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The Paradoxes of Humanitarian Aid

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DURING the 1990s, an increase in the occurrence of humanitarian disasters has led aid organisations to expand their emergency response capacities, and the allocation of government funds and private donations to emergencies has reached unprecedented levels. Development assistance, which focuses on longer-term economic, political and social improvements in the well-being of poor or vulnerable communities, has stagnated in many parts of the world, while humanitarian aid, which aims to alleviate life-threatening suffering and help communities traverse periods of crisis (Brauman, 1995:10), has become the most common form of aid in states deemed to have collapsed.

Australia has followed this global trend. By 1993/94 emergency relief activities had become the largest area of Australian Agency for International Development (AusAID) funding to non-government organisations (NGOs), representing 38 per cent of total aid allocations (AusAID, 1995:10). Total multilateral and bilateral emergency aid grew from US$40.1m in 1988 to US$54m in 1991 (AIDAB, 1994:89). Hence, emergency relief represented 5.4 per cent of total official development assistance in 1995/96 (Downer, 1997), up from 3.6 per cent in 1988 (AIDAB, 1994:89). But in spite of this increase in emergency activities, Australian aid organisations, both government and non-government, remain intellectually focused on development. Little debate takes place in Australia about the impact of emergency operations and ways in which aid agencies can improve the effectiveness and efficiency of their interventions. Characterised by the rapidity of the response, the scale of the problem, and notions of 'complexity', 'chaos', and 'anarchy', emergency aid operations are often excused from the scrutiny which is accorded to development programs.

In this article, it is suggested that this lack of debate reflects a culture of justification surrounding Australian aid and the language associated with humanitarian crises. The extent to which humanitarian aid can have unintended negative consequences is illustrated, and the effectiveness of AusAID's mechanisms for ensuring that Australian aid does not have harmful consequences is examined.

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The Australian Non-Debate in a Culture of Justification

According to Hobbs and Goldsworthy (1996:xx), humanitarian aid programs, while important, 'do not fit well with the broader policy which drives the [Australian aid] program and are largely reactive in nature'. In the same vein, the Committee of Review of the Australian Overseas Aid Program (which in 1997 produced the Simons Report) admits that it was not able to examine in depth the issues affecting 'complex emergencies'. It visited only one emergency setting, a well-established refugee camp on the Kenya-Somalia border. Nevertheless, it characterised emergency situations by their 'complexity, speed and confusion' and recommended that 'while immediate relief aid is essentially a reactive element of the overall aid program, longer-term rehabilitation support does lend itself to programming, critical assessment and evaluation ... and should be managed in this way' (Committee of Review of the Australian Overseas Aid Program, 1997:279). This statement implies that emergency aid need not undergo the critical assessment and evaluation to which rehabilitation and development programs are subject.

The complexities of providing humanitarian aid are not openly discussed in Australia in part because the provision of assistance to underdeveloped or disaster-prone countries is not universally believed to be a moral duty or in the interests of Australia. The general public is largely unaware of the economic, moral, political and strategic arguments for and against the provision of aid; and the government aid budget and independent NGO activities must be justified to taxpayers and private donors in terms which will be understood and supported by the average citizen. For example, the AusAID web site shows that, out of each $100 of government spending, only $1.20 is spent on aid, compared with, *inter alia*, $36 on social security and welfare, and $8 on defence; it further justifies this amount by stating that most of it is spent on goods and services in Australia which are then sent to where they are needed overseas (AusAID, 1997a).

Aid agencies are compelled to present their activities in a positive light and to highlight the successes, but not the failures, of aid projects. Since the public, upon which aid agencies are so dependent, may stop giving at the slightest suggestion that their money is not having the intended effects, failures are downplayed with the excuse that 'at least we tried'. As a senior NGO representative was quoted as saying in Ethiopia,

> You can't confuse the public with complex issues. Starving babies and droughts are something people can understand. But trying to explain corruption or aid abuses is not going to help our fund-raising and will only hamper our work. (Girardet, 1993:46)

Yet aid organisations owe their beneficiaries an honest discussion about the dilemmas of humanitarian aid. The Australian government spent A$84m on emergency relief in 1995/96 (Committee of Review of the Australian Overseas Aid Program Simons Report, 1997:281). In addition, NGOs raise millions of dollars from the Australian public; $30m was raised for the Rwandan crisis alone in 1994

(Committee of Review of the Australian Overseas Aid Program, 1997:284). The revenue raised and allocated to disasters, although the most visible component of the response to the Australian public, is only the first step; the provision of aid does not automatically lead to the alleviation of suffering. It is only through recognising that aid can have ambiguous outcomes that aid organisations can attempt to minimise the negative aspects of their work.

'Complex Emergencies' and the Paradoxes of Humanitarian Aid

The provision of aid in an emergency situation, whether a natural disaster or the consequence of war, can result in outcomes which were not originally intended. These are not always negative, but the paradox of aid lies in the fact that sometimes aid itself can play a role contrary to that which is anticipated. The paradoxical consequences of aid tend to be heightened in situations of conflict, where aid can become a stake in war, often without the cognisance of aid organisations. In the past few years, however, European humanitarian agencies in particular have begun to wonder whether their impact in conflict zones is at best marginal or a part of the problem at worst.

The language used to describe humanitarian crises, and the emphasis placed on differences in the global environment between the Cold War and the post-Cold War periods, tend to depict the current dilemmas of humanitarian aid as an unavoidable by-product of the 'new world order'. 'Complex emergencies' is the fashionable euphemism for post-Cold War humanitarian crises, and accompanies notions of 'chaos', 'anarchy' and 'mindless violence' which 'new barbarism' theses (Richards, 1996:xiv-vii) like those of Robert Kaplan (1994) espouse. The term 'complex emergency' is designed to associate the multiple causes of disasters with the multi-faceted direct or indirect consequences, such as large population displacement, famine, and significant mortality (Burkholder & Toole, 1995:1012). The term has been thrust to the fore of emergency response jargon to reflect the need for a broad and integrated response which, for the United Nations, requires a system-wide effort (Duffield, 1994:38).

The complexity of emergencies, however, seems to have more to do with the response of the multiplicity of actors in the humanitarian field than with differences in the causes of suffering between the Cold War and the post-Cold War periods. Humanitarian actors have proliferated greatly since 1990 and each aid agency is armed with a different self-imposed mandate, competing with others for a share of the relief budget. Evaluation reports of emergency operations invariably call for more coordination among agencies in these times of 'complex' problems, a call which is certainly valid. But the causal emphasis is placed on the changed environment in which aid is provided rather than the aid effort itself, and permits aid agencies to excuse failures in this 'anarchic' and 'chaotic' context. Furthermore, this differentiation of Cold War emergencies from post-Cold War emergencies allows aid organisations to minimise the relevance of the lessons of the past.

While the end of the Cold War altered certain aspects of the provision of aid (elaborated below), the paradoxes of humanitarian action and the causes of suffer-

ing remain fundamentally the same. In fact, it was the lack of acknowledgment of the perverse effects of aid, or, in some cases, an overt misuse of the 'humanitarian' nature of aid during the Cold War which has hampered an earlier analysis of the paradoxes of aid. A review of the most significant and publicised relief efforts of the last 30 years shows that aid situations are invariably complex and pose fundamental dilemmas for aid organisations. The 1967 declaration of independence of the province of Biafra from Nigeria, for example, provoked a civil war in which Nigeria blockaded the secessionists' territory, provoking widespread famine. The Nigerian government restricted aid organisations' access, and more than a million people are thought to have perished. When aid organisations gained admittance, the secessionists were facing military defeat. The Biafran insurgents then used the famine to turn public opinion in their favour, and became increasingly intransigent in negotiations with the government at the expense of their own people. The world's first televised famine generated unprecedented sympathy for the victims of Nigerian oppression and the aid and media networks became a tool in the hands of General Ojukwu.[1]

Similarly, the 1984-85 emergency in Ethiopia was not unicausal, as the opposite of 'complex' implies, but was a result of government policies combined with drought. As in Nigeria, aid had unintended consequences, inadvertently supporting the government policy of forced relocation of villagers living in the north. People were attracted by aid to the 'displaced camps' established by humanitarian organisations, which became 'relocation camps' for the government. Of 800,000 people moved to marginal land in the south, some 200,000 died (Brauman, 1997:xxiii).

Although the paradoxes of humanitarian aid are not new, the end of the Cold War has altered the way in which conflicts are fought and increased the visibility and thus the stakes of humanitarian aid in war. Adherence to state sovereignty has diminished,[2] and external interference in a nation's affairs is defended on humanitarian grounds: hence the military-humanitarian interventions in northern Iraq, Somalia, the former Yugoslavia, Haiti and Rwanda. Aid organisations, relegated to refugee camps on the periphery of conflicts during the Cold War, have since gained access to the heart of conflicts. In these predominantly internal conflicts which are free of the East-West ideological context, combatants have adopted strategies which Jean-Christophe Rufin (1996) calls 'predation' and 'criminalisation' in pursuit of war. Lacking patronage from above, belligerents prey on the local inhabitants for sustenance, and make economic resources and infrastructure their target. In Liberia and Sierra Leone, for example, villages are subjected to looting sprees and terror, and government and rebel forces fight over diamond mines. Charles Taylor funded the National Patriotic Front of Liberia for over six years through 'criminalisation' practices; within only six months of the launch of his offensive in

[1] This analysis is limited to the implications of humanitarian aid in the Biafran war. It is not intended as a comment on the justness of the Nigerian or Biafran cause, which is beyond the scope of this article.

[2] The extent to which sovereignty has eroded is a contentious issue and is beyond the scope of this article. See Camilleri and Falk (1992) and James (1995) for aspects of the debate.

Liberia, his movement had earned over US$3.6m from timber exports to the EC (*The Guardian*, 25 June 1991). Opium in Afghanistan, precious stones in western Cambodia, and gold in Zaire serve the same purpose for rebel factions.

Humanitarian aid carried into the heart of conflict becomes a target of 'predation' and 'criminalisation'; since humanitarian supplies are invariably the largest external resource arriving in a war zone, control of aid becomes an objective in itself. When convoys are robbed and protection payments made to secure roads, vehicles, houses or airports, this finance sustains the economy of the war. Through establishment of checkpoints and imposition of taxes, armed groups can ensure that their soldiers are fed or paid. In ex-Yugoslavia, the Serbs appropriated some 30 per cent of aid destined for Sarajevo; in Mozambique, a tax of $150 per tonne was levied on all aid flights to the interior; in Somalia, hundreds of dollars a day were paid for permission to land relief flights at Baidoa airport; and in Iraqi Kurdistan, the official exchange rate imposed on the UN contributed US$250m to the Iraqi budget in 1992 alone (Jean, 1996:568-70).

Humanitarian aid can become a tool in the control of populations since needy people will move to the site of aid if possible, and if not, humanitarian aid will try to move to them. In Liberia, factions held populations hostage, preventing them from leaving in order to attract aid to their region. In Bosnia, humanitarian organisations were caught in a deep dilemma: to bring aid to towns encouraged the occupants to stay, thereby risking their safety at the hands of the opposition, but to encourage them to leave was to comply with the objectives of 'ethnic cleansing'. In the Rwandan refugee camps in Zaire and Tanzania, aid directly empowered the refugee leadership, many of whom were accused of genocide, by giving them the reins of the distribution networks through which they exerted control over the refugees, and discouraged repatriation to Rwanda.

Humanitarian aid, through the services it brings, can also confer on individuals or regimes in situations of conflict a degree of legitimacy, both with their own people and (if the world's media are present) internationally.

But perhaps the most profound paradox of humanitarian aid is the camouflage it can provide to politicians for their indifference to the causes of the crises that create the need for humanitarian assistance. Wars are political and need political solutions. Politicians are reluctant to become directly involved in crises that do not affect their national interests; but, to appease their domestic constituencies, they need to appear to be addressing the problem. Humanitarian aid allows them to do this. When French President Mitterrand was asked what he was doing to stop the Rwandan genocide, he said that the government was allocating funds to two humanitarian aid agencies. This, and inaction on the part of the international community as a whole, prompted Médecins Sans Frontières to launch a campaign proclaiming that 'you cannot stop a genocide with doctors'.

Unless humanitarian organisations become more outspoken and resist allowing themselves to be made substitutes for political action, they risk becoming accomplices in the deception. Unfortunately, many agencies nowadays are either too financially dependent upon governments and the UN to confront the issue, or risk

jeopardising their providers of independent revenue if they question the notion that 'something is being done'. The greatest challenge to humanitarian organisations today is to minimise such paradoxes. Yet despite general acknowledgment by agencies of the role refugee camps along the Thai-Cambodian border played in the survival of the Khmer Rouge, the same mistakes were made in the Rwandan refugee camps of Tanzania and Zaire. Why are the lessons of the past not heeded? Part of the answer may be that the documents like the Simons Report and the Australian Council for Overseas Aid (ACFOA) Code of Conduct stress the need for accountability to donors and taxpayers, but pay insufficient attention to accountability to the beneficiaries of assistance programs themselves.

There is no global body to judge whether an NGO's activities are appropriate or efficient. It is difficult to envisage a global regulatory agency which embodies *the* moral standards to which agencies should adhere, or *the* appropriate way in which aid should be delivered. But at least donor governments should be aware of the wider impact of the aid programs they finance. They have the power to stop funding a project which is detrimental to the beneficiary population, and they can pose questions about the broader impact of a project which may stimulate introspection on ways in which the negative consequences of aid can be minimised.

Monitoring Australian Humanitarian Aid

According to the Simons Report, emergency assistance 'is the part of the [Australian] overseas aid program that has the most visibility and receives the most public attention' (Committee of Review of the Australian Overseas Aid Program, 1997:279). Thus one would assume that assurances of its effectiveness and appropriateness would be a priority for AusAID. The 1994 Government Review of Humanitarian Relief Programs, however, admits that there is little field monitoring of the activities supported by AusAID (formerly Australian International Development Assistance Bureau, AIDAB) other than through the implementing agencies themselves (AIDAB, 1994:vii), and concluded that increased resources need to be devoted to field monitoring of humanitarian relief programs both by AusAID staff abroad and in Canberra. But a recent evaluation of the extent to which the 1994 review's suggestions have been adopted by AusAID found that no additional resources have been devoted to field monitoring, and that new administrative procedures exclude provisions for field monitoring visits. It also found that the prevailing view in AusAID is that the Humanitarian Relief (HUR) Section does not have the resources to monitor projects directly, and that it is more effective to monitor the monitoring process established by implementing partners such as NGOs (Broughton, 1996a:7).

This raises the question whether such reviews are merely cosmetic rather than serving the requirements of transparency and accountability. Whatever the case, the relatively small size of the aid budget necessitates decisions on the cost-benefit analysis of Australian aid, and the establishment of firm priorities. Resources allocated to monitoring and evaluation processes will divert funds from potential projects in the emergency response operation. However, as Peter Urban (1997) argues

in a critique of the Simons Report, the aid program needs to include delivery efficiency in its definition of aid effectiveness, and this is possible only through the establishment of a framework through which aid policies can be assessed.

The recent 'NGO reform package' introduced by AusAID (1997b:137-75), however, is aimed at reducing administrative processes for AusAID officers, by increasing the responsibility for approved management procedures and financial accountability to NGOs, at least on paper. NGOs must undergo an accreditation process to show that they can responsibly manage AusAID funds. While this exercise has assisted NGOs to develop thorough accounting procedures and reporting formats, and has been appreciated by the majority of NGOs (Hunt, 1997), little attention is paid to assessment or evaluation of the overall impact of aid projects. The reform authorises NGOs to evaluate their own projects; in effect, if the reporting criteria are satisfactorily met, AusAID requirements will be fulfilled.

AusAID has delineated two levels of accreditation: 'base level', which entails an NGO appraisal in Australia and for which the ceiling of funding is $100,000; and 'full accreditation', for which a more detailed NGO assessment is required. The HUR section has a funding floor of $150,000, thus necessitating full accreditation for access to this scheme. The full accreditation procedure consists of three phases. The first phase is conducted at the desk level and examines the NGO's structure, experience and philosophy, partnership arrangements, links with the Australian community, and management and financial systems. The second phase involves an examination of the same criteria at the premises of the NGO, based on physical evidence. The third phase involves a field visit to an overseas program to ensure compliance with the same criteria on the ground.

While the appraisal of the project management and financial structures of NGOs and their partners is fairly rigorous, very little emphasis seems to be placed upon the broader aspects of aid. Examination of the philosophy of NGOs is limited to ensuring that their development philosophies are *not inconsistent* with the objectives of the Australian aid program, hence leaving scope for interpretation. Ethical dimensions of the provision of aid are addressed through the requirement that NGOs be signatories to the ACFOA Code of Conduct, and formally adopt the provisions therein. But, as executive staff of ACFOA will admit, the Code of Conduct itself is oriented towards the rights of donors, not the need of beneficiaries to receive appropriate aid which will not have adverse effects.

The crux of the ACFOA Code of Conduct is transparency in advertising and financial accounting, not operational activities. Although the Code has instituted a complaints and compliance process to improve self-regulation of the aid industry, the culture of justification is likely to impede all but petty charges from entering the complaints system. In fact, in the year since the Code was adopted, no complaint has been formally lodged (Hunt, 1997). The repercussions of the allegations against CARE Australia in 1995 affected the entire aid industry; public confidence in NGOs diminished. Perhaps the need for a public show of solidarity explains why members of ACFOA, at the same annual meeting at which they unanimously adopted the Code of Conduct in 1996, welcomed CARE into the ACFOA fold

without one question publicly raised as to the status of CARE's efforts to clear its name.[3] Detailed questions may have been raised in private, but the irony of the situation was not lost on external observers present.

The HUR section of AusAID, however, has moved closer to considering accountability to beneficiaries as well as donors by obliging NGOs to adhere to the principles specified in the 'Code of Conduct for the International Red Cross and Red Crescent Movement and NGOs in Disaster relief'. This Code is oriented towards guarding standards of behaviour in emergencies which relate to independence, effectiveness and impact. The Code specifies ways in which beneficiary communities should be respected, and includes a clause stating that the negative impacts of humanitarian assistance should be minimised. But, to highlight the need for debate on aid issues, the Code puts the 'humanitarian imperative' first, stating that it is the obligation of humanitarian agencies to provide humanitarian assistance wherever needed. It thus denies the possibility that aid may not always be in the best interests of the recipients. The example of Bosnia mentioned above raises the question as to whether aid encouraged people to stay in enclaves which were then attacked by opposing forces. The aid at least gave people the choice of staying or leaving; but are aid organisations sufficiently aware of the possible consequences of their operations?

The Code is effective in increasing awareness of the principles and ethics to which aid organisations should adhere. Like the ACFOA Code of Conduct, however, it has no independent regulatory body, but is 'enforced by the will of the organisation accepting it to maintain the standards laid down in the Code' (IFRC, 1997:144). The Codes are thereby fraught with the same limitations as international law; states sign and ratify treaties and conventions, but cannot be made to observe them. Heads of agencies may agree that their organisation will adhere to the principles established, but this does not obviate the need for scrutiny by donors. The clear standards of operations contained in the Code provide benchmarks which AusAID could use in assessing the broader aspects of NGO humanitarian aid delivery.

With NGO accreditation criteria, and AusAID evaluation criteria as a whole, the measure by which 'effective overseas work ... consistent with the objectives of the Australian Aid Program' (AusAID, 1997c) is judged raises questions. Effectiveness, according to the Department of Finance and the Auditor-General, is measured by the extent to which the program outcomes achieved the stated objectives (ANAO, 1996:20). AusAID sets objectives which can be quite general, or can astutely direct Australian aid away from problematic areas: witness the Australian focus towards repatriation and rehabilitation in Rwanda instead of aid to the Rwandan refugee camps. Once individual project objectives have been approved by AusAID and funding granted, however, the evaluation of that project is based upon the ex-

[3] CARE Australia has received full-level accreditation. A response to the allegations was issued by the Minister of Justice only on 24 December 1997, more than two and a half years after the allegations were made (Joint Statement by CARE and AusAID, 24 December 1997).

tent to which the original project objectives were met. While the evaluation format includes contextual considerations which may have hampered the fulfilment of the project objectives, the overall impact or implications of the project can easily be overlooked. Thus, a project aiming to reduce malnutrition rates in a food deficit area may statistically meet the objectives. But the impact that the introduction of food may have on local prices, and hence on the incentive for farmers to produce food locally, may not be taken into account. Broughton (1996b:1) found that no humanitarian food aid project has ever been formally evaluated by AusAID, which has relied upon the reports submitted by NGOs and UN agencies.

AusAID's preference for strengthening the desk-level supervision of NGO projects over direct field monitoring seems to be contrary to trends in other parts of the world. The European Community Humanitarian Office, for example, sent individual sectoral specialists to Liberia in 1995 to examine projects. While micromanagement is inappropriate, these specialists made beneficial contributions to project design and implementation, and provided weight in difficult negotiations with uncooperative local authorities and factions. In a different role, it was staff of the Office of Foreign Disaster Assistance of the US Agency for International Development who acted as moderators in Somalia between the US troops and NGO personnel. They helped to steer military activities in directions which would complement rather than compete with NGO activities, and coordinated regular meetings among the various actors.

Budgetary constraints necessitating choices between evaluations or field operations can be eased through collaboration with other donors. The Joint Evaluation of Emergency Assistance to Rwanda, proposed by the Danish Ministry of Foreign Affairs, involved contributions from some 18 governments, and was influential in addressing shortcomings of the Rwandan relief effort. Donor governments could replicate this cooperation, perhaps on a geographical basis, to reduce the cost of sending evaluation teams throughout the world.

In order to fulfil such roles, however, AusAID staff and consultants need to have legitimacy, and be respected by experienced relief staff beyond controlling the purse-strings of field operations. If AusAID staff are to make sound judgments about the effectiveness and appropriateness of NGO programs, they need to possess the technical, practical and contextual skills with which to advise NGOs of the strengths and weaknesses of emergency activities. The drought relief program in Papua New Guinea (PNG) will be a good test case, with AusAID staff on the ground coordinating the Australian relief effort with local authorities. They face many obstacles: remote communities separated by mountainous terrain makes the logistics of relief problematic. Aircraft visibility was compromised by smoke from the bush-fires, and transportation along some of the major roads is fraught with insecurity. Population statistics are based on the 1990 census which, in addition to being eight years old, is widely believed to be inaccurate. Thus baseline data needed to calculate mortality and morbidity rates, essential to an efficient and effective response, are absent. According to reports from Australian Defence Force personnel, few mechanisms have been organised to ensure the equitable distribution of

food off-loaded on to airstrips, and the absence of beneficiary lists means that monitoring and evaluation of the relief deliveries will be extremely difficult. Furthermore, the inaccessibility of the terrain hinders aid delivery to individual villages, encouraging people to move to delivery sites. Congregations of people in limited areas could increase public health risks associated with shortages of potable water, lack of sanitary facilities, and the potential spread of communicable diseases.

The PNG drought response has started before crude mortality rates are at the level used by international humanitarian organisations to define an emergency. Thus, compared with the immediate life-saving response needed for the cholera epidemic in Goma, Zaire, or to the bombardment of Grozny in Chechnya, the early response provides an opportunity to plan and execute a program thoroughly, and incorporate lessons of past operations. AusAID personnel should also consider that the need for their intervention derives from institutional failure in PNG, and plan activities which will avoid prolonging this failure.[4] Similarly, in Bougainville aid organisations have the opportunity to consider ways of working which will support local mechanisms and not hinder the peace process. Lessons can be drawn from Afghanistan, Liberia, Angola, Cambodia, Mozambique, Somalia and Rwanda. But are these experiences noted in AusAID evaluations, or were no such evaluations conducted?

Conclusion

The aim of this article is to stimulate debate in Australia about the dilemmas of humanitarian aid, and to promote operational approaches which will consider the broad impacts of the provision of emergency assistance. Rather than fearing that such a debate would discourage the public from supporting aid activities, it is possible that such honesty would gain sympathy for aid organisations and individuals who continue to work in disaster zones, and continue to risk their lives, in spite of all the difficulties.

There is vast international experience and knowledge of emergency response programs from which lessons can be drawn. Unfortunately, terms like 'complex emergency' serve to mask the historical similarities between the causes of humanitarian emergencies today and those of the past. This language encourages us to ignore the lessons of previous operations in allegedly 'simple' times. In reality, it is the omnipresence and multiplicity of aid organisations, responding in a spectrum of specialised sectors, which causes the complexity.

Donors can play a pivotal role in driving the debate about humanitarian aid and encouraging innovative responses to avoid the pitfalls so often associated with aid provision in war. Donors should be encouraging appraisals of the context in which humanitarian aid is provided rather than focusing on the extent to which individual project objectives are met. AusAID's focus on financial and managerial accountability at the Australian level, however, is unlikely to inspire a debate about accountability to recipients: quite the reverse. The Simons Report emphasised the impor-

[4] I am indebted to a referee for this point.

tance of outcomes, and if 'risky' is interpreted from the perspective of beneficiaries rather than from that of investors, the recommendation is relevant to this discussion:

> AusAID must refocus on results. Perhaps the single biggest shortcoming in the administration of the aid program is the lack of priority afforded to evaluation. Development assistance is an inherently risky business. It should not be made riskier still by insufficient rigour in appraising proposals and evaluating results. A more rigorous assessment of results would enable the organisation to learn from its experiences. Evaluation should also be the basis of accountability. (Committee of Review of the Australian Overseas Aid Program, 1997:7)

NGO Codes of Conduct, or an independent NGO ratings agency (McLeod, 1995) are, or could be, useful tools with which to ensure that NGOs conform to a standard of practice and principles which the aid community and donors expect. It is helpful for the public and donors to see comparisons among agencies on, for example, the share of funds sent directly to the field as opposed to that spent on administrative costs. But this is only the tip of the iceberg; what happens in the field, out of the public eye, is of crucial importance to the populations to whom the public and governments are directing their aid.

There are rarely answers to dilemmas posed by situations like that of providing aid to Bosnian enclaves. But concentrating on the 'humanitarian imperative' to save lives in isolation of the larger political picture can cost more lives in the long run. It is naive to believe that good intentions are enough to make a difference; agencies have a moral responsibility to ensure that their aid is going to those for whom it is intended, and does not become a tool of belligerent groups. The only way to work towards this is to have an open and continuous discussion so that the next generation of aid workers going to the field starts rather than finishes with the appropriate analytical tools necessary for working in humanitarian emergencies.

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Committing to Trade Liberalisation in Australia

Gary Banks

NINETEEN NINETY SEVEN was an interesting year for those who thought the protection debate in Australia was over. Newspapers were full of speculation and opinion about the implications of the federal government's decisions on assistance to the motor vehicle (PMV) and textiles, clothing and footwear (TCF) industries. And a flurry of reports commissioned by the Department of Industry and industry lobby groups once again turned public and political attention to arguments for a more activist and selective industry policy. This interventionist push has clearly had some influence on the policy approaches of the government and, more particularly, the Labor opposition.

Although aspects of the current policy environment may give cause for concern, one can also find encouraging signs in the very vigour of the current debate. What we are in fact experiencing is the continuation of an approach to policy formulation that has some uniquely Australian characteristics. By and large the debate is relatively well *informed* and *open*, and the policy-making process is ultimately disciplined by a high degree of public scrutiny.

These observations indicate a theme of this article. Unlike most developed democracies, Australia has generally committed to its own trade liberalisation by sorting out the domestic implications in advance. It has experienced set-backs and side tracks along the way; it may do so again. But the direction of change has been underpinned by a relatively robust policy-making process in which the national interest has had ample opportunity to assert itself.

It is nevertheless important to reflect on what has driven Australia's reform efforts, in order not only to ensure that the conditions needed for further progress can be maintained, but also to consider how Australia's external trade policy might be more effective.

Australia Has Come A Long Way

Preoccupation with current developments can lead us to forget how far Australia has come. Useful reminders are provided by Max Corden (1996) in his 1995 Joseph Fisher lecture and by Richard Snape et al. (1998) in a documentary history of

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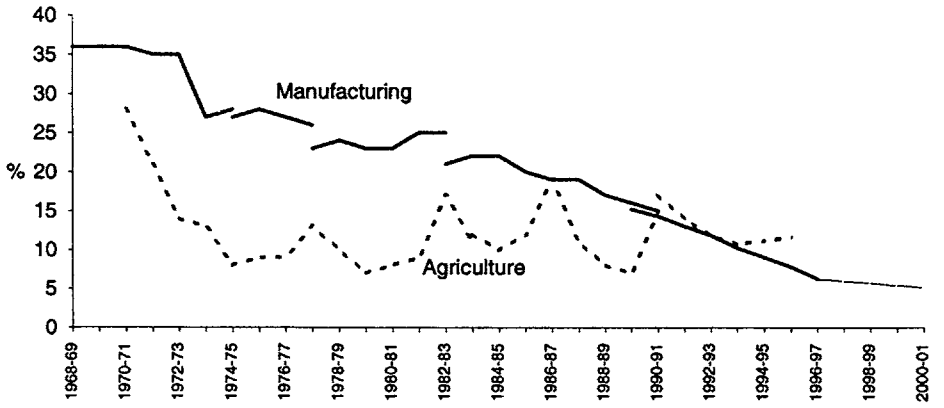
Australian trade policy, a valuable post-1965 sequel to Sir John Crawford's standard work (Crawford, 1968).

Figure 1 tells the story. Average 'net' assistance to the manufacturing sector has fallen from 36 per cent in the late 1960s (it may have been higher previously) to a projected 5 per cent in 2000. Assistance to agriculture, while traditionally well below that for manufacturing, has also fallen — although it has played a more 'countercyclical' role and the numbers are not directly comparable. (The economy-wide costs of agricultural support, which goes mainly to the dairy industry, remain much lower than for manufacturing.) While equivalent historical data are not available for the mining sector, measures of its effective assistance have traditionally been negative. This penalty should have fallen significantly with the decline in manufacturing protection.

Figure 1

Effective rates of assistance for agriculture and manufacturing, Australia 1969/90 - 2000/01



Note: Breaks in series represent re-calculation of cost structures, giving different estimates for value added and therefore different rates of assistance.

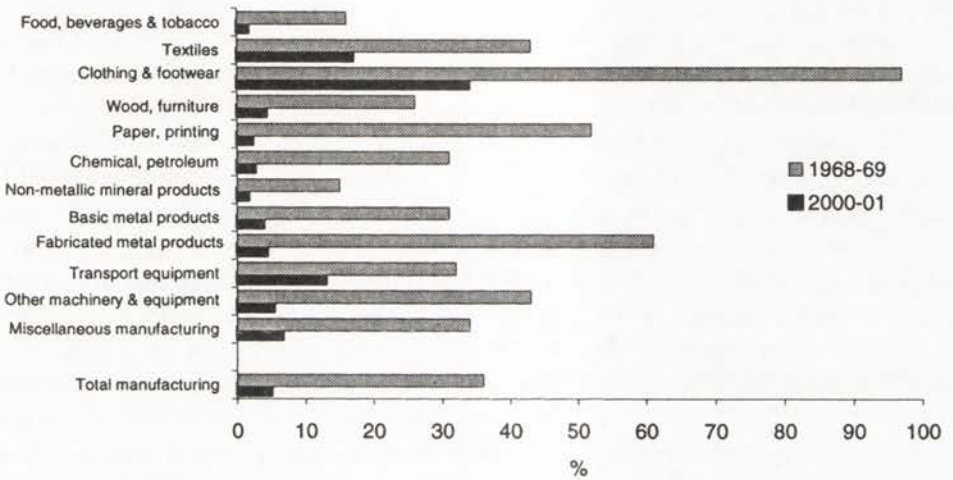
Source: IC (1995a; 1997c).

The liberalisation has been widespread among the various manufacturing industry groupings, and disparities in assistance have declined, as shown in Figure 2. It is also apparent, however, that assistance to the TCF and transport equipment sectors (which includes PMV) has been considerably more sustained than has been the case in other industries. These two sectors have been atypical, in that their assistance levels rose substantially in the decade after 1974. If the rates of assistance in 2000 — which are now finally 'locked in' — are compared with those in 1984, it be-

comes apparent how much progress has also been made in these industries (shown in Figure 3).

Figure 2

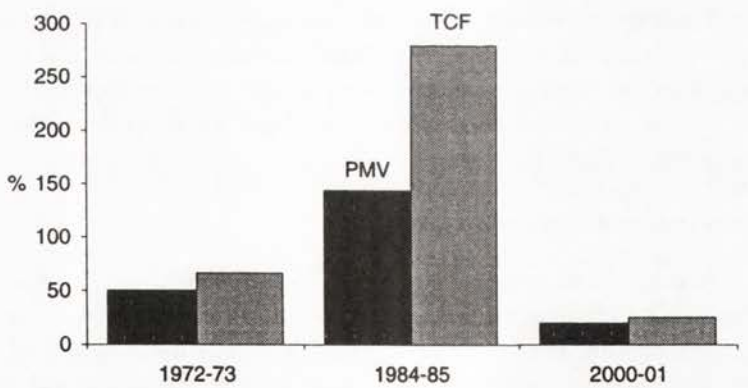
Effective rates of assistance to selected industry groups, Australia, 1968/69 and 2000-01



Source: IC (1995a).

Figure 3

The rise and fall of assistance to PMV and TCF, 1972-2001



Source: IC (1995a).

Of even greater significance than the lower assistance *rates* is the change in the *form* of delivery. Quantitative restrictions ('quotas') have finally been eradicated in favour of tariffs. Thus, the level of assistance has become more transparent and predictable, and the dynamics of foreign competition can generally flow more freely through the economy's price system.

Progress in reducing merchandise trade barriers has been accompanied by (and in some cases has precipitated) a range of other microeconomic reforms — in capital markets, public utilities, labour markets and other areas of regulation — which have exposed Australian producers of goods and services to greater competition, heightening incentives to be cost-conscious, innovative and productive. This has produced substantial benefits in lower prices, wider choice and higher incomes for Australians.

The policy-making environment today is also a great improvement on what it was in the 1960s. The oxymoron of 'protection all round', a phrase first coined by Earle Page, Treasurer in the Bruce Government of 1923-29, had become the guiding industry policy principle of that era. Consistent with that principle, tariffs were tailored to particular industries in a relentless quest by the Tariff Board to compensate domestic industries for their cost disadvantages — always provided, of course, that those industries were deemed 'economic and efficient' (as, it seems, most were). The tenor of the times is nicely captured by Max Corden's recent reflections on his earlier (1967) Fisher Lecture in which he, the epitome of an early economic rationalist, proposed the evolution of tariff-making towards nominal benchmarks of 30 per cent for new activities and 45 per cent for existing activities. As he observes, 'these were this free trader's very radical recommendations' (Corden, 1996:143.)

How did we get from there to here? In any other OECD country, the informed observer would point to the GATT (or other international trade forums). The GATT has indeed been the main vehicle for trade liberalisation activity by industrial countries. Yet it has played very little direct role in Australia's liberalisation. Moreover, the evidence suggests that the GATT's achievements elsewhere, while significant overall, have been seriously compromised in some sectors and suffered setbacks in others, especially when the rise of non-tariff measures (domestic subsidies, bilateral restraint agreements, anti-dumping and so on) is taken into account.

Dealing with these issues requires us to step outside the traditional approach to trade policy as an international issue, and to consider it as principally the outcome of *domestic* forces. To do this we need to confront some home truths about the political economy of protection.

Biases in the Policy-Making Environment

For trade liberalisation to involve meaningful commitments and durable progress, whether in goods or services trade, it must overcome a systemic protectionist bias in domestic policy-making environments. One well-recognised aspect of that bias flows from the uneven incentives facing those seeking assistance and those who eventually bear the burden of it to become informed and organise themselves to lobby government. This imbalance has been summed up as 'concentrated bene-

fits, diffuse costs'. It is compounded by public sympathy for the protectionist arguments of industry, which reflects nationalism and notions of fairness, generally combined with a belief in the 'free lunch'. It is much easier to point to the industry-specific costs of reducing protection or other assistance (including job losses) than it is to understand its economy-wide benefits (including the jobs to come).

It is not so generally appreciated that this uneven pressure on governments to grant rather than remove protection can be compounded by the administrative and advisory mechanisms within government itself. The main source of advice available to government in responding to industries' claims is the bureaucracy. In most countries, the bureaucracy is divided into a few central agencies and numerous line departments, the latter being established to provide a communication link with interest groups. It is well known that in these departments symbiotic relationships naturally develop with their particular client groups. But even apart from this, sectorally oriented departments will tend to be inadequate as sources of information on industry assistance. They are too specialised and have too narrow a focus to be capable of properly evaluating the broader economic consequences. How much of a compounding effect this has depends on the scope within governmental decision-making processes for the economy-wide tradeoffs to be brought out. This is where central agencies and other advisory processes have a critical role.

Depending on how these 'supply-side' tensions work out, governments can find themselves being urged to respond to industry demands for assistance on the basis of partial information, in a political environment in which the majority of the electorate is either passive or supportive of protectionist claims.

Role of the GATT/WTO

The GATT was created with these national political and institutional pressures in mind. The unhappy trade policy experience of the 1930s and 1940s convinced democratic governments that international commitments which constrained each country's freedom to 'beggar its neighbours' could also prevent governments from beggaring their own populations.

There are two sides to the role of the GATT (now the World Trade Organisation, WTO) in addressing the domestic political obstacles to reform. One is a set of international rules designed to provide stable and liberal (though not necessarily free) conditions of market access, based on the principles of non-discrimination and tariff-only protection. The other is a negotiating process, based on reciprocity, intended to create countervailing political forces to those domestic interests resisting liberalisation.

Unfortunately, the GATT did not work quite as intended. The rule of GATT law has suffered from the lack of an authoritative body to interpret and administer it (Tumlir, 1984), a defect that has been only partly addressed under the WTO. But a more practical difficulty is in the rules themselves, which are riddled with ambiguities, exceptions and exclusions, most of which reflect the interests of the very pressure groups they were designed to constrain. The two most notable casualties have been trade in agriculture and textiles.

As well, the logic of reciprocity as a means of countering domestic resistance to liberalisation is flawed (Banks, 1990). The biggest drawback is that it has fostered mercantilist attitudes to liberalisation (Robertson, 1997). As the late Jan Tumlir from the GATT secretariat once noted, the original concept of collectively maximising benefits through reciprocal trade liberalisation has been debased over time to the point where:

> liberal (free) trade is [considered] a good policy only if all countries practice it. This formulation now enables countries to use any failure of their trading partners to live up to the rules for justifying their own protectionist sins. (1983:6).

Thus, most countries have come to approach trade negotiations (and indeed the rules themselves) primarily as a vehicle for gaining access to foreign markets. Domestic liberalisation is regarded as a 'concession' — something to be minimised — rather than the most important source of benefit. It is little wonder, therefore, that negotiating rounds can take so long yet achieve so little in key areas, or that deals made in Geneva against pressing deadlines may be undone or circumvented by other forms of assistance in national capitals. Backsliding is inherent to the process.

The most telling instance of this (from Australia's perspective) coming out of the 1993 Uruguay Round was the agreement on agriculture. This contained, for the first time in the GATT, important liberalising principles of tariffication and reductions in assistance based on aggregate measures. But in practice it has involved little real liberalisation of agricultural trade because of the way the implementation modalities were subsequently manipulated (Gallagher, 1997).

The GATT's undoubted achievements have been the multilateralisation of international trade on a non-discrimination basis (creating order out of the preceding bilateralist chaos) and the substantial lowering of industrial tariffs by its industrialised members. The potential extension of core elements of liberal trade such as non-discrimination to trade in services has been a significant recent development. Against these achievements have been the protracted exclusion of sectors such as agriculture and textiles from the rules, and the rise of other forms of industry assistance that have compromised the gains from tariff reductions. Both phenomena have reflected the dominance of domestic vested interests over external process and commitments.

International Agreements and Australian Liberalisation

Like other countries, Australia has viewed the GATT much more as a means of getting better access to foreign markets than as a vehicle for facilitating domestic liberalisation. This remains largely true today. Thus, the last policy statement on trade by the previous government states that 'trade policy is about opening markets and business opportunities on the most favourable terms for Australian firms' (DFAT, 1995:6). And while the present government's White Paper on foreign and

trade Policy (DFAT, 1997) makes a significant advance in acknowledging close links between trade policy and industry policy, it also clearly sees them as being on separate tracks.

From the outset, Australian governments typically have been wary of the potential for GATT rules and commitments to constrain their freedom to act. Richard Snape (1984) notes that Australia was not initially a supporter of the GATT's fundamental non-discrimination principle. He also notes that in 1956 Australia supported the US request for a GATT waiver, essentially placing that country's non-tariff agricultural protection off-limits. The US waiver heralded the effective exclusion of agriculture from subsequent negotiating rounds.

Snape (1984:24) concludes his survey of Australia's relations with GATT thus:

> It would appear that Australia has not yet really utilised the external constraints that are available from a commitment to the principles of the General Agreement and to its rounds of trade negotiations as a means to enable politicians to resist, in the general interest, the pressure of coalitions seeking the preservation or extension of protection for particular industries.

Australia's access-seeking attitude to the GATT also ensured that, in the absence of action on foreign barriers to agricultural trade, it made relatively few concessions of its own. It was not, of course, alone in this.

Table 1 decomposes the reduction in effective rates of manufacturing assistance shown in Figure 1, according to the main sources of change. Of the 31 percentage point net reduction in assistance since 1968-69, GATT negotiations accounted for roughly 3 percentage points (or one-tenth of the net reduction). The external contribution is even less significant when viewed in the context of all the rises and falls in assistance over that period.

Those negotiated reductions which Australia did make, in the context of the Tokyo Round, are the exceptions which prove the rule about its traditional approach to the GATT. They were based on a reference to the Industries Assistance Commission (IAC) which asked it to report confidentially (an unprecedented step) on those tariff reductions that could be made 'without any adverse employment or structural effects' (IAC, 1976). The request focused on reductions to eliminate the British preferential margin, as well as on reductions in already low tariffs. In the event, the reductions covered some 900 tariff items and their timing was triggered by the devaluation of the Australian dollar in November 1976. While they reduced the average rate of manufacturing assistance, their impact on efficiency was compromised by an associated increase in assistance disparities (IC, 1995a). Moreover, in the same period, Australia was busily increasing protection for its PMV, TCF and other sensitive industries — totally outside the ambit of the negotiations.

In the Uruguay Round, Australia simply sought and obtained credit for the 1988 and 1991 tariff reduction programs, although for a few tariff items larger reductions were agreed. Australia's commitments under the General Agreement on Trade in Services have required little liberalisation other than that which has

emerged from domestic reform processes, and the extent of bound commitments is relatively small (IC, 1995b; 1996).

Table 1

Sources of change in manufacturing assistance, Australia, 1968/69 - 2000/01 (percentage points)

July 1973 25% tariff cut	–8
January 1977 Tokyo Round	–3
PMV + TCF quotas[a]	+10
TCF 1986 and other IAC reviews[b]	–2
PMV 1988	–2
Other (inc. from IAC reviews)[c]	–9
May 1988 program	–4
March 1991 program	–7
Export incentives[d]	+2
Bounties	+1
Change in industry structure[e]	–8
Net total[f]	–31

Notes: [a]Effects of increases in quota assistance to the PMV and TCF industries between the mid-1970s and the mid-1980s.
[b]Effects of post-1988 TCF plan, announced in November 1986, and phased tariff reductions for several other manufacturing industries (such as chemicals, plastics, paper and communications equipment) announced before the May 1988 program.
[c]Includes effects of the substantial depreciation of the Australian dollar in the mid-1980s on the assistance provided by volume quotas for PMV and TCF.
[d]Effects of increased use of export incentives and bounties from late-1970s to mid-1980s.
[e]Effects of changes in the relative shares of industries within the manufacturing sector.
[f] Round figure.

Source: IC (1995a).

Apart from the GATT/WTO, two other external pressures for liberalisation have been the Closer Economic Relations agreement with New Zealand and the APEC liberalisation targets. The former has involved significant preferential reductions in tariffs, but little additional adjustment pressure, at least within the manufacturing sector (BIE, 1995). The latter, while achieving remarkable consensus at Bogor in 1994 on a schedule for the completion of 'free and open trade and investment in the Asia-Pacific', is a declaration of *resolve* and contains significant ambiguities. The apparent lack of concern of those representing the PMV and TCF sectors about the Bogor Declaration and their far greater concern about the Industry Commission's recommendations (which could be seen as simply putting the APEC commitment into effect) is indicative of the relative credibility of external and domestic processes in Australia.

Domestic Factors in Australia's Trade Liberalisation

It follows that the factors driving reform in the Australian case have been almost wholly domestic in origin. The key development has been the increased capacity of policy-making processes to take an economy-wide view on industry assistance issues. Despite some setbacks, this view has increasingly prevailed over the piecemeal industry perspective which dominated in the 1960s and before. How this came about is a fascinating story in which politics, pressure groups, personalities, ideas, institutions and even intrigue all play a part, not to mention the role of timing and the influence of the business cycle.[1]

Australia is clearly not the only country to have undertaken trade liberalisation outside an international negotiating framework. New Zealand and several of our Asian neighbours have also liberalised unilaterally, as have many developing countries in Latin America and, increasingly, Africa. The countries of Eastern Europe have also embarked on more fundamental economic reform. Nevertheless, some aspects of the Australian experience differentiate it from those other countries, and may make it more relevant to the developed countries that we are keen to see liberalise further. In particular, Australia has not experienced or faced economic collapse, or been under instructions from the International Monetary Fund, or even been subject to World Bank conditionality. As well, Australia has instituted a program of trade liberalisation through a bicameral parliamentary system.

One distinguishing feature of Australia's liberalisation path has been the role of the Industry Commission's predecessors, the Tariff Board and the IAC. Table 1 shows that, before the important general tariff phase-downs of 1988 and 1991, much of the liberalisation occurred following public inquiries by the IAC. Even the 25 per cent tariff cut of 1973, while having little in common with a public inquiry, had a direct connection to that institution through the formal advisory role played by its chairman. Perhaps more important, in the preceding years the Tariff Board undertook the ground work which, for the first time, began to make transparent the extent of protection to different manufacturing industries in Australia and its costs to consumers, exporting industries (especially rural interests) and those States that depended on primary production.

The authors who have studied the rise of this new perspective on protection policy appear to agree that there were three critical ingredients:

- the development of academic economic thinking on protection issues, and in particular of methodologies for measuring relative assistance levels and their efficiency implications, of which the world's leading exponent was Max Corden of the Australian National University;

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[1] Detailed accounts are provided by Glezer (1982), Rattigan (1986), Anderson and Garnaut (1987) and, more recently, Garnaut (1994), Corden (1996) and the documentary history by Snape et al. (1998).

- the existence of institutional vehicles that promoted the new thinking, the first being the Vernon Committee (which reported in 1965) and subsequently, and more durably, the Tariff Board; and

- what might be called the 'Rattigan Factor' (after Alf Rattigan, the last chairman of the Tariff Board and the first of the IAC): a chairman who could ensure that, in the face of strong internal and external opposition, the Board could meaningfully pursue the 'economic and efficient' criteria that were supposed to have been shaping its tariff recommendations.

Snape et al. (1998:21) use a battleground analogy to describe the early struggle to subject protection policy to economic reasoning:

> On the one side were ranged many of the heavily protected industries and their industry associations, the Associated Chambers of Manufactures of Australia (ACMA), the Australian Industries Development Association (AIDA, which had grown out of the Australian Industries Protection League), and the Trade ministry; on the other were the Tariff Board, much of the economic press, most academic economists with interests in international trade, and primary industry organisations — though not the leadership of the political party which represented farmers, the Country Party. One of the main weapons of those in the freer trade camp was to bring the battle into the open. 'Public scrutiny' or 'transparency' of policy became the banner under which the Tariff Board and its successor, the IAC, were to fight. The Minister for Trade and Industry (J. McEwen) and the senior members of his department were clearly protectionist and were not keen to have the extent (and sometimes the procedures) of industry assistance publicly displayed.

In effect, the new Tariff Board was beginning to act as a public interest counterweight to the otherwise dominant influence of industries seeking assistance. It provided information about the extent and incidence of the costs of protection, which galvanised exporting interests and made their political advocacy more effective. For broadacre rural interests in particular, new meaning was given to the old expression 'riding on the sheep's back'. The 'protection all round' banner of their own party was revealed as the sham it had always been. Rural and mining interests thus became strong coalitions in support of trade liberalisation: not initially for reasons of trade bargaining with other countries, but because of the costs they were bearing from Australia's own import barriers.

Once the Board adopted a broader perspective in dealing with tariff issues, its semi-judicial characteristics of independence and transparency came into their own. This was recognised by Prime Minister Gough Whitlam who, in marked contrast to McEwen, declared himself a 'Rattigan man' and entrenched a national perspective

in the legislation establishing the IAC in 1974. In the second reading speech, the Prime Minister emphasised:

> The first and most important reason for establishing the Commission is to allow public scrutiny of the process whereby governments decide how much assistance to give different industries ... such a process must be independent and impartial, and seen to be independent and impartial ... (Snape et al., 1998:60)

The need for procedural and institutional counterweights to the clamour of vested interests was recognised by Whitlam, who saw protectionism as an obstacle to the efficiency and national wealth creation on which his social programs depended. The way in which the leader of the Country Party expressed his opposition to the new Commission merely served to underline the point:

> What this means, of course, is the end of the long-established and successful system under which industry policy has been devised — the system of discussion, consultation and negotiation between industry and government. (D. Anthony, cited in Snape et al., 1998:63)

As is now well-known, it was not the end of such a system; it just made that system less exclusive and partial.

These observations should not be interpreted as suggesting that the IAC was the sole driver of liberalisation. Its role, after all, has only ever been to provide advice and information. Implementation required additional ingredients. For one thing, as Corden (1996) and Garnaut (1994) both note, the quality of bureaucratic advice and political advisers was important: a common factor also in the unilateral liberalisation initiatives of many developing countries. As well, from the outset, political leadership was a consistent factor in the more significant reforms. It is indeed the essential ingredient needed to make reform — and the adjustment it involves — acceptable to the broader community, over the heads of the vocal minority who stand to lose from it.

Ross Garnaut (1994) stresses the broad educational program which helped to prepare a climate of opinion receptive to the sweeping liberalisation programs of 1988 and 1991. The latter occurred despite the onset of recession, an unprecedented event. It was announced in 1991 by Prime Minister Bob Hawke (Snape et al., 1998:5-6) thus:

> The most powerful spur to greater competitiveness is further tariff reduction. Tariffs have been one of the abiding features of the Australian economy since Federation ... and the supposed virtues of this protection became deeply embedded in the psyche of the nation. But what in fact was the result? Inefficient industries that could not compete overseas; and higher prices for consumers and higher costs for our efficient primary pro-

> ducers. Worse still, tariffs are a regressive burden — that is, the poorest Australians are hurt more than the richest ... We have rejected the views of the so-called 'new protectionists' because they are simply proposing, in effect, the same discredited policies that had isolated our national economy from the rest of the world and caused the great damage we are all working to repair.

'Backsliding' Australian-style

As shown in the figures and table, Australia's liberalisation path over the past 30 years has not been all downhill. But Australia's policy reversals have generally been more explicit and transparent than elsewhere. The lack of external commitments has, with some exceptions, obviated the need for the kind of double game that most other developed countries have been playing with one another.

The first major policy reversal began little more than a year after the 25 per cent tariff cut in 1973. As Glezer (1982:125) has expressed it:

> No government or agency attempting to change the structure of Australian industry at a pace faster than the industries themselves wanted, could escape a counter offensive. And this counter-attack did not come only from economic interests. The institutional and policy decisions during 1973 had aroused opponents within the machinery of government.

The pressure to reverse the tariff cut was heightened politically by the worsening recession and rising unemployment. In retrospect, the counter-offensive may have also been made more difficult to resist because the tariff cut had been presented to the community primarily as an anti-inflation measure rather than as a move designed to bring substantial efficiency and productivity gains through industry restructuring. This meant that the deteriorating macroeconomic climate could be used as a legitimate reason for reinstating protection.

The reinstatement, while not reversing the reductions across the board, took the costly form of quantitative import restrictions, in the form of GATT-legal tariff quotas, facilitated by Australia's lack of tariff binding commitments with its trading partners. These were initially intended to be temporary, to provide key industries such as PMV, TCF and steel with a breathing space. In reality, they became more or less a fixture for the next decade and a half, leading to an escalation in the effective assistance of the industries concerned (see Figure 3).

Throughout this period, Australia also heightened its administered protection by changing the rules on anti-dumping and concessional entry arrangements. Government procurement was increasingly used as a device for assisting local industry, both through preferential margins and offset arrangements with successful foreign tenders. Subsidies of various kinds also began to proliferate in the late 1970s, with export assistance and production bounties predominating. The special arrangements for TCF and PMV spurred other industries to seek similar deals. Packages

of assistance or industry 'plans' became fashionable for the lucky ones, while the others continued to have their tariffs reduced following IAC inquiries.

This 'backsliding' phase lasted nearly a decade, during which time the average effective assistance to manufacturing was flat or rising. By the mid-1980s, however, the plans were becoming more strategic, being reformulated to facilitate restructuring and greater export orientation. They nevertheless showed the marks of having been negotiated with representatives of the industries concerned (IAC, 1987). Change was gradual; financial assistance was forthcoming quickly, and pressure to adjust postponed.

The IAC continued to conduct inquiries into industry assistance, as well as monitoring developments in industry policy generally. In 1982, it completed a report for the government on *Approaches to General Reductions in Protection*, which were advocated as a more effective way of moving to a less distorted incentives structure. The government took no action at that time, indicating that it was:

> Conscious that the capacity of the community to accommodate the economic and social consequences of such unilateral reductions is necessarily reduced in periods of subdued economic activity — and at a time when our exporters are facing increasing restrictions on their access to overseas markets. (cited in IAC, 1982:4)

In succeeding years, the depreciation of Australia's currency and better economic conditions made adjustment to lower protection easier. Indeed, the protective effect of the tariff quotas for PMV declined significantly, to the point where they were virtually redundant and could be removed in early 1988. This, together with the general reductions in tariffs that were finally instituted in that year, put Australia back on the liberalisation path, and the 1991 program gave it a greater impetus. Since then, it has been increasingly recognised that the era of protection is over, at least for most Australian industries.

But some things are never really over. With the demise of the tariff and continuing high levels of unemployment, there has been growing pressure on government to provide other forms of targeted support to industry. Over the last decade, the arguments for support have become increasingly sophisticated. Strategic trade theory was embraced by those promoting or sponsoring industry interests in the late 1980s, as was the new growth theory in the early 1990s. Most recently, the concept of market failure, which was seen to have justified government support for R&D, has been coopted for much broader duties, in the process distorting the concept almost beyond recognition.

A feature of the more recent push has been the role of special reports commissioned by representatives of industry interests. These have been intended to focus public attention, to provide persuasive arguments and to be seen to have more independence than the industry lobbies themselves. While this approach has been most in evidence recently, some may recall earlier efforts, such as the Pappas Carter report commissioned by the Australian Manufacturing Council (1990).

Reports of this kind have generally attracted much favourable attention at first, especially in the media, but most have had little staying power because they are often seen to be self-serving or client-driven. Despite the growing sophistication in their language, they have generally been less sophisticated in their analysis and less than rigorous in what they present as evidence: anecdote and the personal observations of corporate executives usually loom large.

Of the recent crop of industry reports, the Mortimer Report stands out for its explicit recognition of the need to apply market failure and economy-wide tests to all forms of industry support (Review of Business Programs, 1997). The framework that Mortimer presents for doing this is, on the whole, sensible: indeed it has much in common with that suggested by the Industry Commission in its submission to that review (IC, 1997a; see also Gibbs & Emery, 1998). One important benefit of this part of the Mortimer Report, therefore, is that it made it easier for government to reject the more narrowly targeted industry policy proposals in the other reports. Moreover, it may have also raised doubts about the value of some of Mortimer's own findings and recommendations, including that review's assertion that the current level of public spending on industry programs is 'about right', despite doubts expressed about their rationales, and the proposal for a discretionary fund to entice suitable investments to come to (or remain in) Australia (IC, 1997b).

A related development has been the increased use of economic consultants by industry lobbies. The quality of that work and its contribution to informed policy-making have varied enormously, depending on the nature of the client group and the qualities of the consultant. Public suspicion that 'he who pays the piper calls the tune' has sometimes affected the credibility of such work, however, even when undertaken by public sector agencies to satisfy external earnings obligations.

During the recent Industry Commission inquiries into assistance for PMV and TCF, industry-sponsored (or State government-sponsored) economic modelling had, for the first time, a central role in the debate. The Commission has for many years used Computable General Equilibrium (CGE) modelling to explore the economy-wide effects of trade liberalisation and other policy changes. Industry organisations came to recognise the power of such numbers in the policy debate. The modelling they commissioned, while lacking some of the sophistication and detail of the Monash Model used by the Industry Commission, was in most cases professionally done and contributed to our understanding of the potential impacts of further liberalisation.

Unfortunately, perhaps inevitably, the consultant's results were sometimes misused. A key instance during the PMV inquiry was the inference that protection added on average less than $100 to the cost of a car, based on estimates of the static welfare (or consumption) loss rather than the consumer tax equivalent. As one commentator responded, in that case why not simply replace the tariff with a $100 cash rebate to every purchaser of an Australian-made car? (Trebeck, 1997). But while the technical jousting in the battle of the auto models may have made great sport for the technically literate, it probably did more to confuse than enlighten decision-makers. This may well have contributed to the eventual policy outcome.

It is of interest in this context to quote the reaction to the government's decision of the auto industry's chief modelling protagonist:

> The recently announced approach to tariff reform in the car industry is a step in the right direction, in that cuts are continuing but at a more gradual rate. However, it would have been better if tariff reductions to 10 per cent in 2005 were achieved in small annual steps rather than one large step, and the situation after 2005 had been clarified. (Murphy, 1997:18)

Indeed, the situation after 2005 involves a number of uncertainties, not the least of which is the capacity of a future government to withstand political pressure to reverse the relatively large tariff cuts scheduled for that year, assuming that they are enacted. It is salutary to recall the pressure that was building prior to the Industry Commission's automotive inquiry for the *current* phase-down to be arrested. One unrecognised achievement of the recent decisions on PMV and TCF, therefore, has been to lock in the current programs.

A new element of uncertainty is the requirement that reviews of post-2005 assistance arrangements take account not only of Australia's APEC commitments but also of progress on market access. To industry, this will look like official recognition of its position (which it has argued during the two inquiries) that Australia's liberalising actions should depend on those of its APEC partners. This escalation of the notion of reciprocity through APEC is ironic, given that Australia managed to minimise its influence for so long under the GATT, and that APEC, in contrast to the GATT, is explicitly non-reciprocal in nature.

Australia can only lose from a strategy of waiting for other countries to 'catch up' (if indeed they are behind) or using its remaining trade barriers as negotiating coin to prise open foreign markets. Two facts confound such a strategy. The first is that Australia gains much more from its own liberalisation than from that of other countries (see McKibbin, 1998, for an empirical assessment.) The second is that Australia lacks the bargaining strength needed for reciprocity games. Australia's interests lie in proceeding with reforms that make sense for domestic reasons, while encouraging other countries to do likewise.

Looking Ahead

The Prime Minister, John Howard, observed after the APEC meeting in Manila in 1996 that progress in implementing trade liberalisation depends on achieving greater awareness of the national benefits, to counter the public influence of those industries facing adjustment.

This recognises the reality that international rules and negotiations cannot, by themselves, generate the necessary domestic commitment to resist backsliding. That will depend on the ability within each country of policy-makers and institutions to maintain an economy-wide perspective, despite one-sided political pressure to resist reform. This has also been recognised by a number of eminent international groups examining the world trading system, including a review chaired by Olivier

Long, former Director General of the GATT (Long et al., 1989) and the Leutwiler Report (Leutwiler et al., 1985). Finding a new international mechanism for pursuing politically more neutral domestic environments for trade liberalisation is no easy task. But a recent report by Alf Rattigan and Bill Carmichael (1997) rightly places this issue at centre stage.

Australia's own progress will depend on maintaining the open and relatively informed debate that it has had in the past. Our liberalisation experience demonstrates the importance of processes that can generate the wider information needed for nationally rewarding policy decisions. But it also highlights the pivotal role of our political representatives themselves, who are best placed to sell reform to the community at large, and whose attitudes and actions shape the environment in which the expectations of industry are formed.

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Improving the Governance of New Zealand's State-Owned Enterprises

Jim Brumby, Michael Hyndman and Stuart Shepherd

DESPITE substantial divestments in recent years, the New Zealand central government continues to own a range of commercial businesses, most of which form part of the state-owned enterprises (SOE) portfolio.

An economic case may be made for privatising more SOEs. However, the present National-New Zealand First coalition government has indicated that it intends to retain ownership of at least some of them.[1] This political stance is not unusual internationally, and raises the interesting issue of how the governance of these commercial businesses can be structured within the context of continued government ownership. This article explores the nature of this governance issue, and recommends a set of policies to address it.

The core difference between state and private ownership, from a governance perspective, concerns the rights, obligations and pay-offs attaching to ownership. Private ownership confers extensive rights on the owner to enjoy the income from ownership, and to control and change the use to which resources are put, including transferring ownership to another party. The private owner faces directly the wealth consequences from exercising those rights, and therefore has greater reason to ensure that they are put to best use.

Government ownership, in contrast, confers only a very limited set of rights on the ostensible owner or shareholder (in New Zealand, the shareholding Ministers). The shareholder has limited powers to control or change the use to which a resource is put, and, in particular, is not empowered to transfer ownership of SOE shares without parliamentary consent. The shareholder does not face any direct wealth consequences from exercising those rights, but is likely to face significant political costs or benefits from doing so.

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[1] The Coalition Agreement of 10 December 1996 stipulates that five SOEs – ECNZ, Contact Energy, Trans Power, New Zealand Post, and part of TVNZ (TV1) – are to be considered 'strategic' and are not for sale.

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Many commentators conclude that these differences in the nature of ownership illustrate the need, from an economic efficiency perspective, to move as much commercial activity as possible into private ownership.[2] We agree with that conclusion. However, governments continue in practice to own commercial businesses, and it is in this context that this article addresses SOE governance issues.

Background to New Zealand's SOEs

Corporatisation and privatisation history. Prior to the creation of SOEs, government-owned businesses in New Zealand were largely operated within various departments whose functions also included advising the government on policy issues. This situation entailed frequent ministerial involvement in their operations; multiple, sometimes unclear and often conflicting goals (such as employment creation and profitability); and thus unclear accountability. Their transformation into SOEs through corporatisation resulted in a clear commercial focus, and greatly improved accountability arrangements. Since 1989 the government has privatised 13 SOEs for a total sale price of NZ$9.1 billion, in the context of 31 significant sales of government assets with a total sale price of NZ$15.9 billion.[3]

SOEs remain a major component of both the central government's balance sheet and the wider economy. As at 30 June 1997 their total assets of NZ$10.3 billion comprised about 18 per cent of the book value of total assets controlled by all government entities. Their total revenue equated to about 4 per cent of GDP. They are involved in a diverse range of business activities, including electricity generation and transmission, provision of postal and meteorological services, coal and forestry production, farming and office accommodation, and air traffic control. How SOEs use the resources under their control therefore has a major impact on New Zealand's economic performance (see Table 1).

SOE governance arrangements. Each SOE is formed as a company under the Companies Act 1993 and is subject to its general provisions. In addition, each SOE must comply with specific governance and accountability provisions under the State Owned Enterprises Act 1986. The Act sets each SOE the primary goal of being 'a

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[2] Megginson et al. (1994) found strong performance improvement from privatisation in a study of 61 privatised companies in 18 countries. Vining and Boardman (1992) found privately owned firms tend to out-perform their state-owned counterparts. Galal et al. (1995) showed, in a sample of twelve privatisations in four countries, that net welfare increased in eleven of the cases. Domberger and Piggott (1994:56) argue that 'the case for privatisation rests on the incentives and constraints that the market provides to promote [productive] efficiency within the firm'. They found the empirical evidence, however, provided inconclusive support for privatisation. A World Bank (1996:49) report found that the gains from privatisation and other related reforms are substantial, although only a few countries have reformed their SOEs successfully. Vickers and Yarrow (1991) emphasise that the effects of privatisation in any particular context will depend significantly on the wider market, regulatory and institutional environments in which it is implemented.

[3] These figures sourced from the New Zealand Treasury are as at 30 June 1997.

successful business', and defines this as being as profitable as a comparable business not owned by the Crown, as well as being a good employer and socially responsible. SOE voting shares may not be sold without parliamentary approval. All SOEs are 100 per cent government owned, with the voting shares held equally by the two shareholding ministers: the Minister of Finance and the 'responsible Minister' (who by convention is normally the Minister for State Owned Enterprises).

Table 1

Summary financial data of SOEs as at 30 June 1997[a]

State-owned enterprise	*Total revenue*	*Operating surplus*	*Total assets (book value)*	*Equity (book value)*	*Percentage of total equity*	
	NZ$m	*NZ$m*	*NZ$m*	*NZ$m*	*%*	*cum. %*
ECNZ	1,142	271	3,608	2,084	36.9	36.9
Trans Power	550	92	2,960	1,384	24.5	61.4
Contact Energy	478	83	1,455	862	15.3	76.7
Land Corp	68	10	487	412	7.3	84.0
TVNZ	469	55	495	254	4.5	88.5
NZ Post	678	53	468	179	3.2	91.7
Govt. Property Services	32	29	282	178	3.2	94.9
CoalCorp	209	18	196	116	2.1	97.0
Timberlands West Coast	28	–12	114	111	2.0	99.0
Airways Corporation	94	-	168	40	0.7	99.7
Meteorological Service	24	4	14	11	0.2	99.9
Vehicle Testing NZ	21	3	13	7	0.1	100.0
Terralink	-	–7	16	7	-	
NZ Railways Corp[b]	2	-	9	1	-	
Works and Development	-	33	-	-	-	
Total	3,795	632	10,285	5,646	100.0	100.0

Notes: [a]The revenue and surplus figures are for the year to 30 June 1997. [b]Not an operating company.

Source: *Financial Statements of the Government of New Zealand for the year ended 30 June 1997*, Wellington, New Zealand, 1997, pp. 91-3 n.9.

Shareholding ministers hold the formal rights to appoint SOEs' directors, determine their constitutions, and appropriate (on behalf of government) their residual earnings plus residual assets if they are wound up. The Companies Act requires the directors of an SOE to act in good faith in what they believe to be in the best interests of the company.

The SOE Act requires each SOE board to provide the shareholding ministers an annual Statement of Corporate Intent (SCI) setting out the scope of business of

the SOE, along with its broad goals and specific performance targets. The shareholding ministers monitor the performance of the SOE and its board of directors. The Act also permits the shareholding ministers to direct an SOE board to include particular items in the SCI or omit them from it. Use of this power is subject to parliamentary scrutiny. Moreover, if the shareholding ministers direct an SOE to provide goods or services that it normally would not provide as part of a commercial arrangement, the SOE can require the government to compensate it for any resultant financial detriment.[4]

SOEs are taxed in the same way as privately owned companies and are subject to the same set of commercial, safety and health regulations as other companies. They are able to raise debt in their own name, and this debt is explicitly not underwritten by the government.

Market and regulatory environment. The government has sought to create an SOE only where there is the prospect of competition in the markets for its products, or an effective regulatory regime is in place. Most of the existing SOEs do operate in markets which are already competitive or at least face the threat of competition. The exceptions fall into two categories: natural[5] and statutory monopolies.

The national electricity transmission grid, which Trans Power owns and operates, is the only significant natural monopoly.[6] This SOE is subject to a set of regulatory pricing constraints.

Two SOEs, NZ Post and the Airways Corporation, currently operate in product markets protected by statutory barriers to entry from other suppliers. No compelling economic reason appears to exist for these barriers to continue. Indeed, in NZ Post's case legislation has recently been introduced to the parliament which would remove the statutory barrier.

The governance policies recommended below assume the SOE is operating in a competitive product market. The statutory barriers to market entry are best viewed as transitory issues, leaving the issue of natural monopoly. The definition of 'core business' is one policy recommendation that may need to be tempered to take account of this (as elaborated below).

Differences between Government and Private Ownership

As mentioned above, the key differences between government and private ownership lie in the nature of the rights and obligations in the two cases, and how these differences affect incentives and decision making.

Under private ownership the owners typically have the right to income from the resources. The owners face directly the wealth effects from the way in which the

[4] This has happened on one occasion only.

[5] A 'natural monopoly' exists where output costs in a market for a particular product or its close substitutes are minimised when there is only one supplier.

[6] The Airways Corporation also has a natural monopoly in some of its markets, but changes in technology are reducing the extent of it.

resources are used. They also have the right to control and change the manner in which the resources are used,[7] including the right to transfer ownership to another party. The combination of the right to income and the right to control provides private owners with both the incentive and the ability to move their resources to their highest-value use. This approach to resource management lies at the heart of the allocation of capital within open market economies.

Under government ownership the shareholding ministers have the right to income on behalf of taxpayers. The shareholding ministers do not personally face any wealth effects from the way in which resources are used, but are likely to face political costs or benefits from decisions that they make in relation to how resources are deployed. They also have a more limited set of rights to control and change the manner in which the resources are used. Shareholding ministers are not able to transfer ownership without parliamentary approval, and any direction these ministers give to an SOE is subject to parliamentary scrutiny.

Government ownership breaks the nexus between personal wealth effects and the ability to control and change resource use. Instead, government shareholders can be expected to be concerned primarily with political (rather than economic) outcomes, and to have limited ability to effect change. For this reason, the allocation of capital under this arrangement is likely to be significantly less efficient than under private ownership.

These special features of the ownership structure of SOEs lead to a number of issues for the governance of these companies. First, they result in *weak equity capital disciplines on the board and management.* The absence of active trading in SOE shares, or of owners with a personal equity stake, weakens the discipline on these companies to maximise value. Furthermore, the constraints on the shareholders in relation to divestment remove any credible takeover threat that would otherwise face the board and management of an under-performing company. This weak discipline is likely to feed through to a tendency to operate less efficiently than otherwise would be the case, and to undertake projects that are not justifiable if allowance is made for the full opportunity cost of capital.

Second, they lead to *weak debt-holder monitoring.* Private debt holders have weak incentives to monitor an SOE's performance, to the extent they consider SOEs to be implicitly government guaranteed. Although all New Zealand SOE debt instruments are required to include an acknowledgment that the debt is not guaranteed by the government, the financial markets have seen little evidence of a New Zealand government being prepared to let any SOE fail financially. In cases of financial distress the government has provided additional equity or the promise of additional equity, rather than rely on its limited liability status to restrict its financial exposure. Nevertheless, the structure of debt capital obligations, which typically

[7] These rights are in practice constrained by a range of general legislative prohibitions on resource use, including for example the Resource Management Act.

include specified cash payments throughout the life of the loan, can be expected to provide a greater financial discipline on SOEs than that afforded by equity capital.[8]

Finally, the ownership structure of SOEs leads to *less certainty and clarity about shareholder business policy commitments.* Shareholding ministers' commitment to a particular set of business policy parameters governing an SOE's operation is likely to be seen as less certain than if such a commitment were issued by private shareholders. Private shareholders tend to be more focused on a single clear goal of improving the value of their business. SOE shareholders, in contrast, typically[9] are likely to be influenced by multiple factors (such as changes of government and changes in electoral factors within an electoral term).[10] Forecasting how such factors are likely to impact on SOE-related policies is more complex and uncertain than with private ownership.

Focusing on Core Activities

The remaining sections canvass policies to improve SOE governance from the perspective of a government concerned with the overall efficiency of the economy. This is a wider perspective than that held by the private shareholder, which is concerned only with improving the value of the entities it owns. This wider view results in policies that both improve the efficiency with which SOEs are governed[11] and reduce the extent to which assets remain under SOE control (subject to constraints on privatisation), as there are alternative (private) governance arrangements that can be expected to yield more efficient results.

The policies fall into three groups: focusing the company on its core activities; strengthening financial disciplines; and managing the ongoing relationship between the government and SOEs. Focusing on core activities involves reducing the scale and scope of SOEs and changing their operating structures.

Reducing scale and scope. Reducing the scale and scope of SOEs over time can, if the resulting opportunities are taken up by privately owned firms, be expected to improve overall economic efficiency. A sharper focus can be achieved, in part, by: not extending an SOE's scope beyond a clearly defined set of core business activities or scale of operation (for example, by declining proposed expansions, even though the expected return may exceed the cost of extra capital required); divesting

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[8] Jensen (1986) outlines agency issues associated with a company's free cash flows and the use of debt as one means of addressing these issues.

[9] Shareholding ministers and their SOE policies may change whenever the political party, or coalition, holding executive government power changes. Control of executive government is contested at least every three years.

[10] Moe (1991) and Horn (1995) discuss how political institutions are designed partly for performance and partly for protection against political uncertainty, but often at a cost to the performance goals.

[11] We accept value maximisation through time as a proxy test for achieving both productive and dynamic efficiency, and as consistent with allocative efficiency where an SOE's product market is subject to either significant competition or an effective regulatory regime.

assets that are not critical to the business; and limiting the level of equity to constrain the company's ability to broaden its scope or scale.

This constraint may impose opportunity costs on SOEs by preventing them from undertaking value-adding projects that could take advantage of economies of scale or scope. It is not likely to impose costs on the wider economy, however, if other firms can undertake these projects at the same or lesser incremental cost.[12] Other firms could be expected to do so, except where an SOE holds a unique set of assets or capabilities relevant to the project.[13] Such uniqueness is most likely to exist where an SOE has a natural monopoly, such as Trans Power.[14] In other cases, as the market is able to sustain more than one supplier, other suppliers are likely to have similar assets and capabilities to the SOE, and therefore can be expected to be able to access similar economies of scale or scope.

This focus on core activities has some important implications. First, it may result in SOEs not undertaking value-adding projects otherwise available to them, whereas private investors are likely to undertake them. Second, it means that through time the reported value of an SOE business intentionally may be less than otherwise, and even decrease through time. This may occur, for example, if an SOE does not expand its core business, sheds non-core activities, and returns its excess capital to shareholders. Third, it is likely to mean that the type of skills required for directing and managing an SOE may change — with a greater emphasis on people skilled in generating maximum value from a company that is not taking up investment opportunities as ordinarily would be the case.[15] Fourth, where an SOE is a dominant player in its product markets, public awareness of the constraints on its future expansion or diversification options may lower entry barriers for its potential competitors.[16] Lower barriers would result from the constraint on scope and scale, reducing the extent to which an SOE could engage in deterrent behaviour and improving allocative efficiency.

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[12] This approach, which focuses on incremental costs, assumes SOEs and privately owned firms face the same conditions in other dimensions of the project (such as the same output prices). In practice, market conditions are likely to change through time, which raises dynamic efficiency concerns as to the relative abilities of different firms to adapt and take advantage of new opportunities. It seems reasonable to expect privately owned firms to be at least as efficient in a dynamic sense as an SOE, as they are likely to have stronger incentives to adapt.

[13] Uniqueness in this case refers to any assets or capabilities that the SOE holds that provide it with a significant comparative advantage in relation to the particular project.

[14] Where an SOE has a unique set of assets or capabilities, any constraint on its scale or scope may impose costs on the wider economy (if other firms incur greater economic costs than the SOE would in undertaking the project). These costs could be ameliorated by other firms gaining access to these unique assets or capabilities (for instance, through franchising, leasing, or some other access agreement). If access is impracticable, expanding the scope or scale of the SOE could be appropriate.

[15] A key assumption in this approach is the availability of directors and managers that are capable and willing to work to this objective.

[16] The investment constraints placed on ECNZ subsequent to the formation of Contact Energy are an example of this.

In New Zealand the means of implementing this strategy already exist. The State Owned Enterprises Act, for example, provides mechanisms for shareholding ministers to influence the size and scope of an SOE's business, most notably the SCI that must be negotiated each year between an SOE board and the shareholders.

Operating structure changes. A second means of focusing an SOE on its core value-adding activities is to consider alternative ways of structuring its operating arrangements. The key boundary here is that between relying on the SOE's internal governance rules for decision making and contract enforcement, and relying on external market mechanisms. Options include: management contracting, franchising, contracting out, and leasing out. These options have the effect of altering the boundary of the company, and can be viewed as withdrawing from direct involvement in various parts of the value chain of a business. In the extreme, an SOE could become a shell (or virtual) company, with its primary function being limited to managing a set of contracts (buying not making).

The suitability of the following possible operating structure options will depend on an SOE's circumstances.[17]

- *Management contracting* entails hiring an outside firm to manage some discrete part of a company's operations or to exercise operational control over the entire operations. It would mean devolving some rights to the contractor in return for various benefits such as access to specialist competencies.

- *Franchising* involves leasing out the right to use a clearly identifiable 'brand name' or other intellectual property owned by the SOE. This enhances unit managers' incentives to control costs as they have a direct stake in its profits.

- *Contracting out* means buying some of the goods and services needed to produce finished goods from an outside company. The benefits come from the greater use of competitive-market pressures.

- *Leasing out* entails transferring some of the rights of ownership to a lessee for a specified period. It could be used when the government is willing to devolve control of a portion of a business into the hands of someone who can operate it more efficiently.

These options may improve efficiency in one or more of the following ways: by shifting some of the residual claimancy rights and obligations outside the company, as a means of overcoming the limitations of the SOE governance arrangements; by harnessing the benefits of competitive markets for intermediate products or services; and/or benefiting from stronger incentives to produce outputs at least cost, by

[17] The nature, implications and suitability conditions for each option that is discussed in this section are analysed in generic terms by Brumby, Hyndman and Jamie (1996:34-58).

shifting some strategic and/or management control to parties that typically have stronger incentives to minimise costs.

Strengthening Financial Disciplines

The capital structure of a company determines the nature of the claims on a company's cash flows and the company's financial flexibility.[18] In the two polar cases, debt financing commits a company to specified servicing costs (in cash), whereas equity financing provides the company with greater financial discretion. There is a range of intermediate financial instruments. Empirical evidence suggests there is a range of debt:equity ratios over which a particular company's cost of capital is minimised, allowing some latitude in the mix of debt and equity without significantly altering its overall cost of capital.

A degree of financial flexibility is necessary to enable a company to accommodate downside deviations from its business plan without major disruption to its operations or undermining its market position. However, excess flexibility can be costly, particularly where equity capital disciplines are weak, to the extent that it: reduces external discipline on managers to control costs; increases the likelihood that management will invest in projects that do not at least return their cost of capital (that is, projects that erode company value); and signals to potential new entrants the possibility that the SOE has the financial ability to deter potential competitors from entering its market.

Most SOEs typically have had relatively large free cash flows after meeting all costs, including debt obligations, but before paying dividends. These free cash flows have been, and remain, the primary source of SOE expansion; they also reduce the discipline on management to maintain and enhance company value.[19]

Reducing the level of these free cash flows by paying them out to the suppliers of capital could be achieved in two ways: substituting private[20] debt for government equity, and/or raising dividend levels. Either option would strengthen financial disciplines on an SOE, and could be expected to lead to more efficient use of capital.[21] Substituting private debt for equity would raise the requirement on SOEs to meet their capital costs in cash, and thereby reduce the cash pool available for use at the discretion of a board. This would place greater discipline on managers to control costs and only take on those projects which return at least their cost of capital.

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[18] Financial flexibility refers to the ability to meet obligations at short notice and reasonable cost under a range of financial market circumstances.

[19] See Jensen (1986, 1993) and Williamson (1988) for an analysis of the governance implications of corporate capital structure.

[20] Private debt is recommended as the government does not appear to have a comparative advantage in supplying debt capital to SOEs. It would also increase the SOE's exposure to another source of monitoring and potential pressure to perform efficiently.

[21] The 1997 Budget speech (Peters, 1997:9), for example, indicated that shareholding ministers would be asking SOEs to adjust their capital structures to achieve a debt:equity ratio in line with that of comparable private sector businesses.

It may also strengthen the incentives on the debt holders to monitor the SOEs.[22] Raising dividend levels would raise the requirement on SOEs to meet their remaining equity cost of capital in cash, thereby reducing their access to cash reserves.

Managing the Relationship between SOEs and Government

Continued government ownership of SOEs raises the issue of how the relationship between government and the SOE should be managed. Managing this relationship warrants close attention in the absence of the salutary impact of capital market pressures that privately owned businesses typically face. In New Zealand this relationship is prescribed in broad terms by the State Owned Enterprises Act 1986. This section explores various aspects of the relationship within that context.

Clarifying and communicating the government's intentions. At present, SOEs and the shareholding ministers (and their advisers) tend to debate issues about the capital structure and scope of an SOE's business case by case. The focus of such debates is usually on implications for the SOE's value. Discussion of the issues, and any ensuing decisions, would be better informed if the shareholding ministers were both to articulate their medium-term preferences and expectations, and to communicate them to the interested parties. A public commitment to clearly stated expectations would enhance their credibility by raising the cost to the shareholders of deviating from them.[23] A possible means for achieving this would be for the shareholders to issue a statement of shareholder expectations (SSE). Such a statement would apply to SOE policy some of the principles already adopted in relation to fiscal policy through the Fiscal Responsibility Act.[24]

If the shareholding ministers were to signal to each SOE that it should focus on its core activities and pay out more of its free cash flows, they would also need to communicate clearly that the value of the government's equity in the SOE may decrease over time. This would encourage SOE management to concentrate on the task at hand, rather than seeking out value-adding projects in related (but not core) areas of business.

In summary, providing greater certainty and clarity to an SOE's board and management about its shareholders' expectations and preferences, and about the higher costs to shareholders if they deviate from a publicly committed direction, should improve the efficiency of SOE governance arrangements. More particularly, it could be expected to facilitate management of SOEs within clear parameters that are aligned with the preferences of the shareholders.

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[22] Any strengthening would depend on debt holders having some concern that the government would not meet all their costs in the event of financial distress, that is to say, that any implicit government guarantee was not complete.

[23] This approach would make the contract between shareholders and the SOE more 'complete'. See Hart (1993) and Aghion and Bolton (1992) for a discussion of incomplete contracting issues.

[24] For an explanation of this legislation, see New Zealand Treasury (1996).

Monitoring and value-based reporting. The relative lack of capital-market related pressure on SOEs means that the shareholding ministers need to rely on administrative monitoring procedures to hold SOE boards accountable. Current practice includes setting expected financial performance targets in the SCI for the future three years, and reporting against those targets at quarterly, half-yearly and full-year intervals. Boards are required to explain significant deviations from expected financial performance targets. In addition, each SOE may be subject to a business review at periodic intervals, normally no more frequent than every five years. Such monitoring provides a suitable basis for the shareholding ministers to consider the future direction of the company and any changes that may be required.

This monitoring is basically reactive and focused on published *ex post* financial performance measures.

The absence of capital market disciplines to help align the interests of SOE shareholders and their agents (boards and management) forces greater reliance on in-house performance monitoring. Setting clear goals for SOE boards to achieve, and strengthening incentives for them to do so (consistent with the SSE), is one form of such monitoring.

The general adoption of value-based reporting (VBR) by SOEs would enhance shareholding ministers' ability to assess the extent to which an SOE is creating or eroding value. VBR involves a company reporting its economic returns, the opportunity cost of the capital used to produce those returns, and the extent to which its various activities add to or reduce its value.[25] It is a very useful tool that the shareholding ministers could use both to set performance targets and to measure performance, in a way that takes account of the opportunity cost of the equity capital involved.

Director appointments and performance. An SOE's board of directors has a crucial role in maintaining and improving the company's performance. From the government's viewpoint, therefore, it is important both to obtain sufficient suitably skilled directors to oversee these companies, and to ensure that each board of directors has strong incentives to enhance a company's value. This is not a small task: there are about 90 SOE directors, and some 350 directors of all Crown-owned companies.

The following measures could help the government to secure the best performance from its SOE directors.

- *Ensuring independence and objectivity in the selection process.* This needs to involve selecting SOE directors on the basis of systematically matching candidates' skills and experience to meet a particular set of job specifications tailored (as necessary) to suit a particular SOE.

[25] See Rappaport (1986) and Stewart (1991) for a comprehensive explanation of VBR.

- *Clearly specifying the equity holders' expectations of directors.* This could be achieved by the equity holders providing clear terms of reference for individual directors when they are appointed, and each board as a whole through the proposed SSE.

- *Strengthening directors' incentives to ensure the company performs well.* Directors' incentives could be strengthened by introducing performance-related rewards and sanctions, and enhancing accountability mechanisms (including shareholder monitoring of the SOE, and VBR). This should include re-appointment being contingent on good performance (given factors within the board's direct sphere of influence), thus preserving the value of reputation.

Conclusions

In New Zealand a significant number of SOEs have now been privatised. For those SOEs that remain government owned (and where privatisation is ruled out), the important issue of how best to govern them remains. This article has outlined a set of measures that, if adopted, would both limit exposure to the problem of SOEs' inherently weak governance structure, and strengthen incentives for SOEs to perform where the exposure remains.

Aspects of this approach to strengthening the governance of SOEs may be able to be extended to the government's wider ownership interests, for example to its investments in housing, financial services, health and education.

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Australia's Corporate Law Reform and the Market for Corporate Control

Philip Brown and Raymond da Silva Rosa

AUSTRALIA'S Corporations Law includes stringent regulations governing the takeover of public companies. Since 1969, the regulations have reflected the influence of the so-called 'Eggleston principles' (named after Sir Richard Eggleston, chairman of the committee which recommended them), which promote 'equity' and 'disclosure' as paramount concerns. The regulatory objective, as noted by the Corporate Law Economic Reform Program (CLERP, 1997:7),

> is to improve market efficiency. Specifically, regulation is directed at achieving an appropriate balance between encouraging efficient management and ensuring a sound investor protection regime, particularly for minority investors.

According to the Commonwealth Treasurer, Peter Costello (1997),

> CLERP is a program to modernise Australia's Corporations Law and give it an economic focus. ...[Its] aim is to introduce world's best practice in business regulation. It is part of the government's broader goal of making Australia a leading financial centre in the region. CLERP is designed to harmonise Corporations Law with pro-enterprise, pro-jobs and pro-investment objectives.

In this article, it is argued that the provisions of the Corporations Law impede the achievement of its objectives with respect to takeovers. The focus on equity and disclosure discourages economic efficiency, to the detriment of small shareholders, by not giving appropriate recognition to the costs of acquiring information about the potential target. Under the existing laws governing takeovers and the reforms suggested by CLERP, an acquiring firm must equitably share the gains among all shareholders of the target company, not just those controlling the target company. It must also disclose to the public its information about the target. But this dilutes the benefits of searching for profitable targets, without commensurately sharing the search costs. This must discourage takeovers from occurring in cases where all the

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potential gains may be diluted, so leaving control of the potential target remains with the incumbent management. But efficiency requires that assets should be controlled by investors who can make the best use of them.

If CLERP is to achieve its goals, its proposals for takeover regulation need to go further. In particular, the Corporations Law would make a more effective contribution towards shareholder equity if it focused on defending rather than eroding the property rights of shareholders.

The CLERP Proposals on Takeover Regulation

Australian government regulation of takeovers has, since the early 1960s, vacillated between attempts at rigid control and a practically *laissez-faire* approach. It is not just government that has been inconsistent. On 24 April 1986, *The Australian Financial Review* ran an editorial which labelled as 'futile' and 'dangerous' a just-released study on takeovers because 'it may be used to justify increased regulation of takeovers'. This was alarming because 'policies that hinder takeovers quite simply prevent resources being used by those who can get the most of them'. Five years later, on 21 May 1991, *The Australian Financial Review* had turned full circle. Its editorial claimed that 'takeover raids, even unsuccessful ones, can have a painfully corrosive effect on companies, morale often suffers and industrial performance flags. ... The intangible cost of diverted management attention and stultified growth is unlikely ever to be known'. It is difficult to explain this substantial turnaround, since no major study on the effects of takeovers in Australia which might have caused a revision of opinion had been released since the date of the first editorial.

This variation in elite views on the benefits of low barriers to entry in the market for corporate control and the magnitude of the wealth effects at stake underline the need for a coherent, consistent framework to evaluate regulatory policy in this area. But CLERP does not inspire confidence that the regulatory authorities have a clear framework in place. Its paper on corporate control begins, encouragingly, with the claim that 'the threat of takeover provides a strong incentive for company directors and management to use capital efficiently. ... It provides market-based incentives to encourage adequate corporate performance and provides a penalty where this is not achieved' (pp. 7-8).[1] The implication of this argument is that the government should strive to eliminate impediments in the market for corporate control. But the proposed reforms fall well short of what could be done.

There are four principal reforms. These are:

- giving a specialist takeover panel the primary role in takeover dispute resolution to improve efficiency and provide a commercial focus;

[1] All page references are to CLERP's Paper No. 4, 'Corporate Control: A Better Environment for Productive Investment'.

- introducing a new compulsory acquisition power to allow any person who holds 90 per cent of a class of securities to acquire the remaining securities in that class at a fair price (whether or not a takeover bid has been made);

- extending the company takeover rules to listed managed investment schemes, so that listed-scheme managers face the same competitive pressure to perform, and unit holders have the same takeover protection, as companies; and

- introducing a mandatory-bid rule, which would allow a bidder to exceed the current statutory shareholding threshold (currently 20 per cent of all shares in a class) before being obliged to make a general takeover offer.

The mandatory-bid rule is particularly significant because, if passed into law, it would substantially increase the rewards from identifying underperforming companies. Under current legislation, a potential acquirer is obliged to disclose to all investors valuable information about a target by making a public bid for all shares in the target once it has acquired 20 per cent of the target's ordinary shares. This promotes a public 'auction' for the target where the eventual winner is not necessarily the company that first identified the target. Even if the firm that first identified a target manages to win its prize, the public auction will have forced it to concede a large proportion of its prospective gains from the purchase. The shareholders of potential target firms may appear to be the beneficiaries of the current system; but they bear the opportunity cost of missing out on takeover bids from potential acquirers who are deterred by the high regulatory costs.

The mandatory-bid rule (or, as it is sometimes termed, the 'follow-on rule') is consistent with the government's avowed intention to promote market-based incentives to encourage adequate corporate performance. In this light, it is disappointing that the mandatory-bid rule's potential to effect beneficial outcomes will be reduced by qualifying provisions that restrict its application. For instance, potential bidders holding 20 per cent or more of the target firm's shares will not be able to acquire control without making a public bid that triggers a public auction for the target.

The Eggleston Principles

The principal stumbling blocks to an overhaul of existing policies in favour of those that would promote increased activity in the takeovers market are the four Eggleston principles that were, ironically, drafted with the intention of protecting the interests of target-firm shareholders, especially minority or non-controlling shareholders. Rather than challenging them as sound guides to takeover regulation, CLERP's paper attempts to accommodate them.

The four Eggleston principles are as follows:

1. the bidder's identity should be known to shareholders and directors of the target;

2. shareholders and directors of the target should have a reasonable time to consider the bid;

3. the bidder should give sufficient information to the shareholders to enable them to form a judgment on the merits of the bid (the 'disclosure principle'); and

4. each shareholder should have an equal opportunity to participate in the benefits offered under a bid (the 'equal opportunity principle').

The four principles are discussed in order of importance.

The disclosure principle. The CLERP paper recognises that the disclosure principle stems from a presumption that legislation should require a uniform distribution of information among the participants in the market for corporate control. It argues that 'Although there are costs of disclosure, they are clearly outweighed by the benefits of facilitating an efficient market and protecting investors' (p. 10). Importantly, the costs of disclosure are borne entirely by the bidder: 'Prospective bidders can expend substantial resources identifying underpriced companies and determining how management can be improved. ... These search costs may not be able to be recovered by the bidder, particularly if a rival bidder acquires the company. In such a case, the rival bidder will "free-ride" on the search costs paid by the initial bidder' (p. 9).

The concern with ensuring informational balance among bidders and the shareholders of their target firms reflects a confusion between the ideal of efficient markets and the processes that contribute towards market efficiency. Efficient markets incorporate several desirable attributes, including that prices reflect available information. However, information is costly and will not be produced unless there is an appropriate return. As the paper recognises, the incentive to produce such information is reduced, if not eliminated, by forcing bidders to broadcast valuable private information without allowing them to capture the gains. What appears not to be appreciated is that target shareholders are thereby deprived of one of the principal market mechanisms that assist them in ensuring their firms' managers turn in 'an adequate corporate performance'. The requirement for informational balance among bidders and target firms' shareholders effectively undermines the market for corporate control by imposing a substantial barrier to entry.

The equal opportunity principle. The primary motivation of the equal opportunity principle was apparently a concern about promoting 'fairness and encouraging investor confidence in the market' (p. 11). The paper notes that the equal opportunity principle is 'an integral element of the takeover provisions of the Corporations Law. ... Even if there is no breach of the takeover provisions, depriving shareholders of an equal opportunity to participate in benefits accruing from a bid may constitute "unacceptable circumstances", leading to a referral to the Panel' (p. 11). It goes on to assert that 'Without the investor protection provided by the equal opportunity

principle, it may be less likely that smaller investors would invest directly in the market, which could affect market liquidity and confidence' (p. 14).

Since critics of the equal opportunity principle risk being unfairly tarred with the same brush as misogynist critics of motherhood, it is important to clarify what is meant or intended by the term 'equality of opportunity'. The paper's discussion implies that equality of benefits or outcomes will reflect an equal opportunity environment; and this presumption informs its view of what the appropriate regulation should be. However, in an equal opportunity environment investors will devote different amounts of resources to gathering information; and their returns will, on average, reflect their different levels of investment. This line of reasoning suggests that insisting on equality of outcomes is not merely inequitable but also inefficient, given that it eliminates investors' incentives to gather costly information.

Because of its uncritical acceptance of the equal opportunity principle, the paper does not canvass the equity implications of depriving the controlling shareholders of their property rights to the premium for control paid by the acquirer, although it does acknowledge that the principle 'could result in a lower premium obtainable by controlling shareholders, where the bidder decides to pay the same total premium and distribute it amongst all target shareholders' (p. 15). In sum, the discussion begs the question whether the investor who purchases a non-controlling parcel of shares in a company and who holds them passively is entitled to a proportionate share of the premium for control. Arguably, equity requires that the entire premium for control should accrue only to the shareholders who can deliver control of the target company.

It is also noteworthy that the paper does not provide any evidence to support the claim that smaller investors exert a significant influence on market liquidity or confidence. On the face of it, the equal opportunity principle acts to reduce rather than increase small investors' confidence, by decreasing their access to the market for corporate control. However, the paper does attend to the efficiency implications of the equal opportunity principle. It states that 'the equal opportunity principle potentially creates higher costs for market participants, reducing incentives to engage in takeover activity. Without the principle, takeover costs could be lower, thereby increasing incentives to bid for a target company and leading to greater efficiency through the prospect of increased takeover activity' (p. 15). But it is then argued that the increase in shareholder protection afforded by the principle gives rise to greater investor confidence, the benefits of which outweigh the costs.

It is difficult to appreciate how reducing shareholders' access to the market for corporate control can serve to increase their confidence. As noted earlier, the paper explicitly recognises that an active market for corporate controls reduces investors' exposure to the risk of managers pursuing non-value-maximising behaviour; yet it does not consider the cost of losing this benefit when evaluating the net attraction to investors of the equal opportunity principle.

Commendably, the paper does acknowledge that the equal opportunity principle is not the only means by which the interests of small (or 'retail') investors can be protected. Retail investors can choose to invest in managed funds or may reduce

'the risk of becoming a minority shareholder unable to sell their shares at the pre-takeover price' by diversifying their funds. However, the paper argues that diversification 'would be a second best alternative to the equal opportunity principle as, in practical terms, diversification can be difficult to achieve without incurring substantial costs' (p. 15). Again, no evidence is provided in support of the assertion, which is questionable given the availability and potential for growth in pooled investment funds.

In sum, it is difficult to agree with the paper's conclusion that 'The equal opportunity principle enhances aspects of the market that are essential: market integrity and investor protection' (p. 16). The arguments for the opposing view are more convincing.

The regulations stemming from the application of the disclosure and equal opportunity principles impose the largest direct costs on bidders seeking to enter the market for corporate control. The indirect but nevertheless real costs are borne by the target shareholders. These indirect costs may be higher than the direct costs, given that bidders have alternative investment opportunities.

The revelation of identity principle. The first Eggleston principle — that the bidder's identity be known to shareholders and directors of the target — is embodied in provisions of the Corporations Law such as those affecting substantial shareholders. Under these provisions, investors are required to lodge a notice that they are substantial shareholders once they are aware that they have a relevant interest in 5 per cent or more of the total number of shares issued by a company. The notices have a significant impact; substantial shareholder notices are interpreted by the market as signalling takeover intentions, and their filing by firms active in takeovers tends to drive up the share price of the prospective target firm.

As with all legislation that effects wealth transfers, the provisions concerning substantial shareholder notices benefit some stakeholders at the expense of others. The direct costs of the principle are borne by the substantial shareholders who fail to capture the full benefit from their information. Prospective target-firm shareholders gain from the knowledge that an offer for their shares is more than likely imminent. Although, from an economy-wide perspective, the first Eggleston principle may appear to exhibit the properties of a zero-sum game because the profits from the increase in information are not lost but partially transferred to the target shareholders, the fact is that depriving substantial shareholders of the full gains from the information decreases their incentives to search for information in the first place. The long-term effect is a decrease in the efficiency of resource allocation as less information is produced. Further, the long-run effects are also negative for target shareholders, given that the reduction in information about firms leads to a decreased incidence of takeover bids.

The ceiling for notification of substantial shareholder status has been reduced from a 10 per cent ownership level to 5 per cent. The decrease has made the provisions more expensive to comply with and more expensive to administer; it has also made it more difficult for bidders to capture the full gain from information.

Given these costs, the alleged benefits of the 5 per cent rule relative to the previous 10 per cent rule should be re-evaluated.

The reasonable time principle. The Eggleston principle that shareholders and directors of the target have a reasonable time to consider the bid is operationalised by the requirement in the Corporations Law that bidders keep their offers open for at least one month during the formal offer period, which begins 14 days after the takeover announcement. In effect, the Corporations Law forces bidders to write a free put option at no cost to the shareholders of the target company for a whole six weeks; that is, the law compels bidders to maintain a minimum price for the target's shares for the duration of the offer, a right which is valuable to the target shareholders but for which they bear no obvious cost. But of course they do bear a cost, implicit in a lower bid price, or, in some cases perhaps, no bid at all.

Surely, six weeks to evaluate the merits of an offer is far longer than is commercially reasonable in today's market. A reduction to 14 days in the formal offer period would lower the cost to the bidder without prejudicing the target shareholders' ability to evaluate the offer. Regardless of the amount of time available to shareholders to evaluate an offer, it is always in their interests to delay making a decision until the last moment, because accepting it can kill the option. The tendering of acceptances late in the stipulated offer period should never be seen as evidence that the whole period was required properly to evaluate the offer. It is typically the optimal response to any normal bid.

Evaluating Barriers to Entry in the Market for Corporate Control

Corporate takeover bids are frequent occurrences. Argus and Finn (1992) report that between 1971 and 1990 up to 16 per cent of all listed companies were subject to a takeover bid in a given year. That is an underestimate of the number of listed firms involved in takeover activity, since many of them bid for companies that are unlisted or foreign-based.[2] Over the past decade, a large majority of the top 100 firms in terms of market capitalisation made at least one acquisition that exceeded 10 per cent of their market capitalisation.

The high incidence of takeover bids indicates that investors, as a whole, have ample opportunities to develop expertise in evaluating bids and therefore can appropriately price the shares of the companies involved in them. Expansion by merger is not an exceptional event but an integral element of the investment plans of most successful companies. Further, although managerial hubris and aggrandisement may motivate some acquisitions, takeover activity is too broadly based among successful companies to sustain the charge that they are its principal spur. In any event, investor reaction to takeover bids permits a direct test of the manage-

[2] A survey in 1996 by the financial services group, Ernst & Young, found that 'while most attention has focused on listed takeovers, at least three-quarters of all acquisitions occurred off market. These involved private companies or businesses, unlisted public companies and off-shoots of public listed companies' (*The Australian Financial Review*, 7 February 1996).

rial hubris-cum-aggrandisement hypothesis. If hubris is a principal motivation, we would expect the share returns to acquiring firms to decline on announcement of a takeover bid. (We review the Australian evidence below.)

The high incidence of takeover bids may suggest that perhaps the barriers to entry in the market for corporate control are not substantial and that their associated efficiency costs are therefore not substantial either. The flaw in this argument is that high barriers to entry in the market for corporate control do not entirely preclude entry. However, high barriers ensure that only takeovers offering the opportunity to reap egregiously large profits will be contemplated by a potential acquirer. High barriers to entry deprive shareholders of the opportunity to profit from a reallocation of corporate assets that yields a net gain that is less than the cost of overcoming the barriers.

It is difficult to derive a direct estimate of the cost of barriers to entry in the market for corporate control. However, the sharemarket performance of target firms relative to that of other firms in the pre-bid period provides one indirect measure of their high cost. The high level of prospective profits required to make a firm attractive to a potential acquirer is more likely to be available in firms that are substantially underperforming relative to other firms, so evidence of substantial underperformance by firms that are subsequently the subject of takeover bids is consistent with the existence of high barriers to entry. This is because, in a takeover market with no barriers to entry, investors will anticipate that underperformance that may be remedied by takeover will not persist and so the share returns of potential target firms will not substantially underperform the rest of the market in the pre-bid period.

Sharemarket-based Evidence

Sharemarket-based evidence is relevant to the debate over the market for corporate control because the focus of the takeover provisions of the Corporations Law is on delivering equitable sharemarket outcomes to the shareholders of target firms. When evaluating the evidence, it is important to bear in mind that studies of investors' responses to corporate events such as takeover bids do not assume that markets are omniscient or unfailingly prescient. The critical assumption is that market participants evaluate companies' prospects in an unbiased fashion and have strong motivations to do so. Given the intense competition to achieve opportunities for abnormal gain in the sharemarket, we may confidently expect that any systematic bias in the evaluation of companies' prospects will not persist.

Notwithstanding the above, sceptics of the utility of sharemarket-based studies may point to the now well-established body of evidence that indicates the apparent existence of market inefficiency, defined as the persistent opportunity to earn positive abnormal returns from relatively freely available information. Among the earliest and best-publicised of these alleged anomalies is the so called 'size effect', which refers to a systematic negative association between firm size and return, even after controlling for risk and other apparently relevant factors.

Investigation into market anomalies is an intriguing area of research in finance because the anomalies defy obvious explanation. However, it is pertinent that despite the venerable age (by the yardstick of financial markets) of many of the alleged anomalies, none of the publicised ones has passed the ultimate test: the ability persistently to achieve for investors positive abnormal returns when investing real dollars. Reports that less than half of investment-fund managers outperformed the All Ordinaries Index in the 1997 calendar year indicate that market efficiency, defined as the unbiased pricing of companies' prospects, is the depressing or reassuring (depending on one's approach to selecting stocks) reality for the overwhelming majority of investors.

Notwithstanding that investor experience indicates that the 'anomalous' empirical regularities in share returns cannot be exploited to achieve persistent abnormal returns, it is apparent that share market studies that use historical data need to control for these regularities when assessing investor reaction to corporate events. This is the approach the present authors adopted in reviewing the shareholder wealth consequences of takeover activity by firms listed with the Australian Stock Exchange (ASX) (Brown & da Silva Rosa, 1997). Our study measured the abnormal performance of a virtually exhaustive sample of the ASX-listed firms that were involved in takeover bids between 1975 and 1990. Each sample firm's performance was assessed over two distinct periods: a pre-bid announcement period, defined as the time spanning three years prior to six months before the month of the takeover bid announcement; and a bid announcement period, defined as the seven months centred on the month in which the takeover bid was announced (that is, the bid period begins three months before the month in which the takeover bid was announced and ends three months after it). These operational definitions are consistent with those adopted in similar studies and were based on a judgment that the sample firms' pre-bid period performance did not incorporate takeover-related price effects, while their performance over the bid period includes most of the takeover-related impact on share price.

Target firms' pre-bid performance was unambiguously poor. The sample of 1,371 target firms on average lost 23.3 per cent over the pre-bid period, after controlling for market wide and size-related movements in share prices. This poor performance was reversed on the announcement of a takeover bid. Over the bid announcement period, the target firms gained, on average, 25.5 per cent, after controlling for all non-takeover related factors. This translates into a gain of $15 billion returned to the shareholders of the sample of target firms directly as a result of takeover activity. Bidding firms also did well out of takeovers. Their takeover-related return around the bid announcement period averaged 5 per cent, which, given their market capitalisation, corresponds to a gain of $5 billion. The results we reported are consistent with those of other studies, such as Bishop, Dodd and Officer (1986). Interestingly, we did not find that these positive returns were reversed in the months that followed the bid.

Summary and Conclusions

An active market for corporate control plays an important role in facilitating capital investment through its function as a monitoring and disciplinary mechanism. It protects investors' interests by providing potential bidders with incentives to search for opportunities to reallocate corporate assets to higher-valued uses. Takeovers create value through the removal of underperforming management or the exploitation of potential synergy. The sharemarket evidence strongly supports this view.

The Corporations Law in Australia aims to improve efficiency in the market for corporate control by facilitating opportunities for efficient management and by providing a sound regulatory regime of investor protection. The investor-protection provisions are framed with reference to the four so-called Eggleston principles. However, the Eggleston principles result in confiscating from bidding firms the benefits that accrue from identifying underperforming corporate assets. The appropriated benefits are transferred to target shareholders. The presumably unintended consequence of such wealth transfers is that the return to resources devoted to identifying underperforming assets is significantly reduced and corporate assets are not employed to their best economic advantage.

Reform of the takeover-related provisions of the Corporations Law aimed at protecting property rights to information would go a long way towards securing equity and efficiency in the market for corporate control.

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Social Studies: The Plan for New Zealand's Schools

Brian Crittenden

IN 1993, the New Zealand Ministry of Education adopted a 'curriculum framework' of seven key learning areas for primary and secondary schools. These are: Science, Mathematics, Languages, Social Sciences, Technology, Health and Physical Wellbeing, the Arts. Documents setting out the essential learning in each area have been in preparation since that time. This discussion focuses on the 'core statement' for the Social Sceinces learning area, with special reference to criticisms raised by the Auckland-based Education Forum.

The first draft of the curriculum for Social Studies was published in 1994. After considerable debate, much of it through the national media, a revised draft was issued in 1996. The statement appeared in its final form in 1997 under the title *Social Studies in the New Zealand Curriculum.*

The Executive Committee of the Education Forum has about a dozen members (several from the manufacturing, commercial, and agricultural sectors along with a number of principals of private and state schools). The Forum contributes to debate on educational policy in New Zealand, and sponsors publications for this purpose. In relation to the Social Studies curriculum, it published a submission on the first and revised drafts (Education Forum, 1995, 1996), and issued a short media statement on the final version. Dr Geoffrey Partington contributed substantially to the two submissions. Professor Kenneth Minogue wrote a Foreword to the second.

In the context of the 'curriculum framework', Social Studies is interpreted as an integrated approach to the social sciences and aspects of the humanities. Its main stated aim is to 'enable students to participate in a changing society as informed, confident, and responsible citizens' (Ministry of Education, 1997:8). To achieve this aim, the Social Studies curriculum is designed to develop a broad understanding of people in the New Zealand society and in the wider contexts of its place in the Pacific, Asia, and the world generally.

Comparisons with Recent Australian Curriculum Planning

Before turning to the Education Forum's assessment of the Social Studies program, it may be of interest to note some comparisons with recent developments in programs for schooling in Australia. At its meeting in Hobart in 1989, the Australian Education Council (AEC), made up of State ministers for education and the Com-

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monwealth minister, issued a statement on agreed national goals for schooling. This was the beginning of the process for the development of 'national curriculum profiles' in eight 'key learning' areas (Art, English, Health and Physical Education, Languages other than English, Mathematics, Science, Studies of Society and Environment, Technology). With some minor variations in nomenclature, the later New Zealand list is the same, except that it treats English and other languages as a single learning area.

Final draft 'profiles' were presented to the AEC meeting in 1993. At this meeting, it was decided that the profiles would be referred to States and Territories, which would take responsibility for adapting their content. In Victoria, for example, its 'Curriculum and Standards Framework' accepted the eight key learning areas agreed to nationally, each organised at seven levels of difficulty covering the compulsory years of schooling. The general curriculum statement for Studies of Society and Environment (SOSE) was published in 1995 (Board of Studies, 1995). Like the other learning areas, its main content and processes are set out in several 'strands', which are the same at each level. In SOSE, there are five strands: time, continuity and change (drawing on the discipline of history); place and space (geography); culture (anthropology, religion, sociology); resources (economics and related disciplines, geography, environmental studies); natural and social systems (economics, ecology, sociology). SOSE emphasises three main processes in each strand at every level: investigate, communicate, participate. (It should be noted that the second and third processes involve a good deal of overlap.)

An examination of the structure of *Social Studies in the New Zealand Curriculum* reveals that it too has five 'strands' with essentially the same titles and background disciplines as in SOSE. There are also three key processes: inquiry, value exploration, social decision-making. Although they include substantially the same activities as in the SOSE processes, the New Zealand program gives more emphasis to the examination and clarification of each individual's values and those of others as they concern social issues.

One important difference is that material in the Social Studies core statement is set out at eight levels and covers all the years of primary and secondary schooling. As well, it explicitly refers to five perspectives: bicultural (Maori and European), multicultural, gender, current affairs, the future. As we shall see, the distinction between the first two raises difficulties. (The curriculum material, it should be noted, is published in both Maori and English.) With the exception of the first, these perspectives are, in fact, included in SOSE. Under the multicultural perspective, explicit attention is drawn to Aboriginal beliefs and practices.

While there are many variations of detail between the broad curriculum outlines presented in SOSE and the New Zealand statement, they are substantially similar in objectives and design. Perhaps the main differences are, first, that SOSE puts a little more emphasis on an understanding of the disciplines that relate to the strands, while the New Zealand program gives somewhat more attention to learning to participate as a responsible member of society; and second, that the study of values has a more central place in the Social Studies statement than in that of SOSE.

Despite the striking similarities between the New Zealand curriculum framework and the common learning areas for Australian schools (devised somewhat earlier) and, with particular bearing on the present topic, between the general program for Social Studies in New Zealand and for SOSE in Australia (again, produced somewhat earlier), it is surprising that the former makes no reference to the latter. I should note that detailed course advice for teachers has now been produced (at least in Victoria) for all strands of SOSE at every level.[1] While something similar will probably be prepared in New Zealand, the discussion here refers to the Social Studies 'core statement'.

Criticisms by the Education Forum

The two submissions by the Education Forum on the draft Social Studies program (and the media release on its final form) make the same main criticisms. It seems that the designers of the program were largely unmoved by the Education Forum's arguments.

The first draft. In reference to the first draft, the key deficiencies, in the Forum's view, can be summarised as follows.

First, there is an exaggerated emphasis on the learning of skills at the expense of content, and a distorted interpretation of what counts as a skill. Learning to communicate clearly, understanding the causes of a significant historical event, applying statistical methods appropriately in social scientific inquiry are all labelled, without qualification, as skills. However, such an activity as conjecturing and testing hypotheses in scientific inquiry cannot be treated as a skill in the same sense as, for example, being able to type.

Second, the felt needs and interests of learners play too dominant a role. The consequences are an overemphasis on the 'here and now', inadequate attention to expanding the experience and understanding of students, turning the teacher's work to that of a minder or coordinator rather than an active educator.

Third, in its approach to Maori and European society and culture, the curriculum statement concentrates on the positive features of the former and puts distorted emphasis on the negative features of the latter. In addition, it underplays the influence of the cultural traditions of the British Isles in New Zealand's development.

Fourth, the various strands fail to present the main content of the related intellectual disciplines in any systematic way. Despite the emphasis on skills, those that are distinctive of these disciplines are treated very inadequately.

The Forum concludes its first submission with serious doubts about the possibility of a social studies area in which the social sciences (and relevant disciplines from the humanities) can be integrated with intellectual coherence, in a way that is man-

[1] Although I would criticise many aspects of the general SOSE curriculum design, I have been a member of an 'expert panel' of four that has commented on the detailed course advice drafts. Their development has involved the contributions of a large number of individuals, schools and other organisations. The substantial course advice material helps to offset weaknesses in the general curriculum.

ageable for teaching, learning and assessment over the course of schooling, and that can resist ideological distortion. It would prefer to see the social science disciplines established in their own right in the curriculum. It suggests that, if the attempt at an integrated social studies is persisted with, at least the study of geography should have a distinct place in the curriculum.

Some of the defects that the Forum submission identifies in the draft Social Studies statement reflect its conformity to principles of the general New Zealand Curriculum Framework, while others are deviations from the Framework. An example of the former is the exaggerated emphasis on skills. The second is illustrated in the deficient induction that the Social Studies program provides into history, geography, and economics.

The Forum submission draws attention to the defective treatment of key concepts. For example, there is no indication that there are serious disagreements over the notion of human rights, or that agreement at a general level does not exclude differences of interpretation in particular circumstances. Another example is the treatment of values. Emphasis on procedures for clarifying what values one actually holds and how one regards their relative importance is combined with the view that there are certain values that everyone should or should not hold. Again, in endorsing a general value (such as social justice), the curriculum statement does not take account of reasonable differences over its interpretation as a general value or, when there is agreement at this level, what counts as social justice in particular circumstances.

On the five 'strands', the Forum submission argues that they do not provide an effective organising structure for the learning of systematic knowledge and related skills. For example, 'Time, Continuity and Change' (drawing on history) consists largely of superficial activities and a random selection of topics. There is no clear indication of how skills for historical inquiry are to be developed. It is also unlikely that students would gain any sense of chronology.

Probably, the Forum's most serious criticism of the Social Studies draft is its lack of any substantial basis for an integrated, coherent treatment of the social science disciplines on which it draws. One could add that the objective of a coherent program would need to include aspects of the humanities: not only history, which may be regarded as belonging to both the social sciences and humanities, but also something of social philosophy and ethics.

Although the Forum prefers the study of separate social sciences, it suggests a set of significant themes that would be more likely to achieve a coherent program than the five strands. Each theme (for example, human control over nature) would, unlike the strands, bring together contributions from history, sociology, anthropology, economics and geography.

I should note that, while this approach is a better way of coordinating the relevant disciplines, it still does not address the issue of how students come to an adequate understanding of the radical differences in methodology and objectives of the contributing disciplines.

The revised draft. The revised draft of Social Studies as one of the essential learning areas in the New Zealand Curriculum Framework was published in 1996. The Education Forum published its submission on the revised draft later in that year. As none of its key criticisms of the first draft was taken up, it is not surprising that the second submission makes very much the same points as the first.

In the Foreword, Kenneth Minogue notes, in particular, the excessive preoccupation with skills and their detachment from the structure of systematic inquiry and knowledge; a distorted and thus patronising picture of a bicultural New Zealand drawing equally on Maori and European traditions; the failure to acknowledge the British Isles as the most significant source of the culture and institutions that characterise New Zealand. His conclusion is that 'this entire project is so flawed as to be impossible to salvage' (p. xii).

The summary of the Forum's view of the revised draft claims that, apart from a few minor concessions (such as a 'faint reflection' of New Zealand's British background), it has not been substantially changed. Its reference to 'bicultural' gives predominant emphasis to features of Maori culture, and its description of New Zealand as both bicultural and multicultural remains unexamined. Values continue to be treated as subjective feelings, attitudes and the like; it is the personal ordering of these that each individual needs to clarify. At the same time, the revised draft promotes its own preferred scheme of values. The most serious criticism is the claim that the proposed program fails to provide students with a sound basis for acquiring a systematic understanding of New Zealand and its place in the world from the perspectives of history and the social sciences (p.xiii).

These criticisms are developed in the course of the Forum's submission on the revised draft. The submission argues that there is no clear defence of what social studies is as a 'distinct' subject and what its relationships are to the social science disciplines on which it draws. It reflects two interpretations of social studies in recent decades: as promoting a reform agenda for society; as a set of learning experiences directly linked with students' experiences in everyday social life. Major concepts (such as 'democracy' and 'liberalism') are neglected. History tends to be treated as a generalising social science such as physical geography or theoretical economics, rather than as the interpretation of particular developments in human society and culture. Skills (even 'critical thinking' and others of a non-generic kind) are treated as though the content in which they are developed is purely incidental to their exercise. The design of the strands still reflects fundamental weaknesses such as lack of internal sequence; confusion and overlap among them; neglect of structured areas of knowledge and critical understanding of their key concepts; biased selection of material (especially the neglect of the British cultural influence).

The Forum repeats its suggestion that, if a 'mixed' approach is to be maintained, it would be preferable to combine the three strands dealing with social organisation, culture, continuity and change over time. The past could be treated chronologically, and contemporary events could be treated in relation to students' experience on an 'expanding circle' model. The other two strands would each be based directly on a social science (geography, economics).

The Social Studies 'core statement' was published in its final form in October 1997. In January of the previous year the Ministry of Education had published an analysis of responses to the revised draft statement. The only significant difference in the final version is the identification (with some elaboration) of three basic processes: inquiry, value exploration, social decision making. No mention is made of them in the summary of responses. A table sets out, in a general way, how one or more of these processes relate to each of seven broad skills identified as essential to the objectives of social studies. (These skills were listed in each of the draft statements.)

The Education Forum returned to the fray in a media release dated 30 October 1997). It reiterates basic criticisms made of the two drafts. First, the nature of 'social studies' remains vague. There are no clear criteria for distinguishing significant from trivial learning in this area. Although there are many references to 'knowledge', the statement gives little indication of what the crucial content is. Second, the Social Studies curriculum is largely an instrument for advancing government policy on biculturalism in New Zealand. The British origins of the society continue to be underplayed, being treated in the broad category of European influence. Third, the integrated approach involves difficulties for the study of such subjects as history and geography, and offers no clear compensatory advantages over their treatment as separate disciplines.

The Forum's criticisms of the Social Studies core statement are, I believe, substantially correct. I would endorse, in particular, two of the major points. First, the principles of integration relating to the key contributing disciplines are weak. They fail to take adequate account of the distinctive nature of these disciplines and how this affects their study as part of general education. Second, there is an exaggerated emphasis on skills. It seems to be supposed that they are all generic attainments and can be acquired and exercised regardless of particular content. The statement identifies seven essential skills, each of which is related in overlapping ways to three processes. The achievement objectives and indicators at the eight levels for each of the five strands are set out mainly in terms of explaining, identifying, and describing (with reference to a wide range of loosely connected content). The whole document has a mechanical, artificial air about it, like a set of instructions for assembling and using an appliance.

The New Zealand document is, as I noted earlier, very similar to the general outline for SOSE in Australian schools. However, the latter (at least in the Victorian version) does emphasise that one of its goals is to develop students' understanding of concepts in the underlying disciplines. The detailed course advice for teachers that has been produced in Victoria does give more attention to the content of the contributing disciplines and its close relationship to the exercise of critical inquiry and other skills within these disciplines. If the equivalent of course advice material is developed in New Zealand, it may go some distance in meeting the criticisms of the Education Forum.

Social Sciences and their Study in the Curriculum

The nature of the social sciences and a number of the humanities has been a topic of close attention in recent decades. During this time there has also been considerable debate on integrated school curricula in the social sciences and humanities, and a number of significant efforts at such curriculum design.[2]

In the 19th century, strong efforts were made to develop the study of social systems through disciplines that conformed to the nomothetic model of the natural sciences. Sociology (under Auguste Comte's influence) emerged as the clearest example. The character of others was more complex. Anthropology, for example, developed in the context of the colonial activities of European nations. For a long time, it relied on participant observation or a mainly idiographic model. It had links with oriental and classical studies. These were concerned mainly with the analysis of significant texts and were identified as studies in the humanities.

Anthropology, economics, geography, political science, psychology, and legal studies became well established in the early part of the 20th century as disciplines in universities. Although they aspired to the methodology of the natural sciences, they were linked by their objects of study to the humanities. At an organisational level, they came to be accepted as occupying a middle ground between the natural sciences and the humanities.

In recent decades the study of fields that involve the perspectives of several, if not all, the social sciences has substantially increased. In particular, these refer to occupations and to complex social issues and matters of public policy. The presence of ethical issues, the increased attention to historical background, and the growth of 'cultural studies' in the humanities have all contributed to a close relationship between the social sciences and the humanities. One of the most important consequences has been the development of interpretative and other qualitative methods in the social sciences.

This change has been encouraged by a modifying of the commitment to nomothetic methodology within the natural sciences themselves. But more important has been the much clearer recognition that the radical differences between social and physical facts call for corresponding differences in the purposes and methods of systematic inquiry. Because human beings are purposive agents, with a sense of self-identity shaped by engagement in institutions that reflect rules of human design, they are very different as objects of systematic study from those of the natural sciences. It is now more commonly recognised that moral and other values are part of the fabric of social scientific inquiry: not simply objects of such inquiry, but constituents of the process and calling for justification in their interpretation and relative weighting. The methodology of the social sciences includes normative and interpretative dimensions as well as the quantitative.

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[2] Discussions of the underlying issues include Crittenden (1981:ch. 5); Eisner (1979); Hill (1994); Hirst (1974); Pring (1976); Walsh (1993:ch. 9); Warwick (1974). Examples of integrated curricular designs for social sciences, humanities include Bruner (1965) (and see Bruner, 1968, ch. 5); Stenhouse (1970); Keele Integrated Studies Team (1972); Schools Council Moral Education 8-13 Project (1978).

Within the social sciences the relative emphasis on these dimensions of methodology varies. Sociology, economics and social psychology are examples of social sciences in which the quantitative has a substantial place. By contrast, the discipline of history, as Isaiah Berlin (1997) has clearly argued, is predominantly concerned with depicting the whole pattern of events, eras and so on, not with establishing general laws. It uses quantitative methods where appropriate, but is as much interested in the distinctive features of, say, a revolution as in those that reflect laws applicable to revolutions generally. Above all, historians must exercise sympathetic imagination in trying to understand the ways of thinking and so on of people in very different circumstances from their own. The soundness of such interpretation can be assessed. But the conclusions are not reached on the basis of either deductive or inductive argument. It is the particulars, not generalisations, that are the primary concern of historical study. The main categories with which the historian works are qualitative, such as plausibility, likelihood, and sense of reality. History reflects a general condition of systematic inquiry: the richer the content of a science, the less rigorous are its explanatory and predictive theories. The price that some social sciences pay for precise laws (in economics, for example) is inaccuracy in prediction when these laws are applied to the complex circumstances of social life.

There are difficulties in Berlin's account of incommensurable goods, and more can probably be done than he allows in identifying likely patterns for the future based on what has happened in the past. But he highlights the distinctive methodological features of historical inquiry. These place it firmly among the humanities as well as the social sciences, and illustrate how distorting it is to treat the social sciences as though they conformed to a single methodological paradigm.

In examining the nature of the disciplines, Stephen Toulmin has drawn attention to characteristics that have a crucial bearing on their treatment in the school curriculum. As he points out, disciplines are not static ahistorical constructions. They are 'historically evolving collective enterprises that are institutionally organised' (1972:148). There is a continual interaction of processes and content. Given this dynamic character, they are distinguished at any time by their set of common questions and problems and their specific common aims. In relation to the latter, he stresses differences in epistemological objectives: causal generalisations; making phenomena intelligible in terms of human reasons and motives; interpretations of meaning; evaluation; prescription. Disciplines differ according to their focus on one or a particular combination of such objectives. Depending on the range of objects being investigated and the objectives of inquiry, the concepts and theories of some disciplines ('compact') form a more logically coherent pattern than others ('diffuse'). According to Toulmin, some studies fall into the category of 'would-be' disciplines.

On the question of integrated studies, Toulmin notes that variations in the methods of inquiry place constraints on their use as a basis for integration. Any approach that treats inquiry as a kind of constant and neglects the content and historical institutional character of disciplines is as defective as the older practice of treating content as timeless truth. The appropriate criteria for rational inquiry de-

pend on the substantive concepts and the questions into which they enter. This condition is crucial for any defensible form of integration.

As Toulmin (1972:364) emphasises, each discipline is itself an integrating system, and all draw, in various ways, on common-sense knowledge, which itself does not form a fully coherent logical pattern. Among the significant ways in which disciplines can be integrated is in their contribution to the study of complex social issues which go beyond the scope of strictly disciplinable inquiry (for example, poverty, international peace, the treatment of the physical environment). Another basis for integration is provided by complex human activities such as government, the economic order, and education. If the objective is to reach a normative decision on macro-issues of public policy, social morality and so on, the application of a range of disciplines can provide illumination, but not a resolution.

It follows from Toulmin's account of disciplines that any satisfactory curriculum design needs to trace the paths that run from everyday knowledge to disciplined inquiry into a defined range of related topics, and then to the complex human questions that involve a combination of everyday knowledge and the systematic knowledge and ways of inquiring of relevant disciplines. In the development of multidisciplinary studies, the main warning implicit in Toulmin's analysis is against the superficiality of simply drawing particular bits and pieces from a number of disciplines, without any systematic study of their nature.

Unfortunately, this is the approach that both the SOSE framework and the New Zealand Social Studies core statement tend to take. In neither of them is there a systematic plan for developing, over the years of primary and secondary schooling, an understanding of the disciplines in the social sciences and humanities on which they draw: the key concepts, principles, and theories; the main purposes and methods of inquiry. Moreover, there are no significant integrating themes. With few exceptions, there is no interrelating, in either program, of what is to be learnt across the five discipline-based strands at each level.

The designers of the two programs do not seem to have given any serious attention to work that has been done in recent decades on integrated curricula in the social sciences and humanities (see footnote 2). One important example is *Man: A Course of Studies* (MACOS), designed under Jerome Bruner's supervision in the mid-1960s, and reflecting strongly his theory of curriculum and psychology of learning. Many of the details of his theoretical position and of MACOS can be (and have been) criticised.[3] What is important to note for our purpose, however, is the close attention given to the elements through which a significant integration of the contributing disciplines can be achieved. The program is designed to address, at various levels, three basic questions: What is human about human beings? How did they get that way? How can they be made more so? (Bruner slides over the problem of distinguishing desirable and undesirable features of being human.)

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[3] I have made some critical comments on Bruner in Crittenden (1979). Richard Jones (1972), who worked on the MACOS project, is critical of its neglect of the education of the emotions and the role they play in learning.

Relevant disciplines are applied (with due attention to the structure of their content as well as methods of inquiry) to provoking questions about, and understanding of, five basic human activities: tool making, language, social organisation, the management of humans' extended childhood, and the human urge to explain the world.

MACOS was intended for students in the middle years of schooling. However, we know from Bruner's general theory of education that the 'structure' of the disciplines — that is, their basic concepts, theories, and methods of inquiry together with the pattern of relationship among the key elements — should be presented in ways that are appropriate for the dominant mode of learning at each main stage of development. Each discipline, he stresses, is a complex integrated unit in the whole curriculum. For Bruner, the emphasis moves from learning mainly through action ('enactive mode') to perceptual organisation and imagery ('iconic mode') to direct attention to symbols ('symbolic mode'). As children develop, it is a matter of each later mode becoming dominant, not of its displacing the earlier ones. Thus, for Bruner, the overall pattern of the curriculum should be a spiral one in which the same basic concepts, theories and skills are presented in accord with each dominant mode of representation. There are other ingredients in his proposal for a spiral curriculum — and, of course, it is not immune to criticism. The point to be emphasised here is that neither of the social studies curricula under discussion gives evidence that it is based on any clearly articulated theory of intellectual (and emotional) development through the years of formal schooling.

Concluding Comments

It will be obvious that, for the most part, I agree with the Education Forum's criticisms of the core statement on Social Studies for New Zealand schools, which also apply to the very similar SOSE frameworks in Australia. Some of the concerns may be met in the development of detailed advice for teachers (as for SOSE in Victoria). But the basic defects in the curriculum remain. Perhaps the best arrangement is to have a systematic study of history, geography and one or two other social sciences as distinct fields of knowledge and inquiry, and to include at various levels in the course of schooling a program designed in relation to a set of significant social issues.[4] The latter would bring together content and methods from a range of social sciences — and also several of the humanities. In addition to history which, in various ways, belongs to both areas, these would certainly need to include elements of ethics and social philosophy. There would also be scope for drawing on literature and the arts.

Among the advantages of some such arrangement, at least two should be stressed. First, it enables students to focus on the distinctive content and methods in each of a balanced range of systematic intellectual disciplines; second, it provides the opportunity for students to learn how to apply these disciplines to significant

[4] *The Humanities Project* (Stenhouse, 1970) relates subjects in the humanities (and social sciences) to the discussion of controversial issues in complex areas of human experience, including war, education, the family, poverty, and race relations.

issues whose complexity transcends the boundaries of any individual discipline in order to gain understanding, make informed decisions, and so on. What needs to be stressed is that no integrated curriculum will be educationally effective unless it respects the nature of the disciplines involved (both their central content and methods); provides significant topics that require the application of a range of disciplines; and matches the learning objectives to the students' general level of intellectual and emotional development and previous formal educational experience.

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Associations of Health Consumers: The Key to Health Care Reform

Vern Hughes

HEALTH care reform in Australia has reached an impasse. The public sector, professional medical bodies, and private health insurers face one another in a glorious stand-off. Medicare retains popular support but is structurally incapable of containing demand for health services or restricting expenditure growth even though its available resources are limited. Private insurers are unable to curb health treatment costs, even as they face declining and ageing enrolments. Doctors' organisations lament the high turnover of general practice, the rise of medical entrepreneurs, and the long waiting lists at public hospitals, but fiercely resist the introduction of contracted arrangements with insurers or alternatives to fee-for-service payments in primary care.

None of these three components of the health system — Medicare, professional bodies, private insurers — can unilaterally generate a solution to the system's complex structural and financial crisis. Neither the medical profession nor the insurers are capable of winning sufficient political support to dismantle Medicare. Only one in three Australians may now be privately insured, but their political influence remains strong enough to preclude the dismantling of private insurance. The professional bodies retain significant political influence, but they can no longer dictate exclusively the shape of the health system: some anti-competitive features of guild self-regulation, once enshrined in legislation, have now yielded to the onset of competition policy.

The key to comprehensive health care reform in Australia now lies with the development of new structural mechanisms which can assign to consumers the capacity and the incentive to contain health costs and to integrate service delivery systems.

This article sets out a case for a health care reform strategy based on associations of health consumers within a framework of managed competition. Associations of consumers would be voluntary entities that purchase on behalf of their members (or enrolled populations) comprehensive, cost-conscious health care packages through contracts with preferred providers; they would aim eventually to integrate financing and service delivery (insurance and provision) in the form of prepaid, budget-capped health care. With freedom of entry and exit, consumers would

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have the option of joining competing associations that offer price and service-quality advantages. Consumer governance in such associations is proposed as the best form of regulation against practices injurious to consumers.

The proposed reform strategy comprises a combination of public policy change and immediate enterprise initiatives that may be undertaken in civil society by voluntary associations or alliances of associations. David Green (1996:98) has called such initiatives 'private action plans', by which he means initiatives that can be undertaken in the present which are not dependent on prior public policy change, but which have the effect of creating conditions which are favourable for, or facilitate, further public policy innovation. In health care reform in Australia, the development of associations of consumers is the *sine qua non* of public policy change: without such associations, reform proposals will continue to lack the capacity to create public confidence that alternative structures can be implemented and will genuinely work in the interests of consumers.

Managed Competition

The strategy incorporates the system of managed competition developed by A. C. Enthoven (1978, 1993).

Its features are the following:

1. Information asymmetries between doctor and patient require the intervention of intermediaries or agents which make available comparative price and service quality data to patients, and enable patients as consumers to purchase (individually or collectively) their preferred services.

2. The purchases facilitated by consumer intermediaries must be fully costed. Costs for episodes of treatment or care must be specified and transparent so that intermediaries may substitute lower-cost for higher-cost purchases.

3. To offer integrated and cost-effective care, consumer intermediaries must be able to package a mix of services and insurance products to meet a variety of consumer preferences.

4. Consumer intermediaries must be able to compete for subscribers or enrollees on the basis of package price and service quality.

5. Consumer intermediaries require a framework of internal and external regulation to limit the impact of adverse selection and moral hazard.

The Rationale of Reform

The value of Enthoven's system of managed competition lies in its use of consumer intermediaries, who (unlike Medicare, private insurers and professional medical

bodies) have both an incentive *and* a capacity to contain health costs and to integrate service delivery.

Medicare provides medical benefits for general-practice consultations but has no structural capacity to integrate primary care (which may be dispersed among a variety of providers) or to curtail overservicing. It provides hospital benefits, but its only means of containing costs is rationing of services (exercised indirectly by state governments). It has no capacity to substitute lower-cost regimes of care for higher-cost regimes.

Private insurers reimburse medical, para-medical and hospital expenses incurred by consumers, but have no means of containing the unit costs of these expenses, and no incentive to coordinate or integrate service delivery. There is no capacity for insurers to identify and manage disease risk before it becomes an episode of illness. The community rating of premiums prevents insurance providers from offering packages to attract new and diverse subscribers. The present regulatory regime for health insurance invites adverse selection.

Medical practitioners are remunerated on a fee-for-service basis for highly compartmentalised interventions. They are not reimbursed or rewarded for collaborating with practitioners across disciplinary boundaries to develop integrated care regimes or to monitor health outcomes. Health information records remain the personal property of practitioners, and are not transferable across disciplines or service-delivery types. Fee-for-service incorporates powerful financial incentives to overservicing, and discourages preventive care

Design Features[1]

1. Health consumers would have the option of joining an association of their choice. Membership would be voluntary, with freedom of entry and exit. Associations may be constituted on the basis of community of interest or geographic region.

2. Associations would not be permitted to reject members on the basis of health status or risk. A registration entity would probably be required to register associations, with authority to impose severe penalties on any association which rejected membership on the basis of age or health status.

3. Members who choose to join an association would have their Medicare contribution paid to the association of their choice. This contribution would receive a risk-rated adjustment, based initially on factors of age and sex, and in subsequent years on additional factors related to health status. The amount received by each association would be a per capita based proportion of total Medicare expenditure for each enrolled member, with a risk-rated adjustment.

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[1] Some of the features identified here have been canvassed by R. B. Scotton (1990, 1991, 1995) in proposals for the introduction of managed competition in Australia. Scotton's work, however, has lacked the associational focus proposed here, and has looked to public policy change as the sole agency for health care reform. It has therefore lacked a transitional strategic orientation.

4. Members would also have their share of Pharmaceutical Benefit Scheme (PBS) expenditure allocated to the association of their choice, using the same formula (a per capita-based proportion of total expenditure, with a risk-rated adjustment).

5. Associations would be free to levy their own membership fees, copayments and/or insurance tables. These must be transparent and publicly available to facilitate consumer choice.

6. Associations would be required to meet the full costs of all public and private hospital services, medical services, and those pharmaceuticals covered by PBS. Para-medical services such as dental, allied health and optical services, domiciliary care services, and pharmaceuticals not covered by PBS would be optional.

7. Associations would be free to contract with providers of hospital, medical, domiciliary and pharmaceutical services on a cost-related basis for episodes of treatment or care. They would also be free to provide such services (or combinations of them) directly without regulatory restriction.

8. Contracted providers of services to associations would be required to enter records of consultations, treatments, health maintenance strategies and drug prescriptions in an information system that is the property of the association. This information system would be transferable across practitioner and service delivery types with the aim of enhancing outcome monitoring, and could be tailored to objectives such as improved pre-admission and post-discharge reviews, reduced infection rates, fewer post-surgical complications, and lower readmission rates. Marketable health-value advantages could be developed around these outcomes.

9. Associations would be free to provide primary-care arrangements directly for members on a pre-paid or non-fee-for-service basis and to devise their own remuneration systems for practitioners. The development of integrated primary care teams comprising general practitioners, nursing and domiciliary care staff would enable associations to reduce or prevent hospitalisation and to substitute low-cost post-acute domiciliary care for high-cost hospital in-patient services. They would make possible the introduction of preventive-care strategies based on epidemiological screenings, risk appraisal and containment, targeted intervention for at-risk members, comprehensive immunisation procedures, case management and harm minimisation interventions.

10. Health consumers who elect not to join an association would have their Medicare entitlements preserved as at present for medical and public hospital services.

A Transitional Strategy

The weakness in many proposals for reform of the Australian health system is the absence of an effective transitional strategy. In particular, the inability to identify

non-state agencies of health care reform to initiate and then complement public policy change consigns many proposals to irrelevance. The following is a suggested transitional strategy involving immediate enterprise initiatives on the part of associations.

1. Existing organisations which have enrolled memberships (voluntary associations, cooperatives, friendly societies, business associations, credit unions, clubs, and churches) would be encouraged to explore ways in which they might act as agents on behalf of their members in purchasing health services or health insurance products. Their initial educative focus would be to introduce their members to the concept of enhanced market purchasing power for consumers of health care through the intervention of consumer intermediaries.

2. Some of these organisations would be existing health insurance providers (friendly societies, employer-sponsored bodies such as the Lysaght Hospital and Medical Club, trade union sponsored entities like the NSW Teachers Health Society, or regionally-based entities such as the Yallourn Medical and Hospital Society). Others would be existing health service providers (hospital cooperatives and associations, friendly society dispensaries, or rural entities such as the Victorian Bush Nursing Association). Others would be member-benefit associations which currently have no health-related function (clubs, credit unions, purchasing cooperatives). Through a process of alliance forming, new entities comprising sizeable aggregates of health consumers could be assembled with significant market purchasing power.

3. Associations would make available to their members comparative price and service-quality data. These data would be used to secure discounted price arrangements on services not listed in the Medicare benefits schedule (dental, allied health, optical, non-PBS pharmacy items, and some home-based care), and arrangements concerning medical services which are listed in the schedule but which are priced in excess of the scheduled fee. Associations would package these arrangements in various formats.

4. Associations would develop information and health record systems which are transferable across practitioner and service delivery types. An association would favour practitioners and providers who voluntarily agree to enter records of consultations, treatments and appointment schedules in its member health record. The record would not be a substitute for practitioner records: it would be a patient-held record issued by the association and would remain the property of the association. It would serve as a *de facto* membership card of the association.

Use of the record by practitioners and provider organisations would form the basis for preferred-provider arrangements. The size of an association's market purchasing power would shape the willingness of practitioners and providers to use the record. With sufficient purchasing power, providers could be required to pay a fee

for participation in the record system, which would be used to finance the development of the system.

5. With an information system transferable across service delivery types, associations could then proceed to develop new service-delivery systems. Even within the current system of payment for medical services, associations could introduce new models of primary care. These could take the form of contracts with, or direct employment of, primary-care teams comprising general practitioners, nursing, allied health and domiciliary-care providers, with coordinated arrangements for after-hours and home-based medical care. Shared arrangements could be introduced between primary-care teams and hospitals concerning pre-admission and post-discharge services, similar to current 'shared care' maternity arrangements between general practitioners and hospitals.

6. Associations which have in place some degree of integration of information and service-delivery systems could introduce billing and payment systems for episodes of treatment or care which are inclusive of various practitioner and service types. These systems may entail a single billing and transaction payment for members, with the association allocating payments to providers for the component parts of an episode of care.

7. Associations of health consumers would be well placed to participate in current publicly funded coordinated care arrangements. In 1996 the Commonwealth Department of Human Services and Health commenced twelve coordinated-care trials which will aim to assemble comprehensive packages of care for people with complex health needs. (The trials are part of a program initiated by the Council of Australian Governments to test alternative service-delivery and funding arrangements which have the potential to prevent or reduce hospitalisation and provide cost-effective substitutes for long durations in institutional settings.) Associations of consumers would be the ideal mechanism for trialling and developing such arrangements for wider application.

8. Associations would also be well placed to tender for a range of existing federal and State government-funded health services (Home and Community Care services, Community Aged Care Packages, maternal and child-health services) where a capacity for coordination of service delivery is favoured.

Public Policy Changes

The aim of these immediate enterprise initiatives is to develop the capacity of associations to win public confidence that alternative structures within the health system can be satisfactorily put in place. Without this confidence, significant public policy change will be unlikely: reform proposals will be too easily subject to political campaigns which play on fear of uncertainty.

The reform strategy proposed here is conceived as an optional participation in alternative structures. The shell of the existing system is retained for those who decline to exercise their option to join an association. Medicare would thus be retained as a system of universal health coverage, though the following seven policy shifts would, as a package, substantially alter the forms of health-care financing and delivery that are possible within it.

1. The Medicare levy and current Medicare entitlements would be retained, but consumers would be permitted to have their Medicare contribution and their share of PBS expenditure (with a risk-rated adjustment) paid directly to the association of their choice. In turn, associations would be required to meet the full costs of all public and private hospital services, medical services, and those pharmaceuticals covered by PBS.

Since the purpose of consumer associations would be to maximise service benefits to their members, it would be self-defeating for associations to be for-profit entities. It is likely that some investor-owned organisations would wish to assume at least some of the functions proposed here for associations in a regime of managed competition, but the potential conflict in a for-profit entity between the interests of investors and the interests of consumers would undermine the possibility of winning the public confidence required for reform. For this reason, it is proposed that only not-for-profit entities would be permitted to register as associations of health consumers eligible to receive Medicare-generated funds. (Investor-owned enterprises would, of course, be free to trade as managed-care enterprises, but would not be eligible to receive Medicare contributions. It might be objected that this exclusion is an unnecessary restriction on competition. The political reality is that the participation of investor-owned organisations in this scheme would render it politically unachieveable.)

2. Private health insurance would be deregulated. Since associations would receive risk-rated Medicare contributions for each enrolled member (a per-capita proportion of total Medicare expenditure adjusted by factors of age and sex), higher-risk members would attract a higher Medicare payment. This would to some extent offset the impact of risk selection within a deregulated health insurance market. Associations adopting insurance tables which discouraged higher-risk members would lose the Medicare payment that follows these members.

Associations which offered insurance would be permitted to introduce behaviour and outcome-related rebates, bonuses and penalties as incentives for members to manage their own health risks. It should be permissible, for instance, for tables to differentiate between smokers and non-smokers. Bonuses and penalties should be permissible related to compliance with health-maintenance strategies involving immunisation, screenings, dietary and exercise patterns, and weight loss. Rebates could be offered to at-risk members who avoid illness or hospitalisation over a number of years.

Insurers which are not associations would also be permitted to offer flexibilities of this kind. They would be free to seek low-risk clients, but they would not be eligible to receive risk-rated Medicare contributions.

3. Public hospitals would be required to develop a pricing regime for in-patient and out-patient services on a full cost-related basis for episodes of treatment or care. Although the market purchasing power of associations may be sufficient to instigate this regime, a legislative requirement to this effect may also be required.

4. All regulatory restrictions on the capacity of associations to contract with or directly employ medical, dental and pharmacy practitioners would be removed. Associations would be permitted to trade freely in the services of these practitioners. Similarly, there would be no restrictions of the capacity of associations to own hospitals, medical or dental practices or pharmacies.

A great deal of regulatory reform is required in this area. Friendly societies are currently not permitted to own hospitals. Pharmacies and dental practices may be owned only by self-employed practitioners (with an exemption for friendly societies). For many years, Victorian legislation prohibited new pharmacies from opening within five kilometres of an existing pharmacy. The Pharmacy Guild of Australia is currently conducting a campaign to have the National Health Act amended so as to restrict the dispensing of PBS prescriptions to those pharmacies which are owned by self-employed pharmacists. A legislative recognition of associations as the coordinating instruments in the health system would provide a catalyst for sweeping away this regulatory morass.

5. All restrictions on the supply of health practitioners would be removed. Professional bodies and specialist colleges have long sought to restrict supply in order to enhance their market power. In the absence of more rational means for containing health costs, governments still seek to restrict demand by rationing the supply of practitioners (limiting opportunities for practitioner training), thereby colluding with the professional bodies against the interests of consumers. The consumers most disadvantaged by these practices are those in rural areas that face severe practitioner and specialist shortages.

6. Associations would assume ownership rights to the health records of their members, and legal liability for their care management. Providers of services to associations would be required to enter records in an information system that is the property of the association. The association would be responsible for managing the care of each of its members, and the association (and not its providers) would assume liability for care management. For consumers who elect not to join an association, the current arrangements concerning ownership and access rights to health records would apply.

Aged Care Reform

Associations of health consumers could also assume responsibility for long-term care (nursing home and hostel accommodation) (Richardson, 1997). Association members over the age of 40 could elect to have a per capita-based proportion of total Commonwealth expenditure on nursing homes paid to their associations. This contribution may or may not be risk-rated. Continuous membership from the age of 40 would oblige associations to provide the full cost of nursing home care; partial or discontinuous membership from the age of 40 would mean provision of part of the cost on a pro-rata basis. Portability would be enshrined, as in the case of long-service leave.

Associations would be free to develop supplementary benefits of their choice, in the form of fees, copayments or insurance tables. They would also be free to determine their own eligibility requirements. Current arrangements would apply for those who choose not to join an association.

The issue of transitional arrangements would require careful consideration, but need not present insurmountable difficulties. It would be possible, for instance, to delay the obligation on associations to provide for long-term care for a period of three years from the commencement of managed competition to allow associations to accumulate the required funds. The Commonwealth would continue with its present arrangements in the interim.

The case for integrating health-care and aged-care provision within the coordinated service delivery and financing systems of consumer associations is compelling. Primary-care delivery systems which manage transitions between home-based and institution-based care should become the focus for consumer choice, because it is these delivery systems that determine cost-effectiveness and service outcomes.

Consumer Governance

A health system based on associations of consumers within a regime of managed competition would be characterised by minimal external regulation but strong internal regulation through consumer governance. Consumer governance is proposed here not as an optional extra, nor as a throwback to once fashionable New Left notions of participatory democracy. It is proposed simply because it is a fundamental requirement for comprehensive health-care reform, for three reasons.

First, providers and politicians in Australia have waged a century-long battle for control of the health system. The outcome of this battle has been a systematic structural separation of financing and delivery, a highly fragmented service system, a de-alignment of supply and demand, and legislative protection for the market power of providers. One observer has described this outcome as the '"East Berlin Circa 1989" model of health care in which providers intimidate patients, terrorise governments, and steal all the money' (Paterson, 1996:40). Structures of consumer governance are essential to bring down this Berlin Wall, and to establish in practice, as well as in principle, a patient-centred health system.

Second, consumer governance is the only governance structure in health care provision that is fully compatible with an 'active agency' model of health maintenance and financing. This model, whereby individuals as consumers are engaged as active agents in modifying their behaviour to manage health risks, is counterposed to the 'casualty' model of health care, in which illness is viewed essentially as an act of God (Goldsmith et al., 1995:15). Active agency implies the facilitation of self-direction in health maintenance and illness prevention, not passivity. It implies a culture of self-help. An association of consumers is a self-help organisation, conferring the status of *member*, not *client*. Facilitating this cultural shift in health care requires a structural mechanism with a matching culture.

Third, if associations of consumers are to be self-help organisations, they must also be self-regulating. Consumer preferences in health care are increasingly diverse, and associations will adopt various philosophies of care. They would be free to determine their own values and organisational direction, within a framework of core provisions. Many would be based on communities of interest, and would employ the community resources, infrastructure and volunteer networks of those communities. Many would seek to integrate the provision of cost-efficient health care with the strengthening of community supports for the ill, the infirm and the isolated. As consumer-governed, self-regulating entities, associations would make their own judgments about which practices enhance good health, and which practices are injurious to good health. They would have low tolerance levels for incompetent or lazy practitioners or poorly performing programs.

Aboriginal health is a case in point. The National Aboriginal Community Controlled Health Organisation (NACCHO) is the peak body of over 100 Aboriginal health services in Australia. It operates in an environment where health outcomes have been, and remain, incidental to the financing and delivery of services. In a regime of managed competition, NACCHO could register as an association of consumers with a clear community of interest, assume control over health-maintenance and illness-prevention strategies, and pursue health outcomes in new and co-ordinated ways.

Case Study: Seattle's Group Health Co-operative

Group Health Co-operative in Seattle is a consumer-governed health maintenance organisation in the United States (Davis & Andrews, 1992). It has 477,778 enrollees and 7,344 staff (FTE), including 1,007 physicians and other medical staff members and 1,533 staff nurses. It contracts with a further 1,950 non-staff medical practitioners (1993 figures). Medical staff form a self-managing group which contracts directly with the cooperative for remuneration for services. The contract determines the size of the medical salary pool which is calculated as a fixed payment per enrollee. The medical group works with its own capitated budget (also a fixed payment per enrollee) within the global budget of the cooperative (which is also drawn from a fixed payment per enrollee). The cooperative has 30 primary-care centres, two hospitals, an in-patient centre, a skilled nursing facility, and five spe-

cialty medical centres. It contracts with 38 other health institutions for selected specialty services.

The cooperative was formed in 1947 as a pre-paid health maintenance organisation. Its initial group of medical staff were drawn from a group practice in Seattle whose members were black-banned by the American Medical Association (AMA) for contracting medical services to industrial plants during World War II. It was not until 1951 that the Washington State Supreme Court ordered the AMA to end its boycott of the contracting medical staff, and permit their re-admittance to membership.

The cooperative is governed by an elected eleven-person board of trustees. All are consumers and all are volunteers. There are 23 local advisory councils that advise the cooperative on various matters: a majority of council members are elected consumers.

As a health maintenance organisation, Group Health (1993:3-4) describes itself as a provider of 'comprehensive, coordinated medical care for a fixed, prepaid fee with minimal copayments'. As a managed care organisation, it describes its purpose as 'the full integration of healthcare delivery and healthcare financing' with five characteristics: 'comprehensive coverage, co-ordinated services, strict performance standards, consumer involvement, and predetermined payment'.

The Australian Experience

Most Australians under the age of 50 know little of the history of friendly societies as consumer-governed associations which contracted with medical providers for per capita-based payments for medical services and established pharmacies which employed salaried pharmacists. Two generations of Australians know little of the establishment and financing of bush and community hospitals by voluntary public subscription.

Between the beginning and middle years of the 20th century, the medical and pharmacy guilds fought a long battle to free themselves from the regulatory regimes placed on them by their patients through the friendly societies. By the late 1940s the battle had been won by the guilds. The crucial blow for the societies was dealt by the Chifley Government's health insurance scheme: the Labor governments of the 1940s believed that a state-run system of insurance was preferable to a system that was voluntary and associational. To install this system, it was necessary to sever connections between the financing of services and the provision of services.

The friendly societies that survived this dual onslaught from guilds and the state have today largely been reduced to insurance houses divorced from the actual provision of health care. There are some important exceptions to this generalisation; but, in the main, the once-important connection in Australia between associational endeavour and health care has been lost for two generations.

Health care reform in Australia will involve a combination of comprehensive public policy change and entrepreneurial enterprise initiatives in a variety of settings. But it will also involve rediscovering a culture a self-help and mutual aid, and em-

bodying its principles in contemporary organisational forms and policy arrangements.

Reform in health care and aged care, now such a mass of dilemmas for governments and insurers, and the subject of deep-seated public anxiety, will depend upon our capacity, and our willingness, to rediscover this culture of self-help and mutual aid.

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Collective Licensing of Copyright: Options for Competitive Reform

Jeremy Thorpe

COPYRIGHT law usually lags behind technological developments and changing market circumstances. It is high time that Australia's Copyright Act 1968 reflected the development of copyright collecting societies.

Copyright was originally formulated in an age when mass production was unknown and the geographic distribution of the copyrighted material was limited. In those circumstances, since authors were able to enforce their copyrights individually, there was little need for collective enforcement.

Copyright collecting societies have emerged as technological developments have made it harder for individuals to monitor and enforce their rights. The members of a copyright collecting society license their copyrights to the society, which in turn licenses the copyrighted material, and collects and distributes royalties, on behalf of the copyright owners.

Considerable concern has been expressed, especially by small businesses, about the power of collecting societies (HRSCLCA, 1997a:5-6). As a result, the Commonwealth House of Representatives Standing Committee on Legal and Constitutional Affairs (HRSCLCA) is considering the efficacy of the regulation of collecting societies. In this article it is argued that copyright collecting societies should be regulated in a manner consistent with the competitive regulatory regime that applies to other sectors of the economy.

A Framework for Assessing Copyright Laws

While often conceived of as a form of natural right, copyright is better understood as an economic tool (Drahos, 1996; ORR, 1995). It exists to attempt to correct market failures inherent in the production of intellectual and creative works, and hence facilitate the optimal level of creativity.

Copyright law 'protects the property rights of authors, composers and artists as an incentive to creative activity ... and in terms of economics, gives the copyright owner a temporary monopoly on the original work' (Dnes, 1996:33). It is important that the monopoly should be temporary, and limited to those circumstances in which the creative activity would not otherwise have occurred:

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> intellectual property rights are justified only by the need to overcome failures of the market economy in producing creative works; unauthorised uses are prohibited only to the extent necessary to promote the correction of market failure and the efficient production of intellectual works. (Hadfield, 1992:5)

Given that copyright protection is a legislative grant of market power, it is appropriate to analyse the regulation of collecting societies in accordance with the framework agreed to by the Commonwealth, State and Territory governments in clause 5(1) of the Competition Principles Agreement (COAG, 1995):

> The guiding principle is that legislation ... should not restrict competition unless it can be demonstrated that:
> (a) the benefits of the restriction to the community as a whole outweigh the costs; and
> (b) the objectives of the legislation can only be achieved by restricting competition.

This places the burden on those who benefit from the legislative grant of market power inherent in copyright to demonstrate that such power is in the public interest.

Concerns about Collective Licensing

In many cases, individual licensing of copyright is impossible because of the high monitoring and transaction costs involved. The distribution of copyrighted material worldwide often makes it impossible for artists to detect breaches of their copyright. Similarly, the costs become excessive if artists have to negotiate with many potential users. Copyright collecting societies have developed as a modern means to overcome these problems.[1] Six such societies exist in Australia.

Businesses have expressed two kinds of concern to the HRSCLCA (1997b). The first, and the more common, is alleged double-dipping by authors: for example, a singer or a song-writer who has already received royalties from a radio station may be reimbursed again when a shop owner listens to the performance over the radio. The second concern is that, although a licence may be justified, its price may be excessive.

The first concern has no weight as a matter of law, and little weight as a matter of policy. So-called double-dipping can be justified as a risk-sharing mechanism that aids the dissemination of copyrighted material. By providing authors with rights at multiple stages (for example, when a compact disc is sold to a radio station, and when it is played over the radio) the Copyright Act enables authors to share the

[1] The move towards greater recognition of moral rights in Australia (see Clode, 1998) does not sit comfortably with the role played by collecting societies, since if collecting societies grant licences to anyone who is prepared to pay for them, this appears to convert the exclusive rights under the Copyright Act to mere rights of remuneration.

risks by lowering the price of the initial sale licence (hence encouraging uptake), and then earning income later. The second concern, however, is more serious. It arises because copyright collecting societies employ actual or potential anti-competitive means to achieve their objectives. Copyright collecting societies bring together parties who would normally be competitors. This enables creators to discourage users from purchasing other material (tying), and to jointly determine prices for the copyright material (price-fixing) (Treasury, 1996:63).

This anti-competitive conduct raises the price of the work above that which would otherwise be charged and, as a corollary, results in a decrease in use of the copyrighted work. As copyright material has value only to the extent to which it is used, the broader diffusion and use of intellectual property adds value without adding significantly to costs. The collecting societies' restriction of the diffusion and use of intellectual property goes some way towards explaining why low-quality material ('elevator music' or 'muzak') is used in locations where use of original material may be preferred.

In addition, some collective licensing practices, particularly the licensing of all an author's rights to one person or organisation ('blanket licences'), discourage direct commissioning of works. While the majority of individually commissioned works in Australia are created by Australians, collectively licensed material is mostly foreign. Thus, regulation to restrict blanket licences should encourage the use of material created by Australians.

How Collecting Societies Operate

From the perspective of copyright owners, the current system of collecting societies appears quite reasonable. The six collecting societies are broadly aligned with the different classes of right holders; for example, the Phonographic Performance Company of Australia licenses the broadcasting and public performance of sound recordings owned by record companies, while the Copyright Agency Limited provides licences with respect to educational copying and journalists' rights. The Simpson Report on the operations of collecting societies clearly endorsed this logic and found no evidence that the number of societies should be reduced (Simpson, 1995:section 2.6).

From the user's perspective, however, the number and diversity of collecting societies appear slightly less practical. Of particular concern is the relative proliferation of collecting societies that license different rights for different purposes; indeed, Australia appears to have more collecting societies than any other Western country (Lester & Faulder, 1989:108). This means that a business that requires more than one licence is likely to have to approach more than one collecting society; cooperation between collecting societies remains limited and the one-stop-shop is not a real option. International practices demonstrate that such a fragmented system is not necessary (Matsuoka, 1989:50). The multiplicity of societies appears to create significant complexity for non-intensive users of copyright (such as the majority of small businesses), even though the principal rationale of copyright col-

lecting societies is that they reduce transaction costs for both copyright owners and users.

A solution to this problem is to reduce the points of contact that a small business must deal with in respect of copyright licensing. This can be achieved by regulating to encourage the emergence of competing 'one-stop-shop' collecting societies. Again, international evidence suggests that this proposal is feasible (ACCC, 1996:26). The Simpson Report, however, is scathing of such a suggestion:

> Given the frequently expressed concern about the power of societies, it is perhaps surprising that there is also a frequently expressed opinion that there are too many societies and that they would achieve greater efficiency by amalgamating and sharing administrative expenses. The views are in direct conflict. ... there is probably little cost advantage in the amalgamation of the existing societies. Rather, *it is recommended* that there be a multiplicity of societies so that individual societies can represent the disparate interests of the separate groups of rights owners. This is more likely to ensure the equitable representation of members' rights and promote a competitive environment. (Simpson, 1995: section 2.6)

Simpson's criticism is misdirected. Simpson makes the common mistake of assuming that because copyright provides market power to encourage the *production* of the work, such power should also be provided to facilitate the *distribution* of the copyright. As the Hilmer Report noted, it is important to limit the existence of market power solely to those elements where it is necessary, and introduce competition at every other stage (Hilmer, 1993:193).

While it is necessary to provide some form of market power to address the underproduction of creative works that would occur without copyright protection, there is no compelling reason to sanction market power over the distribution of the copyrighted works. Figure 1 demonstrates the social benefits from the introduction of protection through the legislative grant of market power in the form of copyright, and the subsequent benefit of ensuring that competition exists in distribution of the copyrighted work.

Without the copyright protection provided by a legislative grant of market power, only Q0 of copyrighted works would be created by authors (ORR, 1995:13-15, 43-50). While some of Q0 may be sold at relatively high prices, the public's ability to copy the work means that there may only be a single (or at least very few) sales because the remaining consumers have an incentive, absent any intellectual property, technological or contractual protection, to produce (Q^* minus Q0) copies and pay nothing to the authors in return.

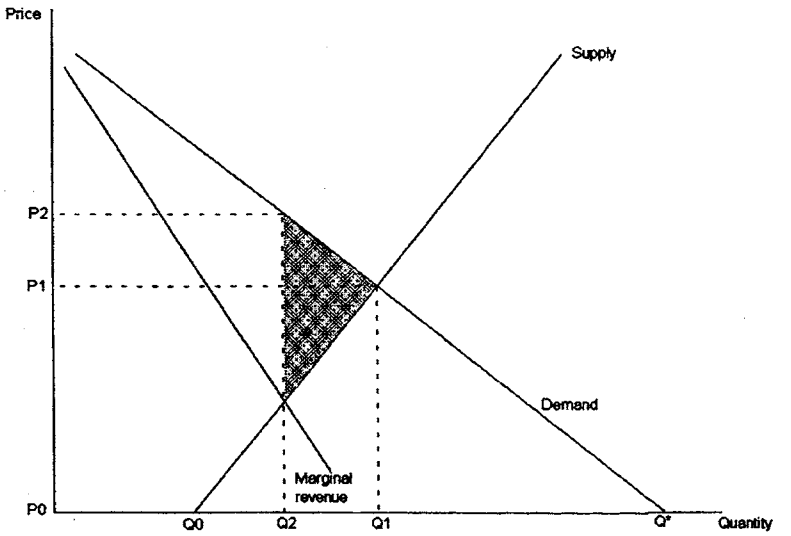
Once copyright protection is granted, each person has a monopoly right over his or her own work, but competes in a broader market of copyrighted material. The grant of copyright protection permits the authors to stop users free-riding; and

hence a market is created. As a result, Q1 copies of the good are sold and produced at P1.

If the formation of a copyright collecting society results in an effective monopoly over distribution, the result will be increased prices and a restriction in distribution. In Figure 1 the introduction of monopoly results in the number of works sold falling from Q1 to Q2, while consumers are forced to pay more (P2 minus P1). This has two principal effects. First, there is a transfer to the collecting society (and hence the authors) from consumers equal to (P2 minus P1) multiplied by Q2. Second, there is a welfare loss to society because some consumers who value the work above what they would have paid in a competitive market (P1) do not value the work sufficiently to purchase it at the monopoly price (P2). This results in a welfare loss equivalent to the shaded triangle.

Figure 1

Supply of and demand for copyright protected goods



Though a stylised example, Figure 1 demonstrates that there are social benefits to encouraging competition in the distribution of copyrighted works, and as a corollary, there are costs in allowing copyright collecting societies to operate as monopolies in the distribution of copyrighted material.

Defects of the Present Regulatory Regime

The Copyright Tribunal sets copyright licence fees. Under the Copyright Act 1968, the Copyright Tribunal has the power to hear disputes about terms and conditions

of licences or licence schemes administered by collecting societies. Licensors, licensees and persons desiring a licence may refer disputes to the Tribunal for determination.[2] In this way:

> The Copyright Tribunal is an arbitrator. It arbitrates disputes concerning the amounts which should be paid by way of reasonable or equitable remuneration under licences granted, or to be granted, sometimes by statute, for the use of copyright material. (Shepherd, 1995:1)

The Tribunal has been used in such a manner only 14 times since 1968 (ACCC, 1996:8), presumably because the proceedings are thought to be expensive, slow and unnecessarily legalistic (Simpson, 1995:254).

The anti-competitive behaviour of collecting societies is regulated by the Australian Competition and Consumer Commission (ACCC) under the Trade Practices Act (TPA). The TPA attempts to accommodate the different emphases adopted by intellectual property laws and competition policy. Sub-section 51(1) states that anti-competitive conduct permitted under intellectual property legislation is subject to the TPA. This blanket coverage is subject to sub-section 51(3), which provides an exception to the prohibitions contained in Part IV, except for sections 46 and 46A (misuse of market power) and 48 (resale price maintenance).[3] Significantly, however, the ACCC has the power to authorise otherwise anti-competitive conduct where the anti-competitive effect is outweighed by the public benefit (subsection 90(6)).[4]

This dual enforcement approach is limited in two fundamental respects. First, the Tribunal is purely reactive. It relies on parties to bring disputes brought before it (which happens often after many years of protracted and expensive negotiation), and does not have any powers to regulate to avoid disputes.[5] Second, the Tribunal does not examine the anti-competitive or public interest effects of any licensing arrangement.[6]

The separation of the price-setting function from an explicit assessment of competition in the market, particularly when the market's existence is made feasible only by the legislative grant of market power, is inconsistent with the treatment of firms in other industries which enjoy significant market power. For example, such firms are often regulated in a manner that combines the price-setting function with consideration of actual or potential anti-competitive conduct. Examples include prices surveillance under the Prices Surveillance Act 1983 and industry-specific access/pricing regulation.

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[2] The Tribunal's jurisdiction and procedures are explained in ACCC (1996:8-12).

[3] See Thorpe (1995) for further details.

[4] See TPC (1991:11-13).

[5] However, a former President of the Tribunal acknowledges that the Tribunal is a de facto industry price setter and has an obligation to look beyond the matter before it to consider the consequences of its decisions in the wider marketplace (Shepherd, 1995:10-11).

[6] *WEA Records v Stereo FM* (1983) 48 ALR 11.

Overcoming the Inadequacies of the Law

Some options for overcoming these inadequacies are explored below.

Extending the Tribunal's power to regulate collecting societies. One option is to expand, and in the process clarify, the jurisdiction of the Copyright Tribunal.

The first step would be to change the Tribunal's reach and fundamental approach. Its reach can be extended by providing it with an arbitration role, and its focus extended to incorporate a specific public-benefit type[7] or competition-related test (either in conjunction with, or in place of, the current 'reasonableness' test).

Care needs to be taken to ensure that any such extension of the Tribunal's jurisdiction is effective and does not create new distortions. For example, compulsory supervision and arbitration would be prohibitively expensive for many small participants.

Potential problems associated with the expansion of the Tribunal's role can be minimised by the establishment of a set of principles to ensure that licensing arrangements are used to further anti-competitive ends. Such a set of guidelines has been suggested by Lupton and Drahos (1996:12):

- the licensing scheme must be the least restrictive possible;
- the arrangements should not discourage direct dealings between creator and user;
- the fee should accord with the amount of material used;
- if blanket licences are necessary, they must have carve-out provisions, which provides a mechanism for authors to have control over selected works rather than giving absolute authority to collecting societies.
- the person who decides which material to use should be, where possible, the person who negotiates and pays for the licence;
- licence rates should not differ between equivalent users;
- all users should have unrestricted and automatic access to the societies' published licence terms;
- the membership input agreements should not exclude the member's ability to licence directly;
- membership of the society should not be restricted; and

[7] For example, sub-section 90(6) of the TPA.

- licence terms should not extend beyond the rights protected by the copy right of the societies' members.

While some of these elements have been unilaterally adopted by societies, and others required by the ACCC in the context of authorisations, a more transparent process would be ensured if they were incorporated in legislation.

Given that the United States has a broadly similar scheme to that advocated above (ACCC, 1996:29-30, 85; Schlesinger, 1989:85), it would be difficult, although not impossible, for it to oppose the introduction of such a scheme. Equally, such an approach appears to be consistent with clause 2 of Article 40 of the international TRIPs Agreement (1994):

> Nothing in this Agreement shall prevent Members from specifying in their national legislation licensing practices or conditions that may in particular cases constitute an abuse of intellectual property rights having an adverse effect on competition in the relevant market. As provided above, a Member may adopt, consistently with the other provisions of this Agreement, appropriate measures to prevent or control such practices, which may include for example exclusive grantback conditions, conditions preventing challenges to validity and coercive package licensing, in the light of the relevant laws and regulations of that Member.

Reforming the Tribunal's price-setting function. The Tribunal's approach to pricing has been relatively controversial (Court, 1987:368-72).

The task facing the Tribunal is far from easy. A former President of the Tribunal, Justice Shepherd, has described the process of determining a price, particularly when employing the 'notional bargaining approach',[8] in these terms:

> The Tribunal's task is one of evaluation or estimation. ...The starting point will be a search for a market. If there is a market, probably the market value will be the value which prevails. If there is no market, or if the object ... is not well sought after so that comparable sales are not easily found, the court will have to construct or endeavour to construct, a notional buyer. This becomes a much more theoretical exercise. It involves a degree of subjective judgement and minds will often differ as to what the appropriate outcome is.

The Copyright Tribunal is almost invariably faced with a task of this kind. It is unlikely that there will be a market for a particular right which is involved. If there is not, the Tribunal usually tries the 'notional bargaining approach', constructing, as best it can from the available material, the factors and considerations which it con-

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[8] See *Spencer v The Commonwealth* (1907) 5 CLR 418 at 432, per Griffith CJ.

siders the parties themselves would consider if they were entering into such a bargain (Shepherd, 1995:8-9).

Concern has been expressed that the Tribunal has at times been inconsistent in administering this approach, vacillating between setting prices based on use and prices based on compensation for forgone sales (Court, 1987:368).

While the Tribunal's decisions are acknowledged to be value judgments,[9] there is a clear appreciation of the economic forces of supply and demand substitution and cross-elasticities:

> In the background is the anxiety that the figure, if too high and thus unfair, may operate adversely because it may paradoxically deny to the authors the remuneration s.53B intended them to have and also deny to educational institutions the ability to use as wide a range of material as they should. All in all the task is a most difficult and responsible one.[10]

While this passage implicitly acknowledges the importance of understanding economic forces (such as the cross-elasticity of demand) when setting licence fees, the Tribunal appears to lack the economic expertise to evaluate those forces adequately.

An obvious answer to the Tribunal's inexperience at price setting is to provide it some expert assistance. One solution is to appoint the ACCC as an *amicus curiae* (a friend of the Tribunal) to assist the Tribunal with the determination of the price. Another solution is to abolish the Copyright Tribunal and vest its responsibilities with the Australian Competition Tribunal. The benefit of this approach is threefold: the Australian Competition Tribunal has significant experience in dealing with complex competition-related matters; it is experienced in dealing with the ACCC as an *amicus curiae*;[11] and it exposes copyright-related practices to the scrutiny of an organisation that is less susceptible to regulatory capture.

A case for temporary prices surveillance? Yet another option is to subject the collecting societies to prices surveillance by the ACCC. The Industry Commission has proposed a simple test to determine when prices surveillance is an appropriate mechanism. It recommends that surveillance should be limited to cases where a single firm has a greater than two-thirds market share and has no major rival; *and* faces sporadic or trivial imports (import penetration persistently below ten per cent of the market); *and* is sheltered by substantial barriers to entry (including the expansion of rivals) (IC, 1994:80).

In this case, whether price surveillance is appropriate for collecting societies turns on the market definition(s) adopted. While the ACCC (1996:66-7) has reached no firm opinion on the appropriate market definition for collecting socie-

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[9] *Copyright Agency Ltd v Department of Education of New South Wales* (1985) 59 ALR 172 at 183, per Shepherd J.

[10] *Id* at 201, per Shepherd J.

[11] Indeed, the Australian Competition Tribunal may be too close to the ACCC (Thorpe, 1997).

ties, its observations suggest that collecting societies satisfy the Industry Commission's checklist, and are hence suitable for prices surveillance.

Given that prices surveillance is a second-best policy measure, it may best be used a transitory policy measure until collecting societies have a more appropriate regulatory regime.

Concluding Comments

The concerns raised by small business regarding the collective exploitation of copyright should not be viewed as a problem that 'needs fixing'. Such an knee-jerk approach would result in (further) piecemeal amendment to the Copyright Act 1968, and possibly introduce new distortions in the process.

It may, however, be too late; in response to the concerns raised before the HRSCLCA, the Australian Performing Rights Association (APRA, 1997) has agreed to support legislative amendments to exempt radio listeners from any liability for copyright licences. The exemption, however, asks that the Copyright Tribunal, in effect, pass the forgone royalties on to radio broadcasters.

Policy-makers should view such business concerns as being charged for listening to the radio at work merely as a symptom of a much deeper problem. That problem is the inadequate regulation of the market power granted to copyright owners and exploited by the collecting societies (ACCC, 1996:1). As this article has demonstrated, there is significant scope for improving the regulatory regime.

While the National Competition Policy reform process has focused on monopoly power and access issues in major infrastructure industries, it appears to have overlooked the same issues with respect to intellectual property. It is time to subject intellectual property, a major input in an on-line information-based economy, to similarly rigorous analysis.

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NOTES AND TOPICS

Official Economic Forecasting Errors in Australia, 1983-96

Jim Rose

AUSTRALIAN monetary policy is guided by forecasts formulated with varying degrees of formality and sophistication. Official forecasters aim to provide tolerably accurate quantitative advice on the course of the economy in the coming year and on the likely effects of different macroeconomic stabilisation policies.

Do official forecasts actually provide operational guidance to monetary policy-makers? Seriously deficient forecasts could, for example, lead the Reserve Bank of Australia (RBA) to believe wrongly that a recession or a boom is likely; or to do too little or too much; or to act too soon or too late.

Official Forecasts 1983-96

The Commonwealth Government publishes forecasts for the coming financial year in its budget papers. These forecasts underpin its revenue and expenditure estimates and the monetary and fiscal polices announced at budget time. The RBA's forecasts are not published.

In the absence of better published data, for the purposes of this note the budget forecasts will be assumed to be not significantly different from those that drove monetary policy. The budget papers between 1983/84 and 1995/96 have been chosen for study in order to avoid any structural breaks that might be attributed to changes in government in 1983 and 1996, or to the adoption of an inflation target by the RBA in 1996.

Over the 13 financial years to June 1996, real annual GDP growth in Australia averaged 3.5 per cent, while the mean of the official forecasts was a little less at 3.1 per cent (see Table 1). The means of the actual and official forecasts of inflation were identical (5.5 per cent).

The real issue is whether official forecasts in particular years helped monetary policy-makers determine the right course of action. For example, the narrower range of forecast real GDP growth (1.5 - 4.5 per cent), as compared with the actual range (–0.5 - 5.5 per cent), suggests that official forecasters may have been reluctant, perhaps

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for political reasons, to forecast marked recessions and booms. Two of only three real GDP growth forecasts below 2.5 per cent occurred in 1990/91 and 1991/92. By then, a slowing of the economy was undeniable; and both forecasts were, in any case, inaccurate with regard to both the depth of the recession and the strength of the subsequent recovery.

Table 1

Official average one-year ahead forecasts for annual percentage increases in real GDP and consumer prices, financial years 1983/84-1995-96

	Real GDP (actual)	*Real GDP (forecast)*	*CPI (actual)*	*CPI (forecast)*
Mean	3.5	3.1	5.5	5.5
Range	–0.5 - 5.5	1.5 - 4.5	1.0 - 9.3	2.25 - 7.5
MAE		1.05		1.2
95% interval		1.0 - 5.2		3.2 - 7.9
75% interval		1.9 - 4.3		4.1 - 6.9
50% interval		2.4 - 3.8		4.7 - 6.3

Notes: CPI: consumer price index. GDP: real gross domestic product in 1989-90 prices forecast on an expenditure basis before 1992-93 and on an average basis thereafter. MAE: mean absolute forecasting error. The confidence intervals are calculated using the MAE and are adjusted for the sample size being less than 30.

Sources: Derived from ABS (1997) and *Budget Papers*, various issues.

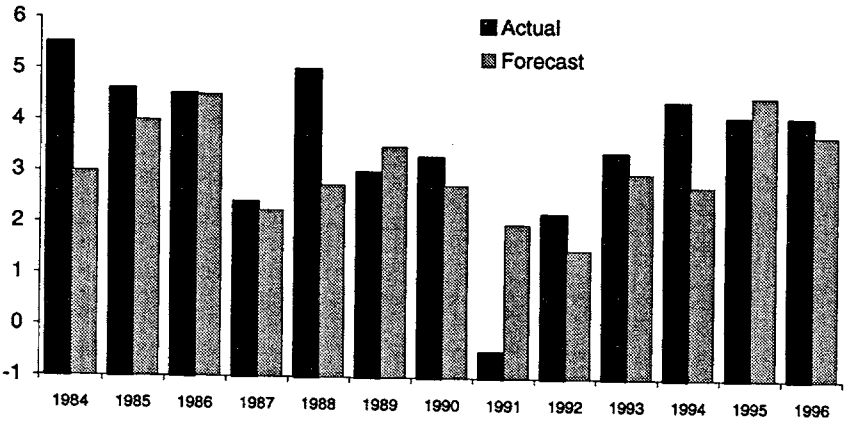
Official forecasts of real GDP growth in the early and mid-1980s were varied (see Figure 1). After underestimating the strength of the recovery by almost a half in 1983/84, actual and official forecasts of real GDP growth in the following three financial years were close to the outcome. However, the actual increase in real GDP in 1987/88 was almost twice the official forecast.

Official forecasting of the inflation rate one year ahead during the recovery from the recession of the early 1980s was fairly reliable (see Figure 2). In 1983/84 and 1985/86, forecast and actual inflation were within half a percentage point of one another. However, the 1984/85 forecast of a significant drop in inflation to 5.25 per cent was confounded by an actual rate of 6.7 per cent — slightly below the figure for 1983/84. In 1986/87, the forecast inflation rate of 8 per cent was well below the actual rate of 9.4 per cent.

Official forecasting went badly astray at the end of the 1980s. The budget papers for 1989/90 reported that the government considered domestic demand to be exceptionally strong. However, by 1990/91 the economy dipped sharply into recession with real GDP growth becoming negative instead of slowing to the forecast 2 per cent. By late 1991, Australia's unemployment rate was in double figures for the first time since the 1930s. After the recession of 1991, official forecasters underestimated the strength of the recovery in 1991/92, 1992/93 and especially in 1993/94 .

Figure 1

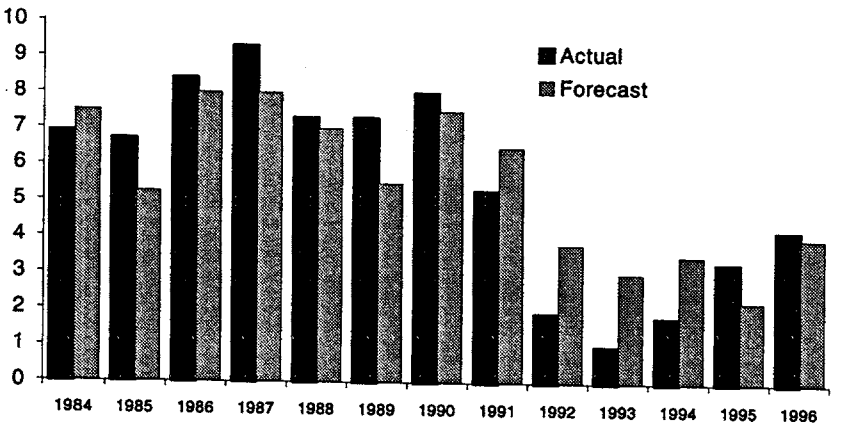
Real annual percentage GDP growth, actual and forecast, 1983/84-1995/96



Sources: derived from *Budget Papers*, various years and ABS (1997).

Figure 2

Annual percentage CPI inflation rate, real and forecast, 1983/84-1995/96



Source: derived from *Budget Papers*, various years.

Official forecasters also underestimated the dampening effect of the monetary contraction on inflation. Inflation for 1990/91 was forecast to moderate to 6.5 per cent, but fell to 5.3 per cent. In 1991/92, inflation was forecast to fall another 1.5 percentage points, but instead fell by more than twice that to less than 2 per cent. In 1992/93, the forecast inflation rate was three times the actual rate for that year and twice the actual rate in the following year. In 1994/95, the inflation rate was forecast to rise slightly on the previous 1.8 per cent but nearly doubled.

Analysis of Official Forecasting Errors

A common method of measuring forecasting errors is the calculation of the mean absolute forecasting error (MAE). This statistic takes an average of the absolute differences between the actual and forecast values. Absolute values are used to avoid the loss of information from the summing of positives and negative values.

The MAE for official forecasts of real GDP growth between 1983 and 1996 was 1.05 per cent. This is about 30 per cent of the mean growth rate of real GDP for the period under study. The MAE for the inflation rate was 1.2 per cent, which is over a fifth of the mean inflation rate (see Table 1).

A common way of assessing the accuracy of forecasts is to calculate a 95 per cent confidence interval using the MAE. The 95 per cent interval covers the area that is two MAEs either side of the mean of the forecasts, amounting to an interval of four MAEs' combined width. The confidence interval indicates that, given the track record of the forecaster concerned, there is a 95 per cent chance that the actual value of the forecast variable will be in this interval. The narrower this 95 per cent confidence interval, the more likely it is that forecasts are close to actual outcomes on a regular basis. Pin-point accuracy is not expected, but forecasts must get reasonably near to have value. For example, a 95 per cent forecast interval for real GDP growth that is one percentage point wide could be regarded as satisfactory. It implies that there is a 95 per cent chance that a forecast is within 1 percentage point of the actual growth rate of real GDP for a given year. However, a confidence interval that is 5 percentage points wide is of little value because it covers almost every possible contingency. A forecast that next year there will be a boom or a recession or anything in between is not informative.

The 95 per cent confidence interval for official forecasts of real GDP growth is the interval 1.0 - 5.2 per cent. This confidence interval implies that official forecasters can say with only 95 per cent confidence that next year will bring a deep recession, or a strong boom, or something in between.

The 95 per cent confidence interval for forecasts of inflation is 3.2 - 7.9 per cent. This interval is more than 4.5 percentage points wide, suggesting that official forecasters have trouble distinguishing stable prices from rising inflation one year ahead. This suggests that official forecasts between 1983 and 1996 may have provided poor operational guidance on whether a monetary contraction, or a monetary expansion, or no change in policy was required.

Some observers might consider that it is more reasonable for official forecasts to operate within a 75 per cent confidence interval. The 75 per cent confidence interval

for official forecasts of real GDP growth between 1983 and 1996 was 1.9 - 4.3 per cent (see Table 1). This interval still includes a recession and a boom; and it covers almost the entire range of official forecasts published between 1983 and 1996. The implications of the 75 per cent confidence intervals for real GDP are similar to those for the 95 per cent interval: official forecasters have trouble distinguishing between strong and poor economic growth one year ahead.

The 75 per cent confidence interval for inflation is a band 3 percentage points in width (see Table 1). This is approaching the 2-3 per cent band that is common in inflation targets of central banks. Official forecasters may have been saying something useful about next year's inflation rate.

Other observers might consider it worthwhile to look at a 50 per cent confidence interval for official forecasts. The 50 per cent confidence intervals for real GDP and the inflation rate are both 1.5 percentage points wide. These intervals imply that official forecasters are reasonably accurate about half the time: that is to say, if their forecasts are acted upon, monetary policy changes in the right direction about 50 per cent of the time. Is this sufficient?

Friedman (1953) has argued that any alternative to a constant monetary growth rule must succeed more than 50 per cent of the time to warrant serious consideration. This is because, on 50 per cent of occasions, the monetary authority is adjusting monetary conditions in the wrong direction. The variance of a discretionary monetary policy injects additional instability and uncertainty into the market. However, a constant monetary growth rule, being changeless, would never be an independent source of uncertainty.

The Hawke Government of 1983-91 was aware of the poor value of the official forecasts supplied to it. According to John Edwards (1996:394), Paul Keating, the then Treasurer, had ceased to believe the forecasts coming from the bureaucracy by 1989. The poor official forecasts of that period were, perhaps for this reason, not thereafter a major independent source of instability. However, the unanswered question is what expectations about the course of the economy were guiding monetary and fiscal policy after 1989.

Policy Implications

One purpose of official forecasting is to alert the RBA to the need to revise its monetary policy stance. However, the record of official forecasters from 1983 to 1996 suggests that they cannot say, with much better than 50 per cent accuracy, whether a monetary contraction, or a monetary expansion, or no action is likely to be the correct policy choice.

Given that official forecasts often seem to go astray, it would be useful to make the forecasting process more transparent. One possible reform is the publication of confidence intervals for the forecasts in the budget papers and in the RBA's semi-annual statement on monetary policy. These confidence intervals could be based on forecasting errors over the previous five or ten years.

A related transparency option has been developed by the Bank of England. Since February 1996, the Bank of England has published a probability distribution for its forecasts of the inflation rate; and it is considering publishing a similar probability distribution for output (King, 1997:10-12). A variation on this proposal is the publication of a central forecast and optimistic and pessimistic forecasts based on variations of the key assumptions in the central forecast.

A further accountability option is to require official forecasters to review their recent forecasts and explain where they went wrong and why, and how they intend to prevent the repeat of such errors.

Despite all their failings, the demand for macroeconomic forecasts seems as strong as ever. It is therefore important that the effectiveness of forecasts be evaluated from time to time, and that forecasters be as open as possible about how fragile and limited their forecasts are as indicators of the shape of things to come.

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Economic Forecasting and the Role of the Economist

Stephen Kirchner

FINANCIAL market economists devote considerable time and effort to forecasting economic data. Yet there have been few systematic attempts to test the efficiency of these forecasts in an Australian context.

An obvious question is whether these forecasts significantly outperform a simple moving average model. For economists to be able to justify the effort they put into forecasting, their average forecast error should be significantly narrower than that generated by a naive model.

Standard & Poor's MMS has surveyed economists' expectations for key Australian data releases for over ten years. While the resulting market medians are the forecast of only the 'middle' economist, the academic literature suggests that individual economists cannot outperform market medians over sustained periods of time. Taking the market median as the 'representative' economist is therefore likely to strengthen the overall forecast accuracy of market economists as a group relative to what any individual forecaster is likely to achieve.

Table 1 sets out the average forecast error made by the median economist for each quarterly GDP and CPI release since the June quarter 1985. This is compared with the average forecast error generated by a simple four-period moving average model. The model takes the average of the previous four quarters' GDP or CPI growth as the forecast for the subsequent quarter. The moving average model is applied to the data as originally reported. These are the same data as those available to economists at the time they made their forecast.

The table shows that the average GDP forecast error of the median economist is only 0.15 percentage points less than that for the naive model. Taking out the more extreme errors by using the median instead of the average error still sees economists outperform the naive model by only 0.19 percentage points. Similarly, the average CPI forecast error of the median economist is only 0.25 percentage points less than that of the naive model. With the CPI, we are probably more justified in using the median error, given some of the large forecast errors made by both economists and the naive model due to the rapid structural break in inflation that occurred in the early 1990s. In this case, the economist does only 0.15 percentage points better than the naive model. While this is a potentially significant difference in forecast accuracy in today's low inflation environment, it is less significant for most of the period since 1985.

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Table 1

Median economist vs naive model, June quarter 1985 to June quarter 1997

	Median economist	*Naive model*	*Difference*
GDP* (% points)			
Average absolute error	0.54	0.68	0.15
Median absolute error	0.43	0.62	0.19
Maximum error	2.60	1.97	
CPI (% points)			
Average absolute error	0.23	0.48	0.25
Median absolute error	0.20	0.35	0.15
Maximum error	0.90	1.88	

*GDP(I) to September quarter 1991. GDP(A) from December quarter 1991. As originally reported.

Sources: Standard & Poor's MMS; Australian Bureau of Statistics (various years), *Australian National Accounts: National Income, Expenditure and Product*, Canberra (Cat. No. 5206.0).

These results are interesting, not least because the quarterly GDP and CPI releases are more amenable to forecasting than many other statistical releases. For example, many of the components of GDP are known with a reasonable degree of precision in advance of the release. Economists have a good idea as to the contribution to GDP from consumption, capital expenditure, net exports, and stocks on the expenditure side. On the income side, they have reasonable clues as to the wages, salaries and supplements component and the private gross operating surplus. Similarly, the CPI is based on the prices of a known basket of goods and services. Most of these prices are readily observable in the market place.

The median economist's forecasts are clearly an improvement on those generated by a naive model, but this is the least we should expect. The key question is whether this improvement adds value for market participants.

The debt and foreign exchange markets are usually quite tolerant of small differences between actual and expected outcomes in official data releases. The small difference in forecast accuracy between the median economist and the simple model suggests that market participants are unlikely to be significantly advantaged in taking a position based on the economist's forecast rather than the simple model. In the case of GDP releases, for example, the market is not much more likely to move on an outcome that is 0.68 percentage points higher or lower than expected than on an outcome 0.54 percentage points higher or lower than expected, all else being equal.

Another way of looking at the usefulness of economists' forecasts is to examine whether there is a relationship between the degree of consensus among economists and forecast accuracy. We might expect that where there is agreement about their forecasts, there is also an increase in forecast accuracy. The use of market medians

is based on a slightly different assumption, namely, that the forecast furthest away from the two extremes is most likely to be correct.

The range of market expectations provides a crude measure of consensus among economists about a given data release. Unfortunately, the original populations for the survey data cited above were not available to generate a more sophisticated measure of market consensus (for example, by taking the standard deviation of the forecasts for each release).

Table 2 reports correlation coefficients between the range of market expectations and subsequent forecast errors for each quarterly GDP and CPI release:

Table 2

Relationship between market consensus and forecast accuracy, June quarter 1985 to June quarter 1997

	*GDP**	*CPI*
Correlation coefficient	–0.03	0.07

*Forecasts for GDP(I) to September quarter 1991. GDP(A) from December quarter 1991.

Sources: Standard & Poor's MMS; Australian Bureau of Statistics (various years), *Consumer Price Index*, Canberra (Cat. No. 5204.0).

The close-to-zero coefficients show no relationship between the range of forecasts and subsequent forecast accuracy. Relative agreement among economists does not make their forecasts any better, but it does not make them any worse, as a market contrarian might argue.

Does this mean that economists should do away with point forecasting of official data? No, but it does suggest the need for more realistic expectations about what point forecasts can achieve. If an economy is as unpredictable as economists' forecast accuracy would suggest, then we should be less preoccupied with generating and acting on these forecasts. Instead, economists should work more with what they know rather than with what they don't. This means putting more effort into assessing data after they are released and also the underlying risks and trends for the market. This would arguably be a more efficient, and often far less embarrassing, use of economists' skills.

Apart from the usefulness of point forecasts, these results raise larger questions about the role of the economist. Given the limitations on economists' forecast accuracy, why do economists enjoy such a prominent role? An obvious answer is that economists provide useful explanations of economic and financial developments. This fits well with McCloskey's (1985) exposition of the rhetorical role performed by the economist. The economist as 'rhetor' is a good description of the 'talking head' role of contemporary financial economists, whose media appearances and presentations to external clients are a major part of their work.

The broader role of the economist is not so much to supply accurate point forecasts as to provide a useful and convenient framework for understanding

current economic and financial developments. An understanding of the reasons behind a given outcome and its wider significance is probably more important than the ability to forecast this outcome with precision. This is a potentially valuable role, which economists are well equipped to perform, so long as these frameworks do not become simple cases of *ex post* rationalisation.

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Dispute Settlement Orders Under Australia's Workplace Relations Act 1996: Are They Working?

Graeme Watson

LABOUR market reform is widely recognised as an essential component in broader economic reform. Reforms of federal and State industrial legislation in the 1990s have involved a change in focus from a centralised system based on awards and arbitration to enterprise bargaining with awards operating as a general safety net.

The Workplace Relations and other Legislation Amendment Act 1996 was one of the major reforms of the Howard Government in that year. One component of the reforms was the enhancement of powers of the Australian Industrial Relations Commission (AIRC) to issue orders to stop or prevent industrial action, along with the ready enforcement of such orders by way of injunction in the Federal Court.

Enforcement of dispute settlement orders has had a chequered history in Australia. Mechanisms have always been available to make orders that industrial action cease or not occur; but such orders have been either observed in the breach or granted in very exceptional circumstances. Former ACTU Legal Officer Professor Breen Creighton (1991) has described this situation as a paradox within the Australian industrial system. In practice, it has represented a serious imbalance that has undermined the standing of the Australian system and its institutions. A system which imposes enforceable obligations on employers yet makes largely ineffective recommendations, directions and orders against industrial action by trade unions has been widely criticised. The issue is of critical importance to the evolution of the AIRC towards playing a less interventionist role in 'interest' disputes (disputes over claims for improved entitlements) while retaining an important role in the proper settlement of 'rights' disputes (disputes over compliance with existing entitlements).

Effective dispute settlement powers are most important in the case of irresponsible wildcat stoppages, especially in industry sectors of major economic significance and in which unions engage in militant industrial behaviour generally over managerial decision-making. More effective dispute settlement powers could also help improve Australia's record on industrial disputes. Although the number of working days lost through industrial action dropped through the 1970s and the 1980s in common with the rest of the western industrialised world, it remains above the OECD average. Whereas the annual average number of working days lost in OECD countries during 1990-96 was 85 per 1,000 employees, in Australia the equivalent number was 143 (Sweeney & Davies, 1997).

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In this note, some of the experiences of the revised dispute settlement power during its first twelve months of operation are briefly examined. It is argued that further reforms are needed to remove the significant discretion enjoyed by the AIRC and the Federal Court in making and enforcing dispute settlement orders.

The New Dispute Settlement Power

The 1996 amendments provide for enhanced dispute settlement powers under a revised Section 127 of the Workplace Relations Act. This section replaces previous provisions allowing 'bans clauses' to be inserted into awards by presidential members and full benches of the AIRC and little-used provisions relating to the public service. Section 127 is a broad power, vested in all members of the AIRC, to issue orders prohibiting any industrial action which is occurring, threatened, impending or probable. The AIRC is empowered to make orders on its own initiative, or on application by parties to an industrial dispute, by persons who are directly affected or likely to be directly affected by the industrial action or by organisations with members directly affected or likely to be directly affected. The AIRC is required to hear and determine an application as quickly as practicable. Compliance with an order is expressed as a statutory obligation; and the Federal Court may grant injunctions, including interim injunctions, if it is satisfied that the order has been contravened or if conduct is proposed which would involve such a contravention. The extension of the power to all members of the AIRC and its ready enforcement through Federal Court injunctions were no doubt intended to ensure that the exercise of such powers was not confined to exceptional or unusual circumstances and so would provide an effective remedy against irresponsible industrial action (Reith, 1996).

Experience of the New Laws

The experience of applications lodged under s.127 in the first twelve months is mixed. On some occasions the AIRC has promptly and effectively dealt with matters before it. But on other occasions the provision has operated unsatisfactorily.

The Mobil Oil case. The first application under s.127 was made by Mobil Oil on 31 December 1996, the first day the section became available. The dispute related to the remobilisation of a construction project to install a new catalytic cracker unit at the Altona refinery in Victoria. Unions banned the project over demands that employees previously engaged through another contractor be employed on the project. The ban prevented work on the site restarting. The orders that the AIRC had issued in December 1996 under its previous general powers had been ignored by the unions. Nevertheless, the AIRC granted the unions a further adjournment, and hearings were ultimately conducted on 8 and 9 January 1997. Orders were issued on 17 January, but the unions ignored them and proceedings were initiated in the Federal Court to enforce the orders. These proceedings were delayed and the Court deferred applications for interim injunctions in order to allow the AIRC

to make further attempts to broker a compromise. Eventually, in view of the persistence of certain continuing problems, limited injunctions were granted in June 1997.

As this case shows, significant delays can occur even when major projects are held up by industrial action and when the legislation requires the AIRC to act expeditiously. The approach of the AIRC and the Federal Court demonstrates a lingering reluctance to make orders against industrial action and an apparent preference for doing so only in exceptional circumstances or as a last resort.

The Coal & Allied cases. In early 1997, Coal & Allied, a subsidiary of Rio Tinto, attempted to use s.127 to bring about more responsible industrial behaviour and adherence to dispute settlement procedures in awards and agreements at the Hunter Valley No. 1 Coal Mine in New South Wales. The Company produced evidence to demonstrate that 14 24-hour stoppages occurred in 1996, both against management decisions and associated AIRC decisions and as part of national or statewide stoppages over political issues.[1] A further 24-hour stoppage in breach of the dispute settlement procedure in the award occurred in January 1997, when two employees were issued diary notes for minor breaches of the Company's code of conduct. This stoppage prompted the Company to apply for an order prohibiting future industrial action inconsistent with the disputes procedure in the award. Proceedings began in January 1997, and on the unions' application were referred by the President to a full bench of the AIRC for hearing and determination. The full bench sat on six hearing days between March and May 1997, and on 20 June 1997 granted an order against industrial action in breach of the disputes procedure. The order was directed towards local industrial action in protest against, or to secure the reversal or non-implementation of, a decision made in the reasonable exercise of an available award right or managerial discretion.

The full bench made the following comments about such industrial action:

> Local unprotected industrial action of the kind we have described was not comprehensively defended in Mr Kelly's (CFMEU) evidence. We do not consider that such industrial action can reasonably be defended. Industrial reaction to disciplinary measures is not defensible or legitimate when review and grievance procedures are now so readily available. Resort to industrial action in a manner that pays little or no regard to disputes procedure obligations, and in some instances to Commission directions and recommendations, is not reasonably justifiable. Such industrial action is symptomatic of a kind of industrial conflict that no longer commands a respectable place in Australian industrial relations, if it ever had one. Where it occurs, as it has here, in an industry of national importance, a public interest is attracted in restraining further occurrences of such action. That is not to deny the reality and extent of the Company's private interest

[1] The infamous march on Parliament House in August 1996 accounted for two strike days, after the employer refused to release 10 per cent of its workforce on full pay to attend the rally.

> in seeking to constrain disregard of the dispute settlement procedure. That relative private interest augments, but must also be balanced with, the public interest in seeking to bring about a workplace level arrangement consistent with the objects of the Act.[2]

This approach demonstrates that the AIRC is prepared to issue orders to prevent irresponsible industrial action.

The AIRC reserved consideration of actual or probable industrial action engaged in on a national, district or Statewide basis. This decision assumed test-case proportions and has provided significant guidance as to the exercise of the AIRC's powers under s.127 by formulating a test for determining whether an order should be issued. That test evaluates the character of the industrial action for the purposes of establishing whether, in the AIRC's view, the industrial action is illegitimate to a degree that the commencement or continuation of it should be subject to a direction, causing it to be unlawful. In applying its discretion, the scheme of the Workplace Relations Act and the treatment of industrial action should be taken into account by the AIRC. This involves the division of industrial action into three categories:

- Protected industrial action: for the purposes of furthering and supporting claims made in enterprise bargaining and after complying with statutory requirements for establishing an immunity for industrial action.

- Unlawful industrial action: action directly contrary to a statutory provision or order of the AIRC under s.127.

- Unprotected action which, although generally inconsistent with the scheme of the Workplace Relations Act, is not automatically unlawful but may be rendered so by an order of the AIRC.

The approach of the AIRC in relation to national statewide or district stoppages was tested in October 1997 during an extended stoppage at the same Hunter Valley coal mine as subject to the s.127 test-case decision. The unions involved in that mine had engaged in protected industrial action in pursuit of a certified agreement. A six-week strike was followed in early September 1997 by another stoppage when further negotiations and conciliation by the AIRC failed to lead to an agreement. In response to obstructive picketing activity, Coal & Allied sought a certificate from the AIRC permitting it to take common-law action against the unions. The certificate was granted and an appeal by the unions against the granting of the certificate was dismissed by a full bench. The Construction, Forestry, Mining and Energy Union (CFMEU) thereupon called an immediate 72-hour stoppage (without consulting the union members concerned) at approximately 40 mines in the Northern District of

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[2] *Coal and Allied Operations Pty Ltd v Automotive Food Metals Engineering Printing and Kindred Industries Union* (1997) 73 IR 311.

New South Wales, almost none of which had a relationship with Coal & Allied or Rio Tinto. Immediate applications were made to the AIRC for orders under s.127, and a hearing began at the same time as the stoppage began. At the conclusion of the hearing that day, Commissioner Harrison indicated that he intended to issue orders as sought by the employers but before doing so would await the outcome of a meeting between the premier of New South Wales, the unions, and Coal & Allied. When the matter resumed the following morning the unions indicated that they had cut short their 72-hour strike and would be arranging for a return to work later that day. In the light of that advice, the Commission decided not to issue the orders.

Non-enforcement of orders. In two cases, Justice Marshall of the Federal Court declined to enforce s.127 orders. In one case,[3] the AIRC made an order that the Health Services Union of Australia (Victoria No. 1 Branch) and its members employed by the Inner and Eastern Health Care Network 'are directed to cease current bans and limitations' and 'further directed not to engage in, commence or resume industrial action in connection with the issue of market contestability'. Justice Marshall refused to enforce the order because in naming a branch of a union the order was referring to a legal nullity and in any event the order was too vague and uncertain to enforce. He said:

> It is critical for the purposes of proceedings in the Court pursuant to Section 127(6) and (7) of the Act that the order made by the Commission under Section 127(1) of the Act be a valid order. It is also critical that such an order clearly identify the persons on whom it is binding and the precise conduct which it seeks to prohibit. ... A direction to cease 'current bans and limitations' leaves room for later debate as to what the extent of such bans and limitations were at the time of the order. Similarly, a direction 'not to engage in, commence or resume industrial action in connection with the issue of market contestability' leaves room for debate as to whether any such action is so connected let alone 'industrial action'.

The second case concerned an order made against employees covered by various manufacturing awards in the face of widespread industrial action in protest at Victorian government's reforms of workers compensation.[4] Justice Marshall found that the terms of the order did not adequately specify the relevant awards and criticised the employer representatives for seeking to have the AIRC remedy the defect in its order. Justice Marshall's decision allowed the stoppage to occur accompanied by a decision that the order made by the AIRC was invalid and unenforceable. Experiences such as this have given rise to considerable frustration amongst employers as to the utility of seeking orders under s.127.

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[3] *Inner and Eastern Healthcare Network v HSUA* VG619/97 (unreported 11 November 1997).

[4] *MTIA v AMWU* VG 647 of 1997.

Concluding Comments

In some cases, s.127 has been shown to be capable of limiting illegitimate industrial action. By 21 November 1997, 236 applications under s.127 had been made. According to the Minister for Workplace Relations, Mr Peter Reith (1997), most resulted in a return to work without an order being required; and the AIRC made only 24 orders. Given the particular circumstances involved, the issuance of orders has been hardly surprising or controversial. But even in these cases there are grounds for concern. Significant delays, the cost and inconvenience of lengthy litigation and the reluctance to issue and enforce orders other than in exceptional circumstances sustain a pattern of imbalance within the Australian industrial system.

Despite the intent of the legislature, the practical application of laws can lead to different results. In one example, Deputy President Duncan[5] in December 1997 refused to issue orders sought by Telstra even though he found that the industrial action concerned was not protected. The union had failed to comply with the notice requirements for protected industrial action in circumstances where it intended to take industrial action without specific notice as to timing and its nature, in order to cause maximum damage to Telstra's business in the Customer Service area.

Effective remedies against irresponsible industrial action should be freely available to all businesses, regardless of their size and resources. Procedures should be swift and effective, and orders should be made unless there is some clear justification for the industrial action concerned. Given the range of options available for resolving disputes, industrial action other than action properly in compliance with the requirements for protected action in enterprise bargaining should rarely be considered justifiable.

Where discretions are vested in tribunals and courts and there is limited guidance in the legislation as to how the discretion is to be exercised, there is a tendency for historically generated value judgments to influence unduly the exercise of that discretion. Further reform is needed in this area to ensure that irresponsible industrial action ceases to be as prevalent as it has been at Australian workplaces.

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[5] *Telstra Corporation Ltd and CPSU* Print No. P7102.

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REVIEWS

Beyond Rational Economic Man

*Robert Skidelsky, **Beyond the Welfare State**, The Social Market Foundation, London, 1997*

*Reviewed by **Mark Latham***

THE reform of the welfare state has become one of the great enigmas of governance and political debate in the Western world. While social democrats like Tony Blair and Bill Clinton boast of wanting to 'think the unthinkable', they are yet to present the type of legislative program on which lasting reform might be based. On the other side of politics, welfare policy remains synonymous with reducing the role of government; yet it is not clear how the work of the free market might break the personal despair and disenfranchisement associated with entrenched poverty. In Australia, the greatest shortcoming of the federal Coalition lies in its failure, especially during 13 years of policy-making in Opposition, to think through and promote a program of welfare reform. No more creatively, however, some elements in the Labor Party still regard welfare policy as simply a matter of wheeling out more money for more programs of the old kind.

Despite massive changes to society and its economy over the past 30 years, the political system is still trying to work out how to reform the relationship between the state and its citizens. Changes to the structure of welfare, at best, have been incremental, even though the evidence everywhere shows that old systems of open-ended transfer payments and service provision have failed to break the cycle of long-term poverty. Much of the policy-making process appears gridlocked, not just by a paucity of ideas but by the unwillingness of politicians to upset the entitlements and expectations of those in the electorate who have grown dependent on welfare. Public policy requires a new paradigm and direction for the reform of the welfare state.

Few of these answers, however, can be found in Robert Skidelsky's slim and densely argued book. Skidelsky, biographer of J. M. Keynes and head of the Social Market Foundation, a recently formed London think tank, echoes the age-old view of libertarian economics: that welfare recipients become lazy and manipulative once presented with the comfort of income support. 'High levels of social protection weaken the incentive for people to work by raising the reward for leisure' (p. 74). Skidelsky believes that the welfare state, in developing systems of social insurance to deal with moral hazard (whereby people maximise their satisfaction at other people's expense) has, in fact, made this problem endemic. He argues that social welfare, as 'a tax on efficiency, liberty and morality' (p. 83), needs to be replaced by the self-discipline and incentives arising from personal welfare and private insurance.

The problem with this analysis is that it positions welfare recipients solely within a framework of rational economic decision-making. Skidelsky maintains that people become dependent on public income support because they see this is a rational way of maximising their economic welfare. Yet the evidence about long-term poverty suggests that disadvantaged people, having lost the skills and habits of regular work and rewarding social contact, are more likely to make perverse decisions about their well-being. Whenever, for instance, I visit the public housing estates in my electorate in south-west Sydney, it strikes me as totally irrational for so many citizens to have to endure high rates of unemployment, family breakdown, drug dependency and street crime.

Skidelsky admits that he has had little personal contact with the welfare system, beyond the education of his children. This illustrates the problem of applying bold economic theories in a manner divorced from social circumstance. It is absurd to believe that welfare recipients have rationally manipulated the welfare system when, in cases of entrenched poverty, people have been forced to live without any satisfying degree of economic or social participation. In truth, welfare analysis needs to reach well beyond the parameters of 'rational economic man'. It needs to examine other aspects of human behaviour which might lead to a more productive agenda for welfare reform.

A starting point is to understand how the human condition has been set apart from the animal world by a yearning for recognition — the acknowledgment that each of our lives holds worth and value for others. As Francis Fukuyama (1992:xvi) has argued:

> Human beings, like animals, have natural needs and desires for objects outside themselves such as food, drink, shelter and, above all, the preservation of their own bodies ... but in addition, human beings seek recognition of their own worth, or of the people, things or principles that they invest with worth. The propensity to invest the self with a certain value and to demand recognition for that value, is what in today's popular language we would call self-esteem ... It is like an innate human sense of justice.

This concept of recognition takes us a long way towards a comprehensive understanding of the relationship between citizens and society. It explains why many aspects of economic activity are outside the bounds of rationality, such as the accumulation of income and assets beyond the capacity of any individual to consume them. Libertarians like Skidelsky need to appreciate that, beyond the satisfaction of basic material needs, the role of money in society is primarily to do with the search for status or recognition. Given the social stigma now attached to most forms of public income support, it is difficult to see welfare dependency as rational behaviour. In the popular culture, transfer payments have become a symbol of personal failure and worthlessness.

Recognition theory also helps with an understanding of the social problems arising from entrenched poverty. It explains the sense of non-material loss people

feel when they face unemployment: the hopelessness that comes from a loss of self-esteem and social worth. It explains why the victims of poverty, without the capacity or opportunity to excel by conventional means, might seek recognition through various forms of negative behaviour, such as the escapism of drug use or trying to impress their peers with acts of vandalism and other property-related crimes. It explains how teenage pregnancies are more likely to be motivated by a yearning for recognition — the unique love and status arising from the mother-child relationship — than by the quest for single-parent welfare benefits. Most of all, the concept of recognition helps to explain the tragedy of intergenerational unemployment: how the idle and educationally disadvantaged of one generation can become role models for the next.

From this perspective, one can appreciate the shortcomings of both sides of politics on the question of welfare reform. The libertarian Right has erred in believing that welfare solutions can be found only outside the welfare state: in labour market efficiency, savings incentives and robust individualism. Rational incentives succeed only if people see a link between their own circumstances and the incentive system. Citizens are not likely to gain recognition within the market system if their prospects for economic participation are next to zero. This reflects the hardship of social exclusion in an open economy: the longer people stay unemployed, the less likely they are to find work; the longer the term of unemployment, the greater the chance of alienation and anti-social behaviour.

Equally, the political Left can no longer assume that passive forms of welfare create the basis of active citizenship. In an information and recreation-rich society, people are more likely to judge their well-being through the development of skills and social participation than by reference to a material (and rather arbitrary) poverty line. Social democrats can no longer feel satisfied with the impact of cash transfers and universal service provision. A new bundle of welfare issues now dominates the public agenda. Policy reform needs to focus on the ways in which the state might aid the spread of social recognition. Indeed, there can be only two purposes to the public provision of welfare: to move people back into work, and to develop their skills and status. This approach gives government an important role on both sides of the new labour market: strengthening the demand for work through its role as an employer of last resort at a local level; and, on the supply side, embracing the value of life-long learning.

Active welfare, however, involves more than the creation of social opportunity; it also means demanding from citizens the discharge of social responsibility. Without effort in society there can be no achievement or recognition. This is why income support needs to be linked to the reciprocation of responsibility in employment programs, education and training, and the crucial role played by parents as educators in the home. If citizens are not willing to exercise responsibilities of this kind then governments should not be willing to maintain the payment of full benefits.

Welfare reform also requires from the public sector a different scale of public provision. While the old Left and new Right have argued for decades about the raw

size of government, concerns about the scale and quality of state interventions have been overlooked. The mass scale of public bureaucracies has prevented citizens from building the bonds of mutual interest and community. Large, centralised departments have caused considerable public resentment, rather than the type of social trust and recognition arising from a smaller, more virtual scale of public provision. The more people feel that they belong to society and its organisation, the less likely they are to engage in negative forms of behaviour.

This is where the devolution of public governance is so important: forcing the state to shed many of its functions as a service provider, while maintaining its role as a service funder and regulator. The freely formed associations of civil society, creating opportunities for shared trust and cooperation, are crucial to the prospects of mutual provision in our society. During an era of globalised markets and work, they are the best way of conveying to citizens the benefits of social belonging and recognition. As ever, the organisational scale and purpose of the public sector are more important than issues of size.

For those still committed to a small government agenda, a more satisfactory critique of the welfare state can be found in David Green's *From Welfare State to Civil Society* (1996), which has been reviewed in *Agenda* by John Savage (1997). Unlike Skidelsky, Green argues outside the limits of rational economic man by pointing to the value of social belonging and mutual associations. This type of argument resembles some of the policy work of the communitarian movement in the United States. It helps to highlight the way in which, on issues as diverse as economic globalisation and welfare reform, the conventional Left-Right divide no longer represents a satisfactory way of dealing with public policy. Neither the libertarian Right (with its focus on materially self-interested behaviour) nor the old Left (with its romantic attachment to altruism) appears capable of progressing an effective agenda for welfare reform. The next generation of welfare policy will need to rely on a third way, reflecting the value of recognition theory and the construction of a new relationship between citizens and the state aimed at social belonging. From this perspective, Skidelsky is more likely to be remembered as an outstanding biographer than an influential welfare reformer.

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From Welfare to Wage Subsidy

*Edmund S. Phelps, **Rewarding Work: How to Restore Participation and Self-Support to Free Enterprise**, Harvard University Press, Cambridge, Mass., 1997*

*Reviewed by **Tim Maloney***

WAGE inequality among US workers has increased substantially over recent decades. Edmund Phelps's remedy for this predicament is to use employment subsidies to lift the wages of the poorest workers. He argues that the problem can no longer be ignored, and that employment subsidies are preferable to other government policies that could be adopted to deal with it.

Rewarding Work is aimed at a general, non-academic audience. The author, an economics professor at Columbia University, refers only in passing to economic theories that could either support or refute his conclusions. Detailed empirical evidence is almost non-existent. Phelps offers no new historical evidence on the increasing wage inequality in the US. However, this is not a criticism of the work; rising wage inequality has been well documented by others. Phelps takes its existence as given, and seems to believe that we don't need to worry about the specific factors that are responsible for it (such as technological change or free trade).

Phelps argues convincingly that rising inequality should be of great concern. Since the early 1970s, wages for the low-skilled and poorly educated have fallen substantially in real terms, while increasing markedly for the high-skilled and well educated. Market work and the receipt of a 'living wage' are necessary for normal, healthy life. Falling wages lead to lower household income and standards of living. It also hurts the self-esteem of the low-paid, reduces their participation in the community, and undermines social cohesion. Low wages and poor employment prospects create a sense of exclusion, powerlessness and despair. The deterioration in the position of America's second-class workers thus creates negative externalities for society, such as increasing crime, drug and alcohol addiction, welfare dependence and parental failure.

Who or what is to blame for rising wage inequality? Typically for an economist, Phelps refuses to attribute it to attitudinal changes or shifting cultural factors. Although I think he is correct, he doesn't provide any direct evidence that would lead the non-economist to the same conclusion. The best that can be said is that two other factors are more apparent. The first is structural change in the US economy over recent decades, such as a growing reliance on information technology, reductions in trade barriers and economic globalisation. The second is the rise of the welfare state. Welfare 'devalues' work and reduces 'job attachments', which reduces morale, undermines the work ethic, and results in criminality and drug use. Phelps argues that his proposed employment subsidies would, in contrast, promote independence, self-reliance and social cohesion.

This analysis has two problems. First, although real wages for the disadvantaged have declined since the early 1970s, they haven't declined relative to the wages

received by similar workers in the 1950s. As Phelps admits, the decline in living standards attributed to lower wages over this longer period should be viewed as relative rather than absolute. But this weakens Phelps's claim that lower wages lead to increased criminality, drug and alcohol use, and welfare dependence.

Second, Phelps's claim that welfare programs are among the key factors behind the declining relative position of the poor is unsubstantiated by evidence. To claim that welfare programs *worsen* the position of the poor implies that the positive redistributive effects of welfare programs are more than offset by negative behavioural consequences that reduce households' current and future earning capacities. One advantage of welfare programs is that they directly target household income, whereas raising *individual* wages through employment subsidies does not necessarily raise the living standards of the poorest households. Although the incentive effects of welfare are clearly problematic (and current US welfare reforms seem to address at least some of them), welfare is relatively more 'target efficient' than wage subsidies.

Phelps's proposed direct wage subsidies (for example, an employer who pays a worker US$4 an hour might receive a subsidy of $3 an hour) would taper off as the wage increased, disappearing almost entirely by the time it reached $12 an hour. Its estimated cost of US$125 billion would be offset by reductions in expenditures on welfare, Medicaid, police, judicial and correctional services; by increasing tax revenues; and by making possible the elimination of the Earned Income Tax Credit. It could even increase the productivity of the entire workforce. Wage subsidies would be preferable to increasing the minimum wage (which discourages employment), providing public-sector jobs (which creates a two-tier wage system for the disadvantaged, discouraging job attachment in the private sector), promoting training and education (which helps only in the long run and is ineffective among the disadvantaged), expanding welfare programs (which discourages positive behaviour) or pushing for faster economic growth (which may worsen, rather than improve, the lot of the poor).

Employment subsidies for low-paid workers are not a novel idea. For example, in the 1970s the Work Incentive Tax Credit gave US employers a 20 per cent tax credit for hiring welfare recipients. It is unclear why Phelps does not acknowledge the existence of these earlier employment subsidies, or survey the literature on their possible effects in the labour market (for example, Palmer, 1978; Haveman & Palmer, 1982).

I have three problems with Phelps's discussion of his proposed low-wage employment subsidy. First, the details of the program are sketchy in places, and not very well thought out in others. An example of the latter is the proposed limitation of the subsidy to full-time low-paid jobs. What is wrong with subsidising part-time work, especially of women with children at home? Do we want employers to reduce the availability of such jobs? Phelps also argues that firms should not have to report hours of work, but simply declare that a job is full-time (say, 35 or more hours a week) to receive a fixed subsidy. This would provide clear incentives for firms to create jobs with the minimum number of hours necessary to qualify for the

'full-time' subsidy. Do we want artificially to restrict workers' choice in hours of work per week?

Second, there is an underlying tension in the book between employment subsidies and human capital investments in training and education. Phelps dismisses public subsidies for training and education as an alternative policy for raising the earnings of low-wage workers. Such policies, he claims, provide little immediate relief; forecasts of the type of training or education that will be needed in the future are difficult to make; and, most damning of all, the payoffs from such investments among the disadvantaged are exceedingly low. Yet human capital investments overcome one of the key drawbacks of employment subsidies. It is possible to raise the earnings of the poor without increasing their productivity; but training and education raise can raise their earnings *by* increasing their productivity. Worst of all, employment subsidies might discourage the accumulation of human capital, since narrowing the wage distribution reduces the incentives of individuals to pay for training and education. Because employment subsidies decline with higher wages, firms also have fewer incentives to train their workforces. For modern economies that will rely heavily on increasing their stock of human capital, this is potentially a serious disadvantage of employment subsidies.

Third, Phelps claims that employment subsidies would enhance participation in the community and increase social cohesion. Yet Burtless (1985) and others have concluded that eligibility for employment subsidies can have a stigmatising effect on low-wage workers.

Phelps concludes by addressing the likely criticisms of his proposals. He considers 'perversity objections', or the possibility that any policy may have a variety of unintended, negative consequences. The possibility, mentioned above, that employment subsidies might discourage human capital accumulation is one such objection. Employment subsidies raise the earnings and well-being of the poorest segments of society; yet they encourage employment in the least productive sectors of the economy. It is unclear whether the overall gains to society from a low-wage employment subsidy would outweigh the negative side-effects.

I hope that Phelps's book promotes more discussion of, and research into, low-wage employment subsidies. Although I am not convinced that such policies would be preferable to those that would promote training and education, growing wage inequality in the US is a problem and all policy options should be explored.

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Ending Corporate Stalinism

*Tyler Cowen and David Parker, **Markets In The Firm: A Market Process Approach to Management**, Institute of Economic Affairs, London, 1997*

*Reviewed by **Ken Phillips***

WITH *Markets In The Firm*, Tyler Cowen (George Mason University, USA) and David Parker (Aston University, UK) have, in a succinct 80 pages, provided a snapshot of the philosophies and approaches which have been driving business management since the start of the industrial revolution. They revisit the question that Ronald Coase asked in 1937: why do firms exist?

The conclusion of their study is summarised in the book's title. Until recently, the internal operations of firms have been dominated by command-and-control socialist principles. Markets in free-enterprise economies have operated between firms but not within firms. But in developed economies market principles and practices are now penetrating the internal operations of firms: and so they should, according to Cowen and Parker.

The authors first consider the latter days of craft production, then move on to the Taylorist or 'scientific' approaches to mass production which superseded craft production and which have dominated practice since the industrial revolution. 'Scientific management ... endorsed the separation of thinkers (management) from doers (labour)' (p. 23). Under the scientific principles of command and control, 'The senior managers would plan and control their businesses in a fashion similar to the way Soviet commissars from the 1920s planned and controlled their empires'. This continued until the 1970s, 'when US and European businesses dominated world markets aided by cartels, oligopolistic market structures, tariffs and a relative paucity of global competition' (p. 10). But in the more competitive world of today, firms are obliged to rely more on market based mechanisms, and especially on price triggers, as the most efficient way of processing and transmitting information and providing focused direction through the firm.

The authors draw on the writings of numerous modern business commentators. They associate the success of modern Japan with that country's rejection of Taylorist methods. They cite the works of Charles Handy, Peter Drucker, Edwards Deming, Tom Peters and many others to illustrate their points. In companies such as Rank Xerox, Du Pont, General Electric, ABB, AT&T, Johnson and Johnson, Siemens, Hewlett Packard and Chrysler, to name but a few, 'Employee commitment, "multi-tasking" and organisation in self-motivating teams are replacing Taylorist alienation, specialisation and top-down management' (p. 32). 'Workers must now be thinkers rather than simply doers ...' (p. 28).

But what can the firm be if it is not a system of command and control? What other mechanisms do or can hold firms together and give them strategic direction? How do the CEO and the company board ensure that their business plan prevails when they don't even have 'control' over the top layer of management? Cowen

and Parker look to market principles for the answers, arguing that just as price signals drive the commercial relations between entities in the market place, so price signals should, can and do drive the relationships between entities inside firms. Can the firm then be conceptualised as an organisational series of internal price signals tied to the ultimate price signal of the firm, namely, operational profit? Cowen and Parker appear to believe so. They respond to the problem identified by Coase (1937) — that the transaction costs associated with price mechanisms are too high for such mechanisms to operate inside firms — by insisting that contract management, as opposed to command and control management, resolves the issue: 'A "contract view" of the firm, in contrast to the "command" view, emphasises similarities rather than differences between resource allocation in firms and in markets' (p. 45). This view of the firm has parallels with Coase's (1988:9) own claim that 'Markets are institutions that exist to facilitate exchange'. Cohen and Parker have identified management developments that create market-based institutions that operate inside the firm.

For managers, this penetration of market principles into the workings of firms creates major practical problems. How do managers manage when apparently the invisible hand of the market is in control? How does the contract view of the firm translate into practice? Cowen and Parker do not seek to provide a sweeping 'one method fits all' model: no single organisational model will suit all businesses, just as the specific dynamics of any two markets are not identical.

Markets In The Firm is at its strongest on this point. Cowen and Parker address the practical problems through case studies. They examine the US petroleum wholesaling company Koch Industries Inc., McDonald's, and the retail giant Nordstrom as examples of firms that utilise internal price mechanisms. Nordstrom has bonuses 'tied directly to the sales performances of the individual. Furthermore, sales people who do not meet specified targets are either fired or transferred ... Sales people have a maximum incentive to apply their individualised knowledge' (p. 69). Koch Industries, meanwhile, has upper- and middle-management incentive compensation systems which 'emphasises the discovery of knowledge' (p. 51). But CEOs need to look to the particular circumstances of their firms in seeking suitable market mechanisms. As the authors stress, 'The firm and markets face the same economic problem of efficient resource allocation' (p. 72).

Despite my enthusiasm for this book, I believe Cowen and Parker have overlooked a significant issue. An important ingredient of Coase's analysis of the firm is his linkage of the firm to the law. In *The Firm, the Market and the Law*, Coase (1988) claimed that the existence of the firm was dependent on the entrepreneur-owner having the legal right to control the entities (people) in the firm, in the legally defined master-servant, employer-employee relationship. It is this 'right to control' of the employer over the employee which continues to be the key ingredient of the legal employment relationship. But to what extent can markets operate inside the firm while this remains the case? For contracts to flourish in the firm, the legal employment relationship must be replaced by independent contractor arrange-

ments. I suggest this is the central issue in promoting the play of market forces within firms.

Not that this comment detracts from the importance of Cowen and Parker's pioneering study. A fate similar to that of the Soviet Union awaits firms that continue to apply socialist command-and-control management practices in a market-dominated world.

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Evaluating Australian Economic Policies

*W. Max Corden, **The Road to Reform: Essays on Australian Economic Policy**, Addison Wesley, Lane Cove, 1997*

*Reviewed by **David Henderson***

THIS volume brings together 16 previously published papers by Max Corden, essentially as they were first issued though in some cases with abbreviations. Almost all were written for professional journals, so that, although the whole text is imbued with the author's characteristic and exemplary lucidity, this is a book for economists rather than the general reader. The scope of the essays is notably broad, in two respects. First, Australian issues are set in the wider context of the economic analysis that bears on them and the experience of other countries; and second, the range of topics covered is extensive.

The collection is in two distinct parts, each of which has a short introductory chapter by the author, written for the occasion. In both, there is a judicious blend of analytical and historical material. Part I, with seven republished essays, mostly of earlier vintage (the oldest appeared in 1957), is concerned with 'protection policy and trade liberalisation' in Australia. Essentially, it offers a set of windows on the extended process by which Australia has moved from being a staunchly protectionist country to the present situation, in which trade barriers have been substantially reduced while — notwithstanding the present government's recent equivocations — further moves in a liberal direction are to be expected. The whole story is surveyed in masterly fashion in Chapter 8, which contains Corden's Fisher Lecture of 1996 on 'Australian Liberalisation in International Perspective'.

Part II deals with 'macroeconomic policy and wages', and here there are nine papers dating from 1977 onwards. Of these, three are somewhat separate from the rest. Chapter 14 is a review — courteous and appreciative, but in some respects highly critical — of the (1985) Hancock Report on industrial relations, while Chapters 17 and 18 consider the question of whether and for what reasons a deficit in the current account of a country's balance of payments should be viewed as a matter of concern. The other six chapters review the macroeconomic experience and policies of Australia over the past 25-30 years, with Chapters 15 and 16 in particular providing some illuminating comparisons with developments in other OECD member countries.

It is useful to have these essays brought together in a single volume. Despite their relative antiquity, the earlier five contributions to Part I still make good reading, since their treatment both of the analytical issues and of the actual evolution of policies remains fresh and instructive. As Professor Kym Anderson notes in his foreword to the volume, Corden emphasises the relationship between tariff policy and the exchange-rate regime, an aspect that is apt to be neglected. Again, the essays bring out the incongruity between the general arguments for protection in the

Australian context, which presuppose an ordered and consistent approach, and the complexity and disorder of the protective system as it actually operated.

Two limitations of Part I are worth noting. Unfortunately to my mind, the author's fine essay on 'The Tariff', published in the early 1960s (Corden, 1963), has been omitted on grounds of length: I would like to have seen the historical sections of it included here. More broadly, these seven essays, as also the author's introduction to them, cover trade aspects only: there is nothing on the liberalisation by Australian governments of external capital flows, which makes an interesting and important story in its own right.

In Part II, a longer introduction from the author, or, better still, a further chapter written specially for this book, would in my view have added to the interest and value of the collection. There is a contrast here, as between the two subject areas. Where trade issues are concerned, the characteristic approach of mainstream economics, the prevailing vision of relationships and processes, has not radically changed in the course of the last half-century; and despite continuing professional differences, there has been and remains a consensus of sorts. Hence it is reasonable to consider policy issues without much reference to the changing state of professional opinion. When it comes to macroeconomic aspects, this is not at all the case. The earlier 'Keynesian' quasi-consensus fell apart in the 1970s, in the face of unexpected and dismaying developments in all the OECD economies. Since then, the profession has been struggling, as always against a background of continuing and often unforeseen changes on the world scene, to put together a more adequate agreed framework of thinking for the analysis of economy-wide events and trends. Hence the evolution of macroeconomic policies, and of the debates relating to them, forms part of a wider story which has to include the latest chapters in the history of economic thought. Some of the essays in Part II explicitly consider this latter aspect, and Corden has interesting things to say about rival models of the system, particularly in Chapter 11 of the book, the longest, which dates from 1977. However, I would have welcomed a more systematic and up-to-date review of these issues, taking account of unfolding events, and of related developments in professional thinking, over the whole period since the early 1970s.

In terms of current Australian categories, Corden clearly appears as an 'economic rationalist'. He has been a consistent advocate of liberal trade policies for Australia; and here the course of policies, which he has himself influenced by his writings and teachings over four decades, has broadly taken the direction that he had hoped for. On the macroeconomic side, he parts company from some 'rationalist' commentators in taking a favourable view of the mid-1980s Accord between the Labor government and the unions. However, the two main lessons for policy that emerge from Part II are anti-interventionist. First, and not peculiar to Australia, he stresses the importance of maintaining 'fiscal control', linked to a firm commitment by governments to low budget deficits. A second leading theme is the need for labour market reform as a means to bringing down chronically high unemployment rates; and here there is a distinctively Australian aspect, in the form of the award system which Corden views as 'job-destroying'. At the same time, and

despite its title, there is no suggestion in the book that the appropriate conduct of economic policy today can be viewed simply in terms of pressing forward with further market-oriented reforms. In particular, it is noted at the end of Chapter 15, in which macroeconomic policies are viewed across countries, that 'The difficulty of short-term monetary management, and of maintaining an expectation of low inflation while also stabilising aggregate demand somewhat, arises everywhere' (p. 250).

The publishers are to be congratulated on bringing out this rewarding collection of essays.

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For the Commonwealth Reader

*Antony W. Dnes, **The Economics of Law**, International Thomson Business Press, London, 1996*

*Reviewed by **Stephen Franks***

ANTONY DNES, a professor of economics at Nottingham Trent University in the UK, describes his book in the Preface as an 'accessible survey of law and economics that is aimed at practitioners and advanced students of both economics and law ... located in England or in other Commonwealth countries'.

For my limited purposes as a lawyer, Dnes's book is invaluable. It gives references to leading articles on themes of contemporary debate. The material is dense, but this is not an impediment. Dnes surveys current thinking on vital issues that I nevertheless remember only dimly.

Such a wide and dense survey may, however, be irritating to the newcomer to the discipline. Even supported by references, the summary conclusions may seem tendentious. For example, the introductory chapter refers to D. J. Pyle's 'Economics of Crime in Britain' (*Economic Affairs*, vol. 9, 1989, pp. 6-9). The summary states: 'If the cost of increasing the severity of prison sentences is compared with that for increasing detection and conviction of criminals, it turns out to be much cheaper to obtain a target reduction in crime by increasing the length of sentences' (p. 2). The extended discussion of the topic in Chapter 7 is more balanced.

For the Commonwealth reader, the recognition of Commonwealth cases and the evident poverty of modern law scholarship outside North America will please and alarm respectively. As Dnes notes,

> ... in North America, economics has had a terrific influence on law. There, academic lawyers have been heard to comment that one needs training in the economic analysis of law to understand the law literature, let alone the law and economics literature. This is not yet the situation on the other side of the Atlantic but there is a growing interest in law and economics in both of the parent disciplines. (p. 9)

That may account for a continuing inability in the Commonwealth to recognise what is lost in abandoning the common law for statute. It can mean that even signal achievements in statute go uncelebrated. A telling example appears in a flaw in this book. Dealing with property rights, Dnes looks at common property problems in high-seas fisheries (but without using the evocative phrase 'tragedy of the common'). He reviews the irrationality of various mechanisms for enforcement and suppression of distributional conflict, but says 'in the case of fishing, it seems that the costs of establishing private rights are too high relative to the benefits' (p. 14). Have New Zealanders been too modest to trumpet their successful creation of transferable quota entitlements (property rights in maximum fish harvest shares)? It has been

operating for years within the vast fisheries controlled under New Zealand's Fisheries Act 1983.

The comparative element in this text is particularly helpful. Lawyers in Australasia have debated, relying on little more than intuition and anecdote, the cost effect of differences in law and procedure in the US, UK, Australia and New Zealand. Dnes's chapter on contingency fees, cost rules and litigation compares studies not only from the US and the UK but also Germany. I was surprised to learn, for example, that Germany has rates of tort litigation that are comparable to the US figures. Dnes says: 'the comparisons may be best described as showing England as having unusually low rates of tort litigation' (p. 172).

Dnes speculates on why the economic analysis of law is so well established in North America but remains undeveloped in the Commonwealth. He wonders whether this is partly attributable to the postgraduate framework of law training in North America, which produces legal academics more open to the insights of other subjects. He notes that the English feel 'that somehow the subject reflects a hard nosed American affection for the market economy' (p. 175), but hopes that the book will be of interest on both sides of the Atlantic because of its comparative theme.

Although North American scholars may have developed a pre-eminent learning in these areas, few of them are aware of how culture-bound some of that learning is. In my own field, corporate and securities law, it is astonishing how few comparative studies have noticed, let alone investigated, some illuminating differences. Consider the hot North American debate about the inevitability and efficiency of regulations such as those governing proxy solicitation, or company insolvency. US scholars have rarely looked across the Atlantic to a similar regime which seems untroubled by the absence of proxy solicitation rules, and where, until recently, the procedures and outcomes upon company insolvency were largely determined by antecedent contracts of a kind that some American scholars have only speculated about in 'thought experiments' as to what might happen if legislation had not intervened.

If, improbably, an economist were to ask me to recommend an introduction to law and economics, I would suggest Dnes's book rather than Richard Posner's *Economic Analysis of Law* (1973, 1992). I would be less confident suggesting it to a lawyer. The Preface says that lawyers and economists should be able to 'use the book without any prior knowledge of the other "parent" subject'; but Dnes may overestimate lawyers' willingness to grapple with economics jargon and to study graphical presentations and algebraic expressions. This is not to say that Dnes has overused them, or that Posner will not trouble some lawyers similarly. But Posner's examples seem to me to be more developed. Perhaps Posner, as a practising law teacher and a judge, is more conscious of the frailty of those drawn to the law when confronted with numbers and symbols.

Dnes or Posner? Either or both, as long as it is not neither. Lawyers must realise how feeble their learning is if they cannot cope with either.

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Freedom as Non-domination

*Philip Pettit, **Republicanism: A Theory of Freedom and Government**, Clarendon Press, Oxford, 1997*

*Reviewed by **David W. Lovell***

AUSTRALIA is currently involved in a debate over 'the republic', a debate which turns on the nationality, title and powers of the head of state, and which has ebbed and flowed with the political fortunes of its proponents. The notion of an Australian republic is fundamentally connected with political symbolism, though its detractors fear it may ultimately shift real power in the political system from prime minister to president.

Philip Pettit, a philosopher at The Australian National University, has written a thoughtful and impressive book on republicanism which is quite properly removed from this scrap, chiefly because its focus is on the substance of political systems. As political thinkers have long understood, particular systems can display various forms and symbols; thus did Montesquieu in the 18th century discern a republic under the form of the English constitutional monarchy.

Pettit's book will not do much to illuminate the current Australian debate; it is far more important than that. It seeks to give good reasons for preferring a republican form of government to all others: not the republic as counterpoint to monarchy, but the republic as the embodiment of freedom. Pettit is aware that the project is not a modest one. His book is the culmination of many years of intellectual endeavour, in which the author has investigated the methodological bases and some of the policy settings of a philosophy of freedom. It proposes to point what is a fairly sterile political debate over freedom in a new direction by drawing on the republican tradition of thought associated especially with Cicero, Machiavelli and Harrington.

The book is organised into two major parts: the first makes the theoretical case for a republican version of freedom, and includes a historical account of the origins and vicissitudes of this conception, while the second examines some practical issues for republican government. Useful summaries of each chapter (in a series of propositions) are collected near the end of the book.

The core theoretical issue concerns the republican account of freedom. The modern debate over freedom, which owes something to Benjamin Constant but even more to Isaiah Berlin's contrast between negative and positive liberty, has been stuck in a rut. Against both sides of this debate — the one which sees freedom as non-interference, the other which sees it as self-mastery — Pettit posits the republican notion of freedom as non-domination. One is free, for Pettit, in the sense that one is protected against arbitrary interference, and in the sense that one can enjoy a sense of security and standing among others. The implications of this version of freedom are substantial. It suggests that a free person is subordinate to no one. It is consonant with equality and community, and also with democracy. It does not

oppose self-mastery or autonomy, but sees it as unnecessary for a social project of freedom. It is not limited to the sphere we generally call 'politics', for it is appropriate to all human relations, including those between husband and wife, employer and employee, welfare recipient and bureaucrat. In that other, inconclusive, modern debate between individualists and communitarians, Pettit believes that the republican conception of freedom can steer between the extremes of collectivism and atomism.

Pettit champions the republican conception of freedom in response to what he sees as the shortcomings of liberal conceptions, which, he claims, are relatively indifferent to inequalities of power in 'non-political' areas such as the home and the workplace. He also champions it in the face of its traditional proponents, who thought it appropriate only for an elite of propertied, mainstream males. He thinks that it can be made universal, and that it will be attractive, since it provides a solution to many of our political and social problems.

Pettit distinguishes the republican conception of freedom from the liberal conception by insisting that liberty may be lost without interference, and interference may occur without any loss of liberty. Republicanism differs from liberalism particularly in its view of law: while law constitutes an interference, a properly constituted law does not lead to a loss of freedom. Freedom on this view is not the silence of the law, but is created by law. In the rise of the former view of law from Hobbes onwards, Pettit argues, lay the decline of the republican view of freedom; the latter was finally eclipsed in the debates over the American Revolution.

If to be free is not to be dominated, a great deal turns on the meaning of 'domination'. Domination means living at the mercy of another person, even if that person never moves against you; it gives rise to fear and deference. Domination, Pettit continues, means one agent exercising arbitrary sway over another. It is arbitrary because it does not track the interests and ideas of the other (or, elsewhere, the 'welfare and world view' of the public); those interests may be tested, he suggests, by public discussion. Identifying arbitrariness is a political matter, and cannot be deduced *a priori*. But this clarification does not seem enough to kill objections that the result would encourage those who believed they had a mandate or a mission to force others to be free.

What, then, of the institutional consequences of this republicanism? The main strategies against domination consist of reciprocal power and constitutional provision. Pettit stresses that controlling republican government is not a heroic task, especially when done by the humble committee. He adds that republicanism is not just about the shape of institutions; for institutions to work, and for laws to be effectual, they need to be embedded in a network of norms in civil society. There is, he argues, a higher degree of non-domination (freedom) where norms support republican laws.

The republican conception of freedom, and Pettit's presentation of it, are in many ways attractive. They seem to unite and reconcile the modern tricolour: liberty, equality, fraternity. Pettit sees republican freedom as a primary good, something that people have instrumental reasons to want no matter what else they want.

How, he asks, could people fail to want it? Yet how is it to be achieved? Pettit sees the state as having a larger role than that envisaged by the liberals: as well as establishing equality before the law, the state must seek to reduce material inequalities.

Here we come to the practical nub of republicanism, which will irritate liberals by the larger role it allows to the state for action and intervention in areas of social life. Yet the state's power may be a threat, and Pettit attempts to counter it with constitutionalism (the dispersion of powers and the 'empire of laws') and democracy (where the objective is not so much consent as the genuine ability to contest public decisions).

Pettit's account sometimes seems too good to be true. Just as Marx once declared that 'democracy was the solved riddle of all constitutions', so Pettit might well say the same of his republicanism. He tries to show that it resolves major problems, and that 'environmentalism, feminism, socialism and multiculturalism can be cast as republican causes' (p.134), not to mention the demands of more mainstream groups. Surely opposition to it is a result of ignorance or ill will? Like many thinkers before him, Pettit promotes reason against the demands of sectional interests. Furthermore, he believes that people need not be angels to sustain the behaviours required for republicanism. Politicians, he adds, are inherently corruptible, but he believes that sanctions and screens will provide a sufficient guard.

I regretted the absence of some discussion of nationalism and, relatedly, of some basis for deciding why people should be a member of this state rather than that. Historically, universalist ideas have quickly fallen prey to rather more mundane, particularist associations. And since 'domination' is one of the key concepts presented here, I wondered how it would cope if people were systematically mistaken about their interests (as some accounts of 'ideology' maintain), and even whether the norms of civil society which support republican laws may themselves be or become oppressive.

What are the chances of success of this republicanism? Even less than the Australian republic's. Pettit sees politics as a conversation. He assumes that he will be able to convince people: the few who will read and understand his book, and later, perhaps, others. He discounts the role of unreason, irrationality, and interest. But if politics begins with philosophy, it ends with manifestos. It may listen to reason, but numbers are trumps. There is no doubt that this work deserves serious and careful assessment; whether it will get it is quite another matter.

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NON-AGENDA

With the view of causing an increase to take place in the mass of national wealth, or with a view to increase of the means either of subsistence or enjoyment, without some special reason, the general rule is, that nothing ought to be done or attempted by government. The motto, or watchword of government, on these occasions, ought to be — Be quiet. . . Whatever measures, therefore, cannot be justified as exceptions to that rule, may be considered as *non-agenda* on the part of government.

—— *Jeremy Bentham* (c.1801)

Not the Negative Income Tax Again!

James Cox

Until recently, I had thought that the negative income tax was one of the fashions of the 1960s and 1970s which has since been abandoned in the sober light of subsequent experience. In particular, experiments in the United States, which facilitated an investigation of the effects of replacing the existing welfare system by a more generous one, showed that the negative income tax reduced hours of work, especially by wives and younger men, and increased rates of marital instability.[1]

The idea now seems to be making a comeback. In a recent article, Professors Peter Dawkins and John Freebairn (1997) discuss the reasons for the increase in unemployment since the 1960s and what might be done to reduce the level of unemployment. They conclude that further product-market reform and lower real wages, especially for the less skilled, are required. Since the labour market is unlikely (in their view) to be significantly reformed in the near future, consideration should be given to reducing award wages. Dawkins and Freebairn believe that the Industrial Relations Commission is more likely to agree to this if those receiving reduced award wages can be compensated through the tax and transfer systems. They suggest that a tax credit (or negative income tax program) that takes family circumstances into account could compensate low-wage earners for reduced award

[1] See Murray (1984:147-53) and Munnell (1987) for further discussion.

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wages. The introduction of earned income tax credits might, however, be considered as an interim measure.

In a related publication, Dawkins et al. (1997) investigate alternative negative income tax proposals. They argue that a simple negative income tax could improve incentives by replacing the many complex and overlapping means tests that now exist in Australia. The simplest negative income tax involves providing tax credits to all adults, which are increased for those who have children or pay high rents to private landlords. The tax credits and any private income are then added together and taxed at a constant rate. Low-income individuals (for whom tax credits exceed tax payable) will receive a payment from the government, but higher-income individuals will be required to make a payment.

These authors also investigate more complex versions of the negative income tax, in which tax credits are phased out as income increases; some people receive a reduced guaranteed income (or none at all); or supplements are paid to persons who are eligible to receive social security benefits. These modified versions are less expensive than the pure negative income tax, but they retain some of the complexity of the present tax and transfer arrangements.

Finally, Dawkins et al. cost their alternative negative income tax proposals on the assumption that behaviour would not change following introduction of the program. They proceed by postulating a system of tax credits and then calculating the flat tax rate that would be required to finance both the tax credits and the non-social security expenditure of government. The required tax rates are in the range 45-57 per cent. The pure negative income tax option requiring a tax rate of 45 per cent involves 'the reduction of the income of social security beneficiaries by about 25 per cent' (Dawkins et al., 1997:9). The required reduction in social security incomes would be less if a more selective approach to providing assistance were adopted.

There are naturally many ways in which one might choose to evaluate these arguments. I think it is useful to do so by considering the following questions:

1. How successful are the negative income tax proposals in providing further assistance to low-wage earners, thus (according to Dawkins and Freebairn) making reduced award wages more acceptable to the Industrial Relations Commission?

2. Given that the negative income tax proposals reduce effective tax rates for some individuals but increase them for others, are they likely on balance to result in an improvement or a worsening in the incentives to earn additional income?

3. To what extent are the negative income tax proposals consistent with other proposals for the reform of social security, which emphasise defining and then enforcing the reciprocal obligations which beneficiaries incur in return for receiving benefits?

4. What can be said, particularly in the light of the experiments in the United States, about the possible unintended consequences of introducing a negative income tax?

Some comments follow on each of these points.

Targeting

The main issue here is that, while low wages are earned by individuals, low income in relation to their needs is a problem for all members of a family or a household. Most families or households share incomes to some extent, even if they do not do so with complete fairness. Many people who earn low wages belong to families whose total income is adequate: they may, for example, be secondary earners or sons or daughters just starting employment. By contrast, a single-income family with high needs may experience difficulties even though the sole earner's wage rate, considered in isolation, is adequate. Indeed, these difficulties may result from the limited extent of the family's participation in the labour market rather than from low wages. The relationship between low wages and low family income is therefore probably not a close one. One feels that this point needs to be made carefully to the Industrial Relations Commission. Regrettably, however, Dawkins et al. do not investigate the extent of correlation between low wages and low family incomes.

Low-income families in employment with children, and those paying high rents to private landlords, already receive considerable government assistance. The negative income tax proposals would extend assistance to similar families with higher incomes. This would not do much to address any problem of family poverty that might be worsened as a result of lower award wages.

Dawkins et al. provide tables showing the distributional consequences of their proposals for families classified according to their private (non-benefit) income. The distributional impacts of the various proposals differ substantially. As a general rule, they tend to increase incomes at the bottom end of the distribution of family private incomes and to reduce incomes at the top end.[2] Income survey data from the Australian Bureau of Statistics (1997:12-13, Table 1) suggest that there are relatively few employed persons in families within the bottom three deciles of the family gross income distribution. This is likely to be even more true of the private income distribution, which excludes government benefits. The negative income tax proposals seem unlikely, therefore, to be efficient in providing additional assistance to families which include low-wage earners.

Incentives

Dawkins et al. discuss the incentive effects of their proposals in terms of changes to the effective marginal rates arising from the interaction of the tax and social security

[2] Exceptions are option 1b (a reduction in the income guarantee below the age pension level) and option 2 (a reduced income guarantee plus tax credits which are tapered out as income increases).

systems.[3] They suggest that a flat marginal rate of 45 per cent is a sensible target in the early stages. This is below the top rate of income tax and also below the effective rate experienced over the income range where benefits are abated. Moreover, they argue that many of those who would experience lower effective marginal tax rates under their proposals (for example, women who are thinking about undertaking part-time work) are likely to be particularly responsive to incentives.

Although some individuals pay income tax at the top marginal rate, the majority either pay no tax at all (because income is below the tax threshold) or pay tax at a rate substantially below the top marginal rate. To gain an impression of the overall effects of introducing a negative income tax, one may compare the 45 per cent flat tax with an average of the marginal tax rates arising from the existing arrangements. One might, for example, calculate a person-weighted average marginal tax rate. (This shows how much would be taken in increased tax on average if all taxpayers increased their taxable incomes by one dollar.) This average marginal tax rate can be estimated from taxation statistics to have been 25.4 per cent in 1994/95 (Australian Taxation Office, 1996).[4] In addition, the effect of withdrawal of means-tested assistance needs to be considered. This raises the average marginal tax rate to about 28 per cent.[5]

The difference between the tax rates of 45 per cent and 28 per cent indicates that significantly more redistribution than at present would be undertaken were the negative income tax proposals to be implemented. This would tend to have adverse implications for incentives. (Alternatively, the basic income guarantee could be reduced below the age pension level still further; this would however reduce the attractiveness of the negative income tax proposals.)

Dawkins et al. argue that those who experience lower tax rates as a result of the introduction of negative income tax (for example, sole parent pensioners who work part-time) are particularly likely to increase their hours of work. The overall incentive effects of introducing a negative income tax may therefore be favourable in their view. However, many of those who would experience higher effective tax rates as a result of the negative income tax (for example, women in two-parent families who are contemplating part-time work) may also be particularly sensitive to incentives. In addition, there are many relevant margins other than the choice between leisure and work that would be affected by the introduction of the negative income tax. Dawkins et al. (1997:27) promise us 'forthcoming theoretical simulations' to demonstrate the favourable consequences of introducing a negative income tax for incentives. In the absence of these simulations it seems safest to conclude that the

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[3] It is important to note that income effects (arising, for example, from the extension or withdrawal of assistance) are also relevant.

[4] This is the average marginal rate for both non-taxable and taxable individuals. Alternatively, an income-weighted marginal tax rate could be calculated, which would be higher.

[5] This assumes that 5 per cent of individuals have effective tax rates 50 percentage points higher than would otherwise be the case (Dawkins et al., 1997:6).

higher effective marginal tax rates (on average) resulting from the negative income tax programs would on balance weaken, rather than strengthen, incentives.

Reciprocal Obligations

The introduction of the negative income tax would reverse the trend towards tighter targeting of welfare that has occurred in recent years. Assessment of entitlement to welfare would be based almost entirely on private income. Private income may be too easily subject to manipulation by recipients to be the entire basis for welfare policy. The negative income tax is contrary to the increasing tendency for beneficiaries to be required to perform certain reciprocal obligations in return for receiving benefits. For example, unemployment beneficiaries in Australia are required to be looking for full-time work and may, in addition, be required to work part-time while receiving benefit. There seems to be a good deal of public support for introducing new obligations for certain beneficiaries.

Unintended Consequences

It is easy to contrast the imagined simplicity of a new system, such as negative income tax, with the messy reality of our existing taxation and social security arrangements. Nevertheless, the complexity is there for a purpose, namely, to keep the cost of providing adequate assistance to those who need it within reason. It will not be easy for governments to dispense with this complexity.

Those who believe that further deregulation of the labour market is desirable should argue for that directly. Although the political climate may seem unfavourable, this can quickly change. It is getting things the wrong way round to argue for far-reaching and probably irreversible changes to our social arrangements, the consequences of which can be foreseen only dimly, to remove what may be only temporary difficulties. It is, moreover, simple-minded to argue that labour market deregulation will necessarily lead to lower wages since other aspects of the employment contract (such as non-wage benefits and the organisation of work) would also vary.

One effect of introducing the negative income tax would be to make government assistance available in many circumstances where it is not at present. Although it takes time for behaviour to change, experience suggests that many more people eventually qualify for benefits than was expected at the time of introduction of the benefit. For example, the number of sole parent pensioners in Australia today far exceeds earlier expectations. The unintended consequences of the negative income tax experiments in the United States have already been noted. All this indicates that governments need to be very cautious indeed about extending assistance to new groups of beneficiaries.

By contrast to the negative income tax, Dawkins and Freebairn's alternative proposal for the introduction of an Earned Income Tax Credit is likely to direct additional assistance to persons earning low wages. But there already is a multiplicity of programs for low-income families in employment (such as parenting allow-

ance, family payment and family tax payment). Worries about complexity and disincentive effects will therefore limit what more can be done here.

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