that free, decentralised choice of location of supply outlets would maximize economic welfare. Indeed, as well as underpinning the locational restraints often imposed by vertical arrangements in competitive markets, the sub-optimality of decentralised locational choice provides the basic efficiency rationale for zoning laws. An appendix to the submission shows this for the simplest, classic Hotelling case but there is a vast and well-known economic literature that generalises this point to a broad range of settings.

Secondly, the CBA reported in the submission directly tests this proposition—and shows that a specific deregulation (supermarket entry) would worsen consumer welfare.

Thirdly, the very existence of the PBS scheme itself indicates that government places more weight on the welfare of certain consumer groups than others—and those differential weights will not automatically be taken into account by retailers able to select location (or ownership form) freely. As we have stressed, the Commonwealth purchases dispensing services on behalf of consumers; it is its valuations, not market weights (which obviously depend on consumers' incomes) that matter in judging the scheme's efficiency.

Additionally and importantly, changes in market structure that consumers' individual decisions can impose a fiscal externality on the Commonwealth, insofar as they (1) resulted in a market structure in which the Commonwealth's bargaining power was diminished, and/or (2) required the Commonwealth to rely on other means of achieving its access and service quality objectives. Given the fact that the bulk of costs are borne by the Commonwealth, at least in a financial sense, and hence by taxpayers, it makes no sense to evaluate the outcomes of the location and ownership rules solely from the perspective of consumers 'voting with their dollars'.

This third response links with your own line of questioning. You noted that previous regulations had not secured the continuation of the full-line wholesalers and so CSO payments were arranged. Why then, you asked, had the submission not discussed the use of CSOs in retail pharmacies?

We were puzzled by this question. The mere fact that the wholesalers and retailers are in the same supply chain seems to us very much less relevant than the fact that there are over 5000 pharmacies in Australia, and a handful of drug wholesalers. Moreover, wholesaling is a transport business: so long as delivery standards are met, the location of facilities is irrelevant. We have therefore struggled to understand the question's bearing on the current rules. The submission discusses a far more relevant comparator: the many schemes designed and failing to achieve an acceptable geographic dispersion of medical practitioners.

Finally, your attention has no doubt been drawn to the Post Implementation Review of the Pharmacy Location Rules, available too late for the PGA submission:

<http://ris.dpmc.gov.au/2014/11/25/pharmacy-location-rules-post-implementation-review-department-of-health/>

We especially note the comment on Remuneration Based Incentives: ‘On the costs side, there would be a high degree of administrative complexity to overcome. The Government would likely find this alternative highly problematic, particularly from an implementation perspective’ (p. 23).

The PGA submission provides evidence that the current arrangements have yielded excellent (and competitive) access for all, and especially for those likely to be more heavily reliant on PBS medications and those located outside the capital cities. The Draft Report offers nothing by way of evidence to the contrary. And while it points, in vague terms, to possible alternatives, it does not specify those alternatives nor subject them to serious policy evaluation. Clearly, the Panel would need to do so before it concluded they would better meet community objectives than the current arrangements.

Yours sincerely,

Henry ERGAS and Jonathan PINCUS