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The Welfare State and the Good Society

James Cox

THE growth in spending on the welfare state has been one of the great structural changes in Australia, New Zealand and similar countries during recent decades. Between 1962 and 1995, government spending on health, education, social security and housing rose in Australia from 13 per cent of GDP to 21 per cent; transfers from governments to persons rose from 6 per cent of GDP to 11 per cent.

Critics of the growth of government have stressed its possible implications for the incentives to work and to save and for family stability. Some commentators have detected a decline in the sense of personal responsibility, as manifested in increasing crime rates, avoidance of work by the able-bodied, and unmarried motherhood. Supporters of an even larger role of government, in contrast, argue that government programs are an important and irreplaceable part of the social fabric, and that government policies of recent years, such as privatisation, contracting out and the stricter targeting of welfare, have added to our social problems by damaging that fabric.

This article attempts to evaluate these alternative views of the social effects of the welfare state. First, it considers the arguments recently advanced by David Green and Eva Cox, which are representative of the two positions summarised above. The available statistical evidence is then assembled and discussed, and some implications are drawn. Although the evidence is suggestive rather than conclusive, the views expressed go beyond mere opinion. The relevance, if any, of this analysis for government policy is then discussed. The article concludes by reflecting on some of the broader issues that have been raised.

Conflicting Views of Civil Society

David Green. In *From Welfare State to Civil Society: Towards Welfare that Works in New Zealand* (1996), David Green argues that state paternalism has damaged New Zealand society. Since the late 1970s, the welfare state has been increasingly afflicted by a number of problems, including: rising expenditure on the welfare state (despite efforts by governments to control it); poor service quality and absence of choice in welfare services; rising taxes and increased government debt; and reduced incentives to work arising from the combined effects of the social security and tax systems. More recently, New Zealanders have become concerned about

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rising crime, diminished work effort, family breakdown and the lack of economic progress by the Maori community. In contrast with the 19th century, 'very few people take personal pride in assuming responsibility for the direct resolution of problems' (p. 104). The voluntary associations that previously were so important a part of Australian and New Zealand society have been crowded out by government activity. These days, activism is likely to lead to demands that government — which means other people — should take action. Activism 'is doubly pernicious because, on the one hand, it denies personal responsibility and, on the other, it dresses up political demands as altruism when they are no such thing' (p. 105).

These problems have arisen largely because the welfare state has weakened people's sense of responsibility for themselves and for others. Those down on their luck are considered to be not independent moral agents but victims of circumstance. Moreover, the growth of the welfare state 'has diminished opportunities for people to be of service to each other, impairing the quality of life and encouraging us to look outwards to "the authorities", instead of inwards to our own strengths and skills, for solutions to shared problems' (p. vii). The erosion of the sense of personal responsibility is especially serious because it weakens the qualities on which a free society depends. To resist the concentration of power in political hands 'is to advocate the dispersal of decision making to people assumed to be capable of bearing responsibility, respecting others, and making intelligent decisions' (p. 28). 'Because our eyes have been fixed on the economy', Green argues, 'we have not been alert to mistaken doctrines which have caused family breakdown and turned voluntary associations — once sources of that strength of character which insulates nations from tyranny — directly or indirectly into instruments of the state' (p. 30).

Green's recommendations for limiting the role of government and increasing the scope for self-reliance and what he calls 'community without politics' are inspired by a view of the good society in which human beings achieve fulfilment by assuming personal responsibility for self-improvement and by making the world a better place for others. The community is united not under central leadership but in accepting the conditions which allow us all to exercise responsibility. It is the job of government to maintain the conditions under which all this can take place.

Eva Cox. In *A Truly Civil Society* (1995), Eva Cox is concerned about 'the loss of social cohesion and loss of faith in the possibilities of solving social problems' in our societies (p. 4). More people live alone than ever before and must make deliberate efforts to be sociable. The increased competition that has been encouraged by government policy in recent years threatens to destroy society by limiting the scope for cooperation. Most seriously, there has been a loss of faith in government. 'If part of our sense of well-being is our faith in governments, the denigration of public services by governments reduces our sense of comfort and trust' (p. 10). The reduction in public services and the reform of some utilities have resulted in a sense of loss, an unravelling and tearing of the social fabric, 'suspicion and isolation rather than a sense of belonging' (p. 73). In particular, because child care is not universally provided, we are in danger of producing children who lack the skills re-

quired for good trust relationships. Although pressure for expanded government-subsidised child care has been successful, work-related child-care needs have been over-emphasised. 'Few parents on their own have the capacity to train their children in sociability' (p. 32); hence the need for universal government-provided child care.

Because families are 'small fragile units', a strong state is needed to integrate society. Moreover, the state is 'the best hope for positive change' (p. 47). Democratic, centralised power gives outsider groups 'the best assurance that their needs will not be ignored'. Above all, Cox celebrates the life of the political activist: a life of discussion, openness to ideas, acceptance of outsiders and political engagement (though she pays little attention to how the beneficiaries of government programs, as opposed to those who lobby on their behalf, can participate in this life). Cox wants changes that involve 'the productive interplay of state and community, because it is in this interplay that we can create a truly civil society' (p. 46). So whereas David Green argues that government programs limit the scope for self-improvement and private effort to help others, therefore weakening society, Eva Cox insists that the relationship between government programs and community effort is essentially complementary. Because institutions such as the family and community are so weak, only government can stand between the individual and the blind forces of the market. Policy changes which weaken government programs therefore also weaken society.

In trying to test these conflicting views against the evidence[1] and to determine whether the expansion in government welfare has tended to strengthen or weaken private effort, I will examine the following questions:

- Has the growth in welfare state spending in recent years been well-directed to areas of emerging need or has it reflected other, perhaps political, priorities?

- Has the growth in welfare spending and its funding on balance improved or worsened the situation of families with children?

- Has the expanded provision of subsidised child care by governments affected the care that families provide for their own children?

- Has the provision of care for the aged and the disabled by family or other informal networks diminished to such an extent that expanded government provision is unavoidable?

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[1] The available evidence is patchy and unsatisfactory in many respects. The analysis presented here is based on published statistical tables; a more informative analysis would be based on unit record data from the household expenditure surveys. Because the subject matter of this paper is so important and so little discussed, I believe that the exploratory survey made in this paper is justified. It is to be hoped that better data and more sophisticated analysis will soon be made available.

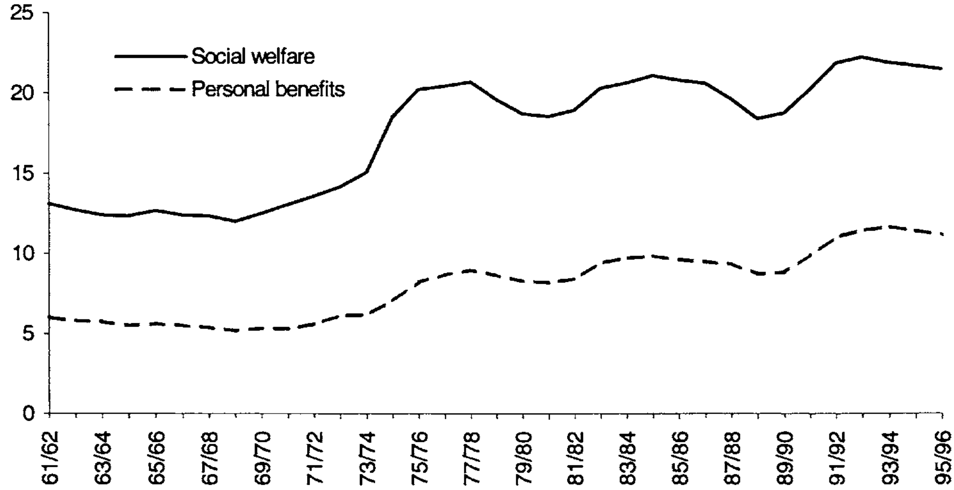
- Has increased government involvement in welfare coincided with increased or reduced voluntary effort?

The Growth in Government Welfare Spending and its Impact on Households

Figure 1 shows total spending since 1961/62 by all Australian governments on education, health, social security and welfare, and housing and community activities, expressed as a share of GDP. Figure 1 also shows the growth in personal benefit payments. The share of the population receiving one of the four main social security benefits (age pensions, unemployment benefits, disability pensions and sole parent pensions) increased from 12.5 per cent of the population aged 16 years and over in 1973 to 23 per cent in 1993 (ABS, 1994:147).

Figure 1

Government social welfare expenditure and personal benefit payments in Australia as percentages of GDP, 1961/62-1995/96



Source: ABS (1995).

The share of government revenue in GDP has also grown since the mid-1970s. During the period 1988/89–1993/94, revenues *fell* as a share of GDP from 36.8 per cent to 34 per cent while total outlays increased from 36.6 per cent to 40.4 per cent (see Cox, 1994, for further discussion). This is of some importance for the subsequent analysis.

The ABS household expenditure surveys provide the best data for understanding how the growth in government spending and taxation has affected the various kinds of households. The Australian Statistician has, since the 1984 survey, pub-

lished estimates, based on these surveys, of the effect of government benefits and taxes on household incomes. Only the more recent developments in the welfare state and its financing can be studied using these data, which therefore do not cover the great upsurge in spending which occurred during the mid-1970s.

Although these comprehensive data are available for only a short period, other, more limited, data suggest that the processes described here have been operating over a longer period. For example, my findings that during recent years the welfare state has increasingly benefited older people and penalised two-parent families with children are corroborated by David Thomson (1991), who shows that the welfare state in New Zealand has provided greatest advantage to increasingly older age groups during the period since World War II, and by EPAC (1988, Appendix 3), which shows that average effective tax rates rose far more quickly over the period 1949/50–1988/87 for a taxpayer with a spouse and children than for a single taxpayer. I show below that these trends have continued in the most recent years, and have affected a wider range of families.

Most attention is usually paid to the effects of government spending and taxation on the distribution of income. However, households in the lowest deciles of the income distribution tend to be smaller (and older) than average; and their needs may also be relatively small. For example, each household in the lowest quintile of the income distribution has 1.6 persons on average but each household in the highest quintile has 3.4 persons on average (ABS, 1996a:12). Income, therefore, may not be closely related to need. Moreover, some households may understate income to qualify for benefits or minimise tax and may report these understated incomes to the ABS.

Although the relationships between benefits, taxation and income are obviously important, it may be equally valid to examine the financial relationships between households of differing ages and composition on the the one hand and government on the other. This is particularly true because I wish to examine the financial situation of average families of different types, and not just those with low incomes. I have therefore chosen to look at the financial situations of households of differing age and composition. (Some methodological and statistical issues in presenting and interpreting the data are explained in the Appendix.)

Distribution among Age Groups

Table 1 reveals the high share of taxation paid by households with a reference person aged between 25 and 54 years. This group, which contained 61 per cent of reference persons in 1993/94, received 56 per cent of benefits but paid 79 per cent of taxes. By contrast, the 32 per cent of reference persons who were aged 55 or more years received 39 per cent of benefits and paid 16 per cent of taxes.

Despite the aging of the population, there was not a large increase between 1984 and 1993/94 in the share of households with reference persons aged 65 years and over. The numbers aged 45-54 years increased as a share of the population but those aged 25-34 years and 55-64 years decreased as a share of the population, in the latter case reflecting the low number of births during the 1930s. The increase in

government welfare spending between 1984 and 1993/94 was therefore not appreciably due to demographic factors.

Table 1

Percentage shares of government benefits and taxes by age of household reference person: Australia 1984-1993/94

	1993/94	*1988/89*	*1984*
Under 25 years			
Benefit share	4.54	3.57	4.91
Taxation share	5.27	5.19	6.50
Share of total households	6.39	5.63	6.83
25 - 34 years			
Benefit share	16.65	14.34	17.53
Taxation share	22.84	24.73	25.64
Share of total households	20.22	21.55	22.44
35 - 44 years			
Benefit share	23.66	26.41	23.89
Taxation share	28.72	30.55	26.29
Share of total households	21.88	23.65	20.82
45 - 54 years			
Benefit Share	16.01	15.15	15.03
Taxation Share	27.08	21.50	21.31
Share of total households	19.34	16.00	15.01
55 - 64 years			
Benefit Share	11.43	12.52	14.31
Taxation Share	10.18	11.99	14.02
Share of total households	12.75	14.56	15.95
65 years and over			
Benefit Share	27.71	28.01	24.32
Taxation Share	5.90	6.04	6.24
Share of total households	19.42	18.61	18.96

Note: Entries may not sum to 100 per cent, due to rounding.

Sources: ABS (1987, 1992, 1996a); author's calculations.

Households in which the reference person was aged 35-54 years were treated *increasingly less favourably* by the welfare state during 1984-1993/94, mainly because their shares of taxation increased rapidly over the decade. By contrast, households where the reference person was aged under 25 years or over 65 years received *increasingly favourable* treatment from the welfare state. For example, the share of benefits received by households over 65 years increased from 24.3 per cent to 27.7 per cent during 1984-1993/94. Those households aged 55-64 years received slightly more favourable treatment over the period, largely because they paid a falling share of taxation. Households where the reference person is aged 25-34 years received less favourable treatment by government in 1988/89 than in 1983/84, but more favourable treatment in 1993/94 than in either of the two earlier years. This apparent change may be due at least in part to the revised treatment of expenditure on child care (see Appendix).

The period 1984-1993/94 was in many ways a difficult one for persons of working age. Unemployment was relatively high on average, and the inequality of earnings increased. The fact that the welfare state treated those aged over 55 years more favourably and those aged under 55 on average less favourably over this period may suggest that, rather than responding to changing needs, the welfare state developed to a considerable extent according to its own, political, logic.

Distribution by Type of Households

Some information on the changing relationship between households of various types and the welfare state is presented in Table 2.

Significant changes have occurred in the proportions of the various types of household in the total. In particular, the proportion of households that are couples with only dependent children fell significantly, from 29.7 per cent of all households to 23.7 per cent during 1984-1993/94, mainly after 1988/89. The size of this reduction is surprising, although census data suggest that the share of households which are couples with dependants has been falling at least since 1976 (ABS, 1994:36). Conversely, younger couples without children, sole parents and lone persons have all increased as a proportion of total households. The share of multiple unit households has remained roughly constant.

Bearing these changes in mind, a number of findings are evident from Table 2. First, younger couples without children received increasingly less favourable treatment from the welfare state, largely because their share of benefits did not increase in line with the increased share of this group in total households. By contrast, the share of benefits going to older couples increased sharply.

Second, couples with only dependent children receive a greater than proportionate share of government benefits and pay an even greater share of taxes. During 1984-1993/94 the tax system became less favourable to families with dependent children (particularly during 1984-1988/89; the reduction in revenue as a share of GDP during 1988/89-1993/94 was of particular benefit to families with children). The benefits system treated families less generously in 1988/89 than in 1984, but this trend was apparently reversed during 1988/89-1993/94, possibly reflecting the

revised allocation of government expenditure on childcare to households by the ABS (see Appendix).

Table 2

Percentage shares of government benefits and taxes by household composition: Australia 1984-1993/94

	1993/94	*1988/89*	*1984*
Younger couples[a] without children			
Benefit share	4.15	2.83	3.52
Taxation share	17.67	13.02	14.18
Share of total households	12.76	9.33	9.69
Older couples[b] without children			
Benefit share	16.79	17.89	15.78
Taxation share	6.63	7.51	7.30
Share of total households	13.09	13.83	14.22
Couples with dependent children only			
Benefit share	28.17	30.79	32.30
Taxation share	30.97	36.72	35.37
Share of total households	23.68	28.36	29.68
Sole parents			
Benefit share	9.06	7.57	5.82
Taxation share	1.84	1.54	1.29
Share of total households	5.11	4.55	3.62
Younger lone persons[a]			
Benefit share	3.04	1.95	2.20
Taxation share	8.05	7.16	6.54
Share of total households	9.95	8.86	7.67
Older lone persons[b]			
Benefit share	11.86	10.87	10.06
Taxation share	2.12	2.04	2.53
Share of total households	11.85	11.45	11.41
Multiple income unit households[c]			
Benefit share	26.92	28.10	30.32
Taxation share	32.71	32.01	32.79
Share of total households	23.57	23.61	23.71

Notes: Entries may not sum to 100 per cent, due to rounding.
[a] under 55 years. [b] 55 years and over. [c] households with non-dependent children or those which include several adults, but not only a couple. Non-dependent children are children aged over 15 years but not full-time students aged 15-20 years.

Sources: ABS (1987, 1992, 1996a); author's calculations.

Third, sole parents received increasingly generous treatment from the welfare state, largely due to their increasing share of benefits.

Fourth, lone persons were also treated increasingly generously, especially older lone persons who received a larger share of benefits and paid a lower share of taxes during 1984-1993/94. The share of taxation paid by younger lone persons did not increase as rapidly as their share in the total population.

Fifth, multiple income unit households received increasingly adverse treatment, due to their sharply reduced share of government benefits. Many of these households include dependent children, or non-dependent children who rely on their parents to some extent, because of factors such as unemployment.

Sixth, younger couples, younger lone persons, couples with only dependent children and multiple income unit households pay shares of taxes that are greater than their shares of *benefits*. Couples with only dependent children, multiple income unit households and younger couples also pay shares of taxes which are disproportionately high in relation to their *numbers*. The reverse of both statements is true for sole parents, older couples and lone persons.

In summary, the welfare state redistributes from younger couples, couples with children and multiple income unit households to sole parents and older couples and older lone persons. On the whole, these trends tended to intensify during 1984-1993/94, with the exception that the reduction in government revenue from 36.8 per cent of GDP in 1988/89 to 34 per cent of GDP in 1993/94 seems especially to have benefited couples with dependent children only.

It is interesting that the proportion of households that are single persons and sole parents increased rapidly over this period but that the proportion of families with dependent children decreased. It is hard to believe that changes to the taxation and social security arrangements are not part of the explanation. As noted, single persons and sole parents received increasingly favourable treatment by the welfare state but families with children received increasingly less favourable treatment. Social policy changes of recent decades have made it increasingly easy for people to live apart from families: indeed, that was part of their rationale.

It is true that changes in the shares of taxation paid by various groups largely reflect changes in the shares of private income they earn. But private income is at least partially under the control of the persons who earn it; they decide the extent and nature of their participation in market activity. The extent to which people arrange their financial affairs to receive a low income will depend on the need for income to support dependents and the availability and generosity of welfare state benefits. In this respect, it is significant that the distribution of private income became increasingly concentrated during 1984-1993/94. Younger couples, couples with only dependent children and multiple unit householders constituted 63 per cent of households in 1984 but earned 83 per cent of private income; in 1993/94 the corresponding figures were 60 per cent and 83 per cent respectively (see Table 2 and references there). Such changes should be taken into account in evaluating the equity impact of the welfare state.

The moral dilemmas facing policy-makers have been sharpened by recent evidence suggesting that the two-parent family is generally better for children than the one-parent family. For example, Alan Tapper (1996) reports, based on a Western Australian survey of child health, that children in sole-parent families are more likely to suffer from mental health problems than children from intact families (the risk from children in blended families is in between these two). Barry Maley (1996) reports, based on a study of New South Wales crime statistics, that there is a relationship between family status and crime. Angus and Hall (1996) claim that data from the Australian Institute of Health and Welfare indicate that children from sole-parent families are eight times, and children in blended families 14 times, as likely to suffer abuse and neglect as children living with their natural parents. There are many possible explanations for this result; perhaps abuse in sole-parent families is more likely to be reported. And the interests of children need to be considered by policy-makers irrespective of the circumstances of their parents. Nevertheless, whatever the role of such factors, the wider social consequences of the existing subsidies are surely a matter of great concern.

Care of Children and of Persons with a Disability

The care of children and of persons with a disability is among the most important and difficult tasks that a society must undertake. Information about the extent to which it is carried out within families or, more broadly, on a voluntary basis within the wider society would give an indication of the strength of civil society in Australia. As well, information about the effect of expanded government child-care subsidies in recent years would help us understand the relationship between government and private effort in this area.

The ABS (1994:47-9) reports that the number of government-subsidised child care places increased from 59,000 in 1984 to 211,000 in 1993. A distinction is drawn between formal care (regulated care away from the child's home) and informal care (non-regulated care — other than by the child's parents — either in the child's home or elsewhere). According to the ABS (1994:47), 'most care of children other than by parents is provided on an informal basis, mainly by other family members'.[2] The proportion of children who are looked after only by their parents decreased from 61.5 per cent in 1984 to 51.2 per cent in 1993, most of this decline occurring during 1984-87. The use of child care has declined overall since 1990, perhaps reflecting a stabilisation in the labour-force participation rate of married women.

The proportion of children receiving formal child care only has increased from 8.7 per cent in 1984 to 11 per cent in 1993; most of this increase occurred during 1990-93, when the use of child care in total was falling. As a consequence, the share of children receiving informal care only has fallen from 33.9 per cent in 1990 to

[2] In 1993, 51.2 per cent of children aged under 11 years of age were cared for by their parents. Eleven per cent received formal care only, 29.4 per cent informal care (mainly from grandparents or other female relations) and 8.3 per cent a combination of formal and informal care.

29.4 per cent in 1993. The increased provision of regulated child care in recent years seems, therefore, to have resulted not in increased work by mothers but in reduced care by grandmothers or other relations. Something may have been lost in terms of the generations providing assistance one to another.

ABS surveys undertaken in 1988 and 1993 of persons with a disability and of their carers (ABS, 1990, 1993) found that most help is provided informally by spouses, other relations or friends and neighbours. For example, in 1993 over 90 per cent of persons who need help for self care, mobility, verbal communication, personal affairs and transport received it informally; over 75 per cent of those requiring help for meal preparation, home maintenance and home help received it informally; almost twice as many people received home care and home-help services from unrelated friends and neighbours as from formal services; and over 54 per cent of persons who receive help for health care received it informally. The most important providers of formal help were relatively unsubsidised: 'privately arranged help/commercially provided service' and 'chiropodist/podiatrist'. Only 30 per cent of persons who received formal help received it from 'home care/home help/council handypersons'.

Most needs for assistance are met: for most activities, unmet need amounts to less than 10 per cent of the total. Exceptions include home care, where up to 15 per cent of need for assistance was reported to be unmet.

According to the ABS (1996c:209), 60 per cent of persons with a handicap who were living in households and who received assistance received informal assistance only. Eight per cent received formal assistance only and 32 per cent received both formal and informal assistance. Only 6 per cent of persons with a handicap live in establishments such as hospitals or nursing homes.

Comparison between the 1988 and the 1993 surveys is not easy: there are differences, for example, in the population covered. Nevertheless, the numbers of people with a disability who received formal help seems to have increased between the two surveys. Much of the increase was for privately arranged help or podiatrists; the number receiving home-care services showed little change. Government-subsidised formal care for persons with a disability does not appear to have expanded greatly during 1988-93; consequently, any 'crowding out' of private effort by government-subsidised services would also have been small. Even so, there are some indications that private, informal care for persons with a disability diminished during that period (though it should be noted that significantly more information was required of carers in 1993 than in 1988, which may have influenced whether people identified themselves as carers). For example, the number of daughters providing home help and sons assisting with home maintenance fell. These changes no doubt reflect broader social and economic trends, including greater labour-force participation by women and perhaps a greater tendency for persons with a disability to live apart from their families. On the other hand, the numbers of people receiving assistance from unrelated friends and neighbours did not fall between the two years.

Participation in Voluntary Community Activities

As noted by Eva Cox, writers such as David Putnam (1993) have argued that a good indicator of the health of civil society is the level of participation in voluntary activities which both have a clear objective and a fairly egalitarian structure. This is because participation in such activities both reflects and develops those skills and attributes, like trust and the habit of cooperation, which are required if the institutions of either politics or the market are to function well.

By these standards, Australian society is healthy. According to the New South Wales Department of Fair Trading, 19,300 non-profit associations were registered under the Associations Incorporation Act in June 1994 (Department of Consumer Affairs, 1994). This represents one association for every 313 persons in New South Wales in that year. The number of incorporated associations is growing by about 2,000 a year and compares more than favourably with Putnam's figures, obtained from a census of associations, for the most civic regions of Italy such as Trentino-Alto Adige (Putnam, 1993:91-2).

The ABS has also undertaken some surveys of participation in voluntary work in Australia. The most recent survey (ABS, 1996b), shows that 19 per cent of the population aged 15 years and over provided some form of voluntary work through an organisation or group in 1995. Women were more likely to volunteer than men, and those with dependants were more likely to volunteer than those without. People aged 35-44 years are more likely to volunteer than younger or older persons. Thus, participation in voluntary work in Australia does not follow the pattern, observed by Putnam (1996), of high membership in associations during the later years of life, which Putnam considers in indicative of the high level of civic engagement among older Americans.

Participation in voluntary work may be waning. Whereas an ABS (1986) survey in New South Wales in October 1986 found that 18.5 per cent of males and 29.3 per cent of females provided voluntary service through an organisation in the twelve months prior to the interview, the corresponding figures from the 1995 survey were 13.1 per cent and 17.7 per cent, respectively (though it should be noted that the ABS did not release the final report of the 1986 survey, presumably because of concerns about data quality).

How Strong Is Australia's Civil Society?

The foregoing analysis permits us to be fairly optimistic about the state of civil society. Well-functioning families are able to protect their children from abuse, mental health problems, and engaging in criminal behaviour. Most care of children (other than by parents) is undertaken by female relations. Most persons with a disability who receive help receive it from a spouse, relation, friend or neighbour. Australia has many voluntary organisations. And a large proportion of the population undertakes voluntary work. Yet the number of sole-parent families has increased in recent years, despite the many disadvantages such families suffer. As well, the num-

ber of persons undertaking voluntary work and providing informal help to persons with disabilities seems to have fallen.

The expansion of the welfare state in recent years seems to have weakened the institutions of civil society. More people now rely on government as a principal source of income. More people now live alone; redistribution within households is less important than it used to be. The growth in government-regulated child care has reduced the amount that is privately provided. The growth in the welfare state has tended to benefit the old at the expense of the young and the middle-aged. Redistribution has increasingly been from households with children and younger couples to single persons and the self-employed. These changes do not seem obviously to be justified by changes in the relative needs of the various groups.

It is true that some government programs, such as payments to working families with children or to carers of the disabled, may support rather than undermine the institutions of civil society; but, as we have seen, the general development of the welfare state in recent years has tended to disadvantage families with children. It is also true that the growth of the welfare state may simply reflect broader changes which in themselves have tended to weaken civil society. These include a greater desire for individual autonomy in an increasingly prosperous society. Many people may, because of the opportunity this provides them to pursue their own projects, prefer an extensive role for government in caring for the aged and the disabled, even at the expense of higher taxes and their consequences, rather than to provide such care themselves. In this connection, it is sometimes said that families are less able to care than in the past because so many adults are working. The irony here is that so many the new jobs in recent years which have been financed through increased taxation involve caring for other people's children and parents. Australia seems to have gone some small way towards the situation in Sweden noted by Rosen (1996:734-5):

> In Sweden a large fraction of women take care of the children of women who work in the public sector to care for the parents of the women who are looking after their children. If Swedish women take care of each other's parents in exchange for taking care of each other's children, how much additional real output comes of it? In order for the state to provide services socially that otherwise would be privately produced in the family or the private sector, many ordinary, inherently personal activities must be reckoned in explicit monetary terms, tax revenues must be raised to finance them, and complex rules and conditions must be imposed to limit undesirable side effects.

Although such policies have been successful in increasing fertility and the economic independence of women, there are hidden efficiency and social losses resulting from the substitution of government-provided services for what otherwise would have been produced or purchased in other, more decentralised, ways. Moreover, the adverse effects of government welfare or private welfare help explain why the

increase in government social spending since about 1960 has provided disappointing results in many countries.[3]

Policy Issues

This analysis suggests that David Green's view of the welfare state is closer to the truth than Eva Cox's. There is a good deal of strength in the institutions of civil society in Australia; but expanded government effort displaces private effort, partly by reducing the need for private effort directed towards similar ends, and partly (through taxation and regulation) by reducing the capacity of society to pursue the ends it may consider desirable.

What are the implications for public policy? It should be remembered that debates about the future of the welfare state do not simply reflect differences in values, but are based at least in part on differing views about how society operates. The modern welfare state is little more than 50 years old; but we are gradually learning more about the connections between government and private effort. This, in turn, may eventually result in greater agreement about which policies are desirable. The World Bank (1994) report *Averting the Old Age Crisis,* which advocates a combination of government and private effort to provide income in retirement, is a good example of this process.

Meanwhile, governments should be cautious about further expansion of welfare programs. For example, the financing of expanded government programs through increased taxation is particularly likely to disadvantage younger people and families with children. A careful assessment of the distributional consequences should proceed any such expansion.

The most difficult issue, however, is the likely consequences of government withdrawal from certain areas of welfare state activity. Some writers, such as David Green, argue that self-help or alternative methods of redistribution would develop easily if government reduced the scale of certain of its activities. As noted, a great deal of private welfare activity already occurs in Australia. A core of private activity thus exists that might well be able to expand if the need arose. Even so, it is hard to assess to what extent, and how quickly, private effort would expand following a reduction in government effort. Even governments that believe in principle that certain activities are better undertaken by the private sector will be understandably cautious about reducing their social programs. They may prefer to reduce spending on the better-off, who can be expected to make alternative arrangements easily, than on the less well-off, who are more likely to be dependent on assistance from others. They may also prefer to reduce their effort in areas where well-developed private alternatives already exist.

Whatever the case, significant external pressures will force governments to reconsider their social policies. These include the need to keep government expenditure (and especially spending on benefits to individuals) under strict control, in order both to reduce government dissaving and, in an increasingly competitive world,

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[3] See Tanzi and Schuknecht (1995) for further discussion.

to permit reductions in tax rates. A good deal of cautious experimentation with alternative ways to meet society's social objectives is, therefore, likely to occur. Indeed, this process has already begun in Australia under both Labor and Liberal-National Coalition governments. There are, ironically, some dangers in caution; in particular, the desire to prescribe acceptable and safe alternatives to government provision can stifle the forces of innovation and competition — as is evident, for example, in the present debate about health insurance.

In considering withdrawal from certain welfare state activities, governments have to balance two sets of risks. The first is the risk of hardship to certain persons if government activity is reduced. This risk is often immediate and urgent. The second is the risk of progressively weakening civil society if government programs are maintained. This risk is longer-term and falls on unknown persons. It is hardly surprising that, until recently, governments have been more concerned about the first risk than the second. Even so, the emphasis is changing. The tension between the desire to reduce dependency on government and the distributional consequences of so doing is likely to continue to be an important issues for Australia, New Zealand and similar countries. But there are likely to be substantial rewards for countries that can manage these tensions well.

Final Thoughts

All of this has, of course, been said before. Scepticism about the effects of the welfare state arose early in its life. An important early criticism was provided by Bertrand de Jouvenal in 1949. As summarised by John Gray (1990:xiii-iv), the relevant part of de Jouvenal's argument is as follows:

> Redistributionist policy is condemned by de Jouvenal … for undermining the sense of personal responsibility. It does this by transferring authority for crucial life-decisions from the individuals who make them to the state. By catering for all the basic needs of the individual, the state leaves him with authority only in the sphere of how to spend his pocket money. Again, the effect of redistributionist policy is to disadvantage the family as against such legal fictions as the corporation — principally by conferring upon business immunities denied to families. The regime of high taxation inseparable from the redistributionist state has the further undesirable consequences of diminishing the sphere of free services in which people engage in convivial relationships without the expectation of payment — and thereby corroding the culture of civility that sustains liberal civilisation.
>
> For de Jouvenal, however, the most profound result of redistributionist policy is the impetus it gives to the baleful process of centralisation. If the state confiscates high incomes and imposes penal rates of taxation on savings and investment, the state must take over the savings and investment activities that private individuals are no longer able to undertake. If, because of the confiscation of higher incomes, there are important social and cultural activities that can no longer be sustained privately, such as provision

> for high culture and the arts, then once again the state must assume responsibility for such activities through a program of subsidy. Inevitably, that state comes to exercise an ever-increasing degree of control over them. The consequence of a redistributionist policy, accordingly, is the curtailment of private initiative in many spheres of social life, the destruction of the man of independent means, and the weakening of civil society.

Many of our present anxieties — about the weakening of the sense of personal responsibility, the weakening of family ties, the weakening of civil society, low rates of household savings and government involvement with high culture and the arts — would therefore be unsurprising to de Jouvenal. But it was reasonable, when he was writing in the late 1940s, to expect that the response in terms of reduced private effort to increased government provision of social services was less than it has turned out to be. And, given a desire to compensate for, and prevent a recurrence of, the disasters of the first half of the 20th century, people of good will had every reason to take an optimistic view about the consequences of government provision. It is not longer possible to take so innocent a view. Reconstructing welfare states in the light of this new and sobering knowledge is a considerable task for policy-makers at the end of the 20th century.

Appendix

Statistical Issues in Presenting Household Expenditure Survey Data

The surveys asked each household how much it paid in direct taxes and how much it received in social security benefits. However, assumptions need to be made if indirect taxes and in-kind benefits are to be allocated to individual households. These assumptions are detailed in the ABS publications (for example, 1996a:59-77). As experience has been gained and priorities have changed, the ABS has changed the way it allocates some taxes and benefits. As new policies (such as the Higher Education Contribution Scheme) have been introduced, the allocation procedures have had to be revised to take account of them. One of more significant changes concerns the allocation to households of benefits for child care. In the 1993/94 survey, outlays on child care were allocated to households with children under twelve years according to household income and the probability that the household used child care. In previous surveys, outlays on child care were not separately identified but formed part of total indirect benefits in social security and welfare, which were then allocated to households that received social security cash payments. This revised procedure may have influenced the 1993/94 survey's recorded share of benefits received by families with children.

Two particular difficulties with the ABS data need to be addressed before the effect of the welfare state on particular types of household can be studied. First, differing proportions of taxes and government expenditures are allocated in the various surveys. For example, 54 per cent of government revenues, but 48 per cent of government expenditures, were allocated in the 1993/94 survey. Thus, more

benefits are allocated than taxes, and average benefits exceed average taxes. As the ABS recognises, the difference between government benefits and taxes for a particular group of households has no particular significance. Moreover, this difference can fluctuate considerably depending on government fiscal policy and the state of the economy. To focus on the *underlying* trends, this article calculates the *shares* of benefits received and taxes paid by each of the relevant groups.

Second, the shares of benefits received and taxes paid by a group can be affected by changes in the numbers in each group (as a result of demographic factors) as well as by changes in government expenditure and taxation policies. To correct for this, it is necessary to adjust changes through time in the shares of benefits received and taxes paid by various groups in the light of changes in the numbers in these groups. For example, if the share of government expenditure on a particular group increased faster than might have been expected on the basis of growth in its numbers, then it is reasonable to argue that expenditure policy has changed in favour of that group. It needs to be remembered that these groups represent different persons in each of the surveys.

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Setting the Reserve Bank's Inflation Target: The New Zealand Debate

Paul Dalziel

SECTION 8 of the Reserve Bank of New Zealand Act 1989 stipulates that the statutory objective of monetary policy is 'achieving and maintaining stability in the general level of prices'. A more precise inflation target, against which the performance of the Reserve Bank is judged, is contained in a Policy Targets Agreement (PTA) negotiated by the Minister of Finance and the Governor of the Reserve Bank whenever the Governor's contract is renewed (every five years), or if a new Governor is appointed, or by agreement between the Minister and the Governor.[1]

The first PTA (dated 2 March 1990) stated that 'an annual inflation rate in the range of 0 to 2 per cent will be taken to represent the achievement of price stability' (*Reserve Bank Bulletin*, March 1990, p. 26), and this target band was retained in the second and third PTAs (dated 19 December 1990 and 16 December 1992 respectively). The fourth PTA, however, signed on 10 December 1996 (the day that New Zealand's first coalition government under its new proportional-representation electoral system was announced), relaxed the top end of the target band by one percentage point. This change followed widespread criticism of the way in which the Reserve Bank's policy response to a small but persistent breach of the top end of the 0-2 per cent target band throughout 1996 caused the trade-weighted exchange rate to appreciate sharply. Some commentators suggested that this might have been avoided if the range of the target band were broader and/or its midpoint higher. Other commentators, however, argued that any relaxation of the target would raise inflationary expectations, and so would be counterproductive in the medium term. The December 1996 PTA embodied what the Governor of the Reserve Bank has described as 'a reasonable compromise' (Brash, 1997:5): the target range was widened from two to three percentage points and the midpoint was lifted from 1.0 to 1.5 per cent a year. These are obviously very small changes, but the latter in particular represents a significant shift in New Zealand's monetary policy framework, which it is the purpose of this article to discuss.

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[1] Section 12 of the Act also allows the government to change the economic objective of monetary policy by Order in Council for up to twelve months at a time. Section 12 has not been invoked in the eight years since the Act was passed, but, if it were used, a new PTA would have to be negotiated in line with the interim objective within 30 days of the Order in Council.

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Accountability, Flexibility and Credibility

Three principles are central to the Policy Targets Agreement mechanism: accountability, flexibility and credibility. Accountability is the most straightforward. Positive inflation imposes a tax on money holders, and, if unanticipated, also involves a tax on creditors and a subsidy to debtors (including, of course, the Crown; net public domestic debt in New Zealand is approximately 30 per cent of GDP). As it is a fundamental constitutional principle that taxes should not be levied without the approval of parliament, both the government and the Reserve Bank should be accountable to parliament for the level of inflation they choose to allow (Kirchner, 1995:171-3; Robertson, 1996:3-9). The PTA, supplemented by a statutory requirement for six-monthly reports by the Reserve Bank Governor to a parliamentary Select Committee, is designed to ensure this accountability.

A degree of flexibility in the PTA is desirable because of unavoidable uncertainties involved in monetary policy. These uncertainties relate to the nature, frequency and size of present and future economic shocks; the lags between policy implementation and policy impact; and the behaviour over time of key parameters in the transmission mechanism between a change in the instruments of monetary policy and a change in the rate of inflation in the Consumers Price Index (CPI). These uncertainties mean that it is unrealistic to expect monetary policy to achieve a single-point inflation target (which strict accountability would otherwise require); and this, in turn, raises the possibility that it may not always be desirable to require policy-makers to offset immediately all shocks to the economy's underlying inflation rate (Dennis, 1997). Consequently, New Zealand's monetary policy framework introduces flexibility into the PTA in three important ways: (i) by allowing the Reserve Bank to permit one-off changes in the price level caused by certain pre-specified supply-side shocks; (ii) by setting a target range rather than a target point for inflation; and (iii) by giving the Minister of Finance some discretion about whether to penalise the Governor of the Reserve Bank if there is a breach of this target range.

There is a strong potential for conflict between flexibility and accountability. For example, if the target range in the PTA is broadened to allow the Reserve Bank more room to accommodate a series of small adverse supply-side shocks, this provides an extra degree of flexibility when the shocks occur, but may also reduce the Bank's accountability for inflation outcomes in other periods. To evaluate the trade-offs involved in this potential conflict, economists tend to focus on the impact of accountability and flexibility on the third relevant principle: credibility (Blackburn & Christensen, 1989, provide an excellent review of this literature). This is because the economic costs of achieving and maintaining a pre-announced measure of price stability depend critically on the credibility of the announced target, due to its impact on inflationary expectations. If an inflation target is only weakly credible, rational agents in the market place will adopt a somewhat higher inflation forecast in their economic decision-making. If policy-makers then persevere with their announced target, they thereby open up a gap between expected and actual inflation, which in turn produces a shortfall between potential and actual output as agents en-

ter into contracts at nominal prices which (*ex post*) overvalue real wages, real interest rates and real exchange rates. There are therefore economic advantages to be gained if accountability and flexibility can be incorporated into the economy's monetary policy framework in such a way as to maximise the credibility of its pre-announced inflation target. Much of the ongoing debate in New Zealand about the PTA rests on different views about how a low and narrow range compares with a higher and broader target in its impacts on accountability, flexibility, and hence credibility.

Grounds for Flexibility in the PTA

The PTA recognises that, in the normal course of events, an economy will experience a range of random price shocks that are 'quite outside the direct influence of monetary policy'.[2] It therefore establishes the principle that the Reserve Bank may accommodate the direct impact of such shocks, but 'in a manner which prevents general inflationary pressures emerging'. The shocks that are explicitly recognised under this principle as 'caveats' to the Bank's CPI inflation target in the fourth PTA are as follows:

- significant changes in the terms of trade arising from an increase or decrease in either import or export prices;
- an increase or decrease in the rate of the goods and services tax, or a significant change in other indirect tax rates;
- a crisis such as a natural disaster or a major disease-induced fall in livestock numbers which is expected to have a significant impact on the price level;
- a significant price level impact arising from changes to government or local authority levies; and
- a movement in interest rates that causes a significant divergence between the change in the CPI and the change in the CPI excluding the interest costs component.

In practice, the Reserve Bank incorporates these caveats by making three adjustments to the CPI statistic each quarter. First, it removes the direct impact of interest rate changes (relying on the 'CPI excluding credit services' series published by Statistics New Zealand). Second, it removes any indirect tax change (a relatively rare event). Third, it removes any other price movement in the PTA list of caveats that in the Reserve Bank's judgment has contributed more than 0.25 percentage points to the CPI inflation rate over the previous twelve months. This calculation

[2] The text of the PTA can be downloaded from the site http://www.rbnz.govt.nz

produces the 'underlying inflation rate', which the Reserve Bank adopts as its PTA target.

Note that the third step requires the Bank to exercise judgment in calculating the statistic by which its performance is monitored. Commentators have observed that accountability would be enhanced if an independent organisation such as Statistics New Zealand produced the underlying inflation rate statistic in a more mechanistic fashion (McCallum, 1995:5; OECD, 1996:42). The Bank agrees in principle (Roger, 1994:112), and continues to research how this might be achieved in practice (Roger, 1995). In the meantime, it has been very careful to maintain its reputation for integrity in its calculations of the underlying rate of inflation. In the year to June 1995, for example, unusually adverse climatic conditions increased the price of fresh fruit and vegetables sharply, adding 0.4 per cent to the CPI inflation rate. This moved the underlying inflation rate outside the target band then in effect (to 2.2 per cent), but the Reserve Bank made no attempt to remove the fresh fruit and vegetable price increase from its underlying inflation rate statistic, on the basis that a weather-related effect is not one of the supply-side shocks explicitly mentioned in the PTA caveats.

Further flexibility is introduced by setting a target range 'within which inflation can vary without monetary policy being deemed unsuccessful' (Dennis, 1997:22), and by allowing the Minister of Finance some discretion in determining *ex post* whether the Reserve Bank Governor is culpable for movements of underlying inflation outside that range. The basis for the Minister's discretion is perhaps the least clearly defined aspect of New Zealand's monetary policy framework, and has been developed in a series of letters between the Minister and the non-executive Directors of the Bank after small breaches of the 0-2 per cent target in June 1995 and again in March 1996. The position of the non-executive Directors is summarised in this extract from a letter dated 19 April 1996 written by the Reserve Bank Governor to the Minister of Finance (*Reserve Bank Monetary Policy Statement June 1996*, p. 46, emphasis in original):

> I think it is important that everybody recall the words of the non-executive Directors of the Bank in their letter to you last June, namely that it was their 'understanding that 0 to 2 per cent was always intended to be a target towards which the Bank would be *constantly aiming*, not necessarily a target which could, given the inevitable uncertainties in forecasting and lags in the effectiveness of monetary policy, always be certain of attainment'. That is certainly my understanding of what the target means, but I think it would be helpful if the wider public began to understand that also.

The Minster of Finance (Hon. Bill Birch) has been cautious in using this discretion, writing to the non-executive Directors that he regards any breach of the target range as 'serious', and asking on each occasion of a breach for a report describing its causes and explaining what remedial actions were being taken to restore price stability (*Reserve Bank Monetary Policy Statement June 1996*, p. 42). To date, the

Minister has been satisfied that the Governor should not be held culpable for the breaches in 1995 and 1996. But this procedure raises a number of important issues. First, Ministerial discretion is reintroduced into the monetary policy framework, and so the attempt to divorce monetary policy from politics falters (this point is discussed more generally by McCallum, 1995:26). Second, the Minister, through the non-executive Directors of the Reserve Bank, is obliged on these occasions to investigate the technical details of whether monetary policy set six to twelve months earlier had been consistent with achieving the missed target (on the information available at the time), working against the autonomy of the Reserve Bank in designing and implementing monetary policy. Third, if the breaches become frequent, the PTA target begins to lose its credibility as an anchor for inflationary expectations. This was very important in New Zealand in 1995 and 1996, when the underlying annual inflation rate lay between 1.9 and 2.4 per cent throughout and breached the 2.0 per cent ceiling in five of the eight quarters.

The Breadth of the Target Band

The December 1996 PTA broadened the inflation target band from two percentage points to three percentage points. In terms of the discussion of the previous section, this increased the flexibility of monetary policy at the expense of reducing the Reserve Bank's accountability for outcomes in which underlying inflation is higher than two per cent but below three per cent.

The primary argument supporting the change rests on an analysis of the precision of the forecasting techniques and policy instruments available to the Reserve Bank, produced during the OECD's 1996 economic survey of New Zealand. Describing New Zealand's regime for controlling inflation as 'ambitious', the survey went on to explain the basic issues and their impact on credibility (OECD, 1996:44):

> Having too narrow a band would risk missing the target sufficiently frequently to call its credibility into question. It could require implausible forecasting ability by the Reserve Bank if changes in inflationary pressure are to be detected early enough for monetary policy to react in time to prevent them driving inflation outside the band, given the quite long time lags before policy takes effect. There will thus tend to be some irreducible minimum for the variation in inflation, determined mainly by the magnitude of the shocks to which the economy is subject and the length of the lags before policy actions take effect. Attempts to go below this will tend to result in instability in the setting of monetary conditions.

Two issues are highlighted in this analysis. The first is that, even if the Reserve Bank uses best available techniques for forecasting price changes and implementing properly targeted monetary policy, the standard error in the inflation equation means that inflation can be expected to move outside any given band with a certain probability, where the probability varies inversely with the width of the band.

Turner (1996), for example, constructs a simulation model of the New Zealand economy that suggests a band of two percentage points might be breached 20 per cent of the time, but a band of three percentage points might be breached only 5 per cent of the time. On the basis of these estimates, the December 1996 PTA change reduces the expected involvement of the Minister in investigating target breaches from once every five quarters to once every five years.

The Reserve Bank has also addressed this issue by examining alternative measures of underlying inflation with smaller variances (Roger, 1994, 1995). Possible candidates include a trimmed mean CPI or a weighted median CPI, both of which reduce the influence of large price movements in the individual components of the CPI to give a better measure of central tendency. Adopting one of these statistics as the official measure of underlying inflation, therefore, would reduce the risk of breaches of the target band caused by a temporary shock to one or more components of the CPI. It is by no means certain, however, that this change would be generally accepted by the public. The PTA explains that the CPI is used as the target because it is 'the measure that is monitored most closely by the public' and it may be difficult to justify a departure from this well-established tradition.

The second issue highlighted by the OECD analysis is that, given the standard error for inflation, the probability of a breach is minimised if the Reserve Bank continuously adjusts its policy instruments so that they always target the midpoint of the PTA band. Some commentators have argued that doing this in an uncertain environment imposes real costs on the economy, such as a higher variance in output, and so propose that the Reserve Bank should be given further flexibility (that is, a wider target band) in order to allow some modest degree of output stabilisation. Bryant, for example, argues that, while a single goal of price stability was probably desirable during the transition period from New Zealand's high inflation policies of the 1970s and early 1980s, 'the credibility advantages of complete abstinence are probably not so overwhelming as to justify keeping macroeconomic stabilisation locked up in the closet' (1996a:26). He further reports simulation analysis based on a simple macroeconomic model incorporating features of the New Zealand economy, which suggests that 'rules for monetary policy that permit output smoothing in addition to the primary goal of inflation avoidance can foster *marginally improved* economic performance' (1996b:33, emphasis added).

This criticism should not be overstated (and the sentence just quoted illustrates that Bryant was careful not to do so). Some significant supply-side shocks are already accommodated by monetary policy (the PTA caveats described above), while policies aimed at price stability will also promote output stabilisation in an environment of demand-side shocks. Further, s.12 of the Reserve Bank of New Zealand Act contains transparent provisions for the government to change the objective of monetary policy for up to twelve months at a time (renewable) which could be invoked to respond to any extraordinary event requiring discretionary stabilisation policy. There are, however, important scenarios where an exclusive focus on short-term price stability might also impose higher costs than a framework that provides some scope for output stabilisation. Consider the case where annual inflation is at

the midpoint of the target band, and the economy experiences a series of small adverse supply-side shocks not covered by the PTA caveats. Under these circumstances, a central bank concerned with output stability might decide to accommodate the shocks, or it might tolerate an easing in monetary conditions as output growth slows and unemployment rises. If, instead, the central bank is concerned solely with price stability, then it should take immediate action to offset the price rise — in order to minimise the probability of breaching the target band in the following period — even if this slows economic growth further.

This argument, of course, attacks the very core of the reform to the Reserve Bank of New Zealand Act in 1989, which stipulated price stability to be the sole statutory objective of monetary policy. Multiple policy targets would make the accountability of monetary policy-makers far less clear cut, and so would reduce the credibility of their commitment to price stability (Evans et al., 1996:1864-5). The Reserve Bank is also concerned that concessions in this direction would lead to a wider variance of inflation and so would reintroduce costs that the current framework is designed to avoid (Ebert, 1994). Thus, the Reserve Bank Governor has been at pains to emphasise that the Bank remains firmly committed to targeting the middle part of the PTA range (Brash, 1996b:3; 1997:5), so that the move to a three percentage point PTA band does not signal any intention to engage in output stabilisation.

To summarise: the broadening of the inflation target band does not represent a significant change in policy. It simply adjusts the upper point at which the Reserve Bank must justify its performance to the Minister of Finance, and is now more in line with reasonable expectations about the ability of the Bank to forecast and control inflation with the instruments at its disposal. More significant is the associated rise in the midpoint of the range, which means that the Bank is now 'aiming at' 1.5 per cent instead of 1.0 per cent (Brash, 1996b:3). It is universally recognised that the CPI underestimates over time both quality improvements in goods and services and the ability of consumers to substitute towards cheaper products in response to relative price changes; and it is therefore accepted that price stability is consistent with a small amount of inflation in the CPI. The policy in New Zealand used to be that the midpoint of the PTA target band should equal this measurement bias, which was assumed to be about 1 per cent (Dawe, 1990:32; Brash, 1996a:312). This is no longer the case. The New Zealand Government Statistician advises that the bias in the New Zealand CPI is certainly less than the bias in the United States CPI, recently estimated to be 1.1 per cent, and so is below the revised midpoint of the PTA target band.[3] For the first time since the 1989 reform, therefore, policy-makers are now willing to accept ongoing inflation above the bias in the CPI, and the reasons for this change need careful examination.

[3] I am grateful to an anonymous referee for this point, confirmed in Brash (1997:4).

The Midpoint of the Target Band

The debate about the optimal midpoint of the PTA target band centres on whether the monetary policies required to maintain strict price stability (after allowing for the CPI measurement bias) impose real costs on the economy that could be avoided by accepting a small amount of positive inflation. The position previously taken by the Reserve Bank (Archer, 1994) is the orthodox 'natural rate hypothesis' or 'quantity theory of money' that holds that monetary policy has no long-run impact on the levels of real output and employment, but monetary expansion beyond the economy's real growth rate is eventually reflected in equivalent increases in the price level only. This position has not gone entirely unchallenged in New Zealand; the late Jan Whitwell (1987, 1990, 1992), for example, consistently argued for non-monetary theories of inflation, while in Dalziel (1991, 1992, 1993) I argued that the process of monetary disinflation could have persistent real effects through hysteresis in the labour market and in the tradables sector. Nevertheless, the focus of the debate in New Zealand in recent years has tended to be not so much on the link between inflation and the *level* of output (an exception is NZIER, 1996:11), but on the link between inflation and long-term output *growth*.

Since New Zealand's experience with price stability is too short to allow econometric investigation of this link, the debate has been fuelled by international empirical studies. Stanley Fischer's address to the Bank of England's Tercentenary Symposium (reprinted as Fischer, 1996) has been particularly influential. Fischer cites his 1993 cross-country study to observe that 'the evidence points strongly to a predominantly *negative* longer-term relationship between growth and inflation' (Fischer, 1996:278, emphasis in original). Fischer's statistical evidence is unable to establish causality, but a plausible transmission mechanism is supported by his data, whereby higher inflation is associated with lower capital accumulation and lower productivity growth. More recently, however, another cross-country study by Michael Sarel comes to a different conclusion (Sarel, 1996:200):

> ... this paper explores the possibility of non-linear effects of inflation on economic growth, and finds evidence of a structural break in the function that relates growth rates to inflation. When inflation is low, it has no significant effect on economic growth; the effect may even be slightly positive. But when inflation is high, it has a powerful negative effect on growth. The structural break is estimated to occur where the average annual rate of inflation is 8 per cent. ... [This] suggests a specific target for policy: keep inflation below the structural break.

Sarel's results (see also the study by Akerlof et al., 1996) have rekindled the debate about whether policy-makers should be more relaxed about allowing a small rate of anticipated inflation to emerge in the economy. Arguments in favour of this rest on the general hypothesis that modern economies have a positive inflationary bias which can be contained only by restrictive monetary conditions that impose real costs. The mainstream theory advocated to explain this holds that workers ef-

fectively resist nominal wage cuts and uncompensated productivity increases, but are less able to prevent real wage cuts through higher consumer prices. Hence, it is argued, most relative price adjustments in the labour market take place through wage increases for workers in high demand rather than through wage cuts for workers in excess supply (see, for example, Krugman, 1996; empirical evidence in support of the downward nominal wage rigidity hypothesis in New Zealand has been presented by Cassino, 1995, and Chapple, 1996). This line of reasoning has been strongly resisted by the Reserve Bank (see, for example, Archer, 1994; Brash, 1996a, and *Monetary Policy Statement*, December 1996, pp. 5-7), partly by denying that workers resist uncompensated productivity growth when effective real wages must fall, and partly by arguing that the empirical evidence for downward nominal wage rigidity in the past was a result of high inflationary expectations under the old monetary policy framework. The Reserve Bank argues that costly nominal wage rigidities of this type will weaken over time, assisted in the New Zealand context by the Employment Contracts Act 1991, once people experience continuing price stability and learn to expect it to endure.

These arguments among monetary theorists have strong implications for the wider credibility debate. If, in the long run, monetary policy has no real economic effects, then a decision by a government to raise the target midpoint to allow a positive (albeit small) amount of ongoing inflation can mean only that the government is not as firmly committed to price stability as before. This sends a signal to markets that the Reserve Bank will not be under as much political pressure to produce price stability as before, and expectations may rise to the top end of the revised inflation target band (or even higher, if it is assumed that the Minister of Finance might use his or her discretion to excuse small breaches of the inflation band ceiling). This outcome would cause real costs if the Bank continued to target the midpoint of the band, since it would produce a positive gap between expected and actual inflation (as discussed in the introduction above). Consequently, the Governor in New Zealand has used public occasions since the new PTA to stress that despite the higher target, 'the Reserve Bank has not gone soft on inflation' (Brash, 1997:5; see also Brash, 1996b).

If, however, an economy does suffer a persistent inflationary bias, then price stability can be maintained only at the expense of real costs in certain sectors of the economy (the agriculture sector, for example, or the tradables manufacturing sector). In the New Zealand context, monetary policy is thought to be unfair because the Reserve Bank's response to inflationary pressure has its primary impact on the tradables sector (due to policy-induced appreciations of the exchange rate) when in recent years the primary source of the inflationary pressure has been in the non-tradable sector. The threat of political backlash against this outcome also undermines the credibility of the commitment to price stability, and so raises inflationary expectations. If the Bank remains focused on zero inflation under these circumstances, again a gap opens up between expected and actual inflation, with an associated decline in economic activity. To counter these effects, the Reserve Bank in August 1996 and December 1996 published two pamphlets, *The Impact of Mone-*

tary Policy on Farming and *The Impact of Monetary Policy on Exporters*, seeking to allay the concerns being raised in the agriculture and tradables sectors respectively.

These considerations have profoundly different implications for the optimal PTA band. If monetary policy has no persistent effects on output and employment, policy credibility would be enhanced if the bias-adjusted measure of price stability were made the midpoint of the PTA band. If, however, the economy suffers from a positive inflationary bias that cannot be reduced, then policy credibility would be enhanced if this bias was included in the framework of analysis used to set the midpoint of the target somewhere above the bias-adjusted measure of price stability. The New Zealand increase in the PTA midpoint from 1.0 to 1.5 per cent therefore represents an important shift in the attitude of policy-makers away from a strict reliance on the former hypothesis towards a cautious acceptance that the latter hypothesis may have some validity.

Conclusion

The revised inflation target in New Zealand's December 1996 PTA widens the target band for the underlying CPI inflation rate from two to three percentage points, and raises its midpoint from 1.0 to 1.5 per cent. In this article it is argued that the widening of the band represents only a technical adjustment to reflect the unavoidable uncertainties in monetary policy and inflation forecasting; in particular, the Reserve Bank has made it clear that it does not signal a move towards using monetary policy for any degree of short-term output stabilisation. It is also argued, however, that the increase in the target midpoint represents a significant change in attitude by policy-makers towards an acceptance that a small amount of fully anticipated inflation may not be harmful in a modern market economy. Hence, it is possible that the costs of achieving and maintaining strict price stability do not outweigh the benefits.

This last proposition, of course, remains controversial, and the debate surveyed in this article will continue. Nevertheless, it is noteworthy that in the five years after the first achievement of underlying inflation within New Zealand's former target band of 0-2 per cent (December 1991), the Reserve Bank did not produce underlying CPI inflation below 1.1 per cent in *any* of the following 20 quarters, and the average value (on a quarterly basis) was 1.7 per cent a year. Recently, underlying inflation was 2.0 per cent or higher in seven of the eight quarters of 1995 and 1996, and the Reserve Bank policy to correct this imposed significant burdens on New Zealand's agriculture and manufacturing sectors. This history inevitably weakened the credibility of 1.0 per cent as a midpoint for the target band, and the increase to 1.5 per cent is a cautious response by policy-makers to the problems this loss of credibility causes for monetary policy. The revised midpoint is still below that being targeted by the Reserve Bank of Australia (2.5 per cent) and the Bank of England ('2.5 per cent or less'). It will be interesting to discover whether it can be achieved by the Reserve Bank on average over the next business cycle or two without any further weakening of political support (a necessary condition for establishing the

credibility of this target), or whether future experience will create pressures for a further increase in the midpoint of the PTA target band.

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Making Fiscal Policy Flexibly Independent of Government

Nicholas Gruen

The art of good government is to constantly review practices to see where improvements can be made. The guiding principles should be to design systems that make it clear what the medium-term goals are, to choose goals that can be communicated easily to the public and accepted as being reasonable, and to ensure that the system is transparent so that people can judge whether policy changes are consistent with the goals. (Ian Macfarlane, Governor of the Reserve Bank Australia, 1996)

ECONOMIC reform consists not only of achieving desired economic outcomes but also of building economic institutions that systematically improve the chances that desired economic outcomes will be achieved in the future. Unfortunately, the first of these tasks often displaces the second. Yet institutional reform can have large and long-lasting benefits.

Institutional reform frequently involves distancing some area of economic activity from the day-to-day workings of government. The Industries Assistance Commission (IAC), established in 1974, is the paradigm example in Australia. While it remained a strictly advisory body, it exerted a strong influence on policy. Its rationale was that it offset the invidious incentives that governments faced: the few individuals who stood to benefit greatly from industry assistance were well organised and capable of exerting considerable political pressure, while the many who stood to lose were poorly organised politically and often unaware of their losses.

Other economic reforms have reflected a similar rationale. For example, the corporatisation of government business enterprises has distanced governments from day-to-day commercial decisions; and over the last two decades the Reserve Bank of Australia has built up respect for its independence and its much enhanced role in managing monetary policy. Would institutional reform likewise improve the management of fiscal policy? In this article a possible reform to the institutions of fiscal policy is outlined, which would help guard against fiscal irresponsibility at the same time as substantially improving the scope for fiscal policy to be used in the management of the economic cycle.

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The central problem is that fiscal expansion is generally more politically popular than contraction, which generates a bias towards expansion.[1] There are at least three ways (not all of them mutually exclusive) to constrain a government's control of fiscal policy: to develop institutions which maximise the transparency of fiscal policy; to distance government from the management of fiscal policy; and to establish and/or constitutionally entrench rules governing the conduct of fiscal policy. The first and third of these options have attracted most attention. Yet in the area of monetary policy the second approach has been most prominent: in several countries monetary authorities either control or heavily influence the management of monetary policy with some degree of independence from government.

Mandating Fiscal Transparency

New Zealand's Fiscal Responsibility Act and the Australian Charter of Budget Honesty take the first of the three courses set out above by mandating increased fiscal policy transparency. One important objective of the New Zealand legislation has been to use public transparency 'to tilt the balance of fiscal decision-making away from the short-term economic and political considerations that have been influential in the past and towards strategic and long-term fiscal objectives' (Scott, 1995:3). Likewise, Australia's National Commission of Audit (1996:278) suggested that a Charter of Budget Honesty would 'provide a useful counterbalance against spending pressures'. But, as Ruth Richardson, a former Minister of Finance in New Zealand, has conceded (1994:10), New Zealand's fiscal responsibility legislation 'places an onus on the government to be explicit about its fiscal strategy, but is neutral as to what that fiscal stance might be'. Within a few years of its implementation in the 1980s, the fiscal effects of former US President Reagan's policies were fully transparent, but had little apparent effect in constraining those policies.

Mandating Fiscal Rules

The third option — constraining government by means of certain established fiscal policy rules — is embodied in various proposals for balanced budget requirements to be established in legislation and/or entrenched constitutionally. But such a response may be worse than the disease, however serious. Such rules can be evaded: a government may be able to conform to the letter of such provisions while subverting their spirit by various accounting and regulatory practices (Keese, 1985:158). And even if legislated rules could be enforced, it is not clear that they should be. Rigid requirements to balance budgets are likely to exacerbate, perhaps gravely, the volatility of the business cycle. During a recession, policy-makers would not only be prevented from engineering discretionary fiscal expansion; they would be required actively to tighten fiscal policy to counteract the effect of the economy's automatic stabilisers. The case against rigid rules was well put by Blinder and Solow (1974:45):

[1] I concede below that this claim is something of a simplification, but it serves satisfactorily as a basis of discussion at this stage of the exposition.

> The best that can be said for rules is that some of them may be better than incompetently managed discretionary policy if that is the only kind of discretionary policy the nation can get. But ... the institutions that produce perverse discretionary policy might equally well produce perverse rules, and follow them only spasmodically.

Arrangements for Flexible Independence

The second of the three options listed above has received so little attention possibly because no mechanism is immediately evident which could deliver to fiscal policy the kind of flexible independence which characterises monetary policy institutions. For instance, having explained how the instruments of New Zealand's economic policy were being progressively removed from direct government control, Bollard (1994:12) comments, 'It is more difficult to envisage how fiscal policy could be carried out at arms length from government, given the exigencies of stabilisation and spending needs'. Scott (1995:15) is more emphatic:

> Fiscal decision making, in contrast [to monetary policy], goes to the very heart of a government's development strategy and political priorities, and cannot be delegated [to a central agency such as the Reserve Bank] in the same way. Only the implementation of detailed fiscal decisions can be delegated.

Yet one can envisage institutional mechanisms which distance the determination of the overall stance of fiscal policy from day-to-day government by analogy with modern economic institutions in areas such as industry assistance and monetary policy. To do so, an independent statutory agency would be necessary with expertise in fiscal policy: let us call it the Central Fiscal Authority (CFA). Equally necessary is an instrument with which the stance of fiscal policy can be changed quickly and simply. This is the rate at which taxes are levied. It would be possible to provide for arrangements such that tax rates specified in existing legislation could be made a function of a parameter, which we will call the 'taxation parameter'.[2]

To simplify for the sake of example, suppose that existing legislation sets corporate tax at a flat rate of 30 per cent, personal tax at the same rate subject to a tax-free threshold of $5,000, and wholesale taxes at a uniform rate of 20 per cent. To introduce the scheme being outlined here, legislation would be enacted which would specify that the effective tax rate to be charged would be the legislated rate *multiplied by the taxation parameter* which would initially be set at 1. As the new arrangements were introduced, it would become possible to vary the taxation parame-

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[2] The exposition here abstracts somewhat from the complications of federal government. The existence of State governments with their own fiscal positions would, if it were brought into the analysis, complicate exposition without adding a great deal. Of course, there might be some merit in applying the kind of arrangements mooted here at the State level, but it would not be necessary to do so for them to have a powerful effect when applied at the Commonwealth level.

ter away from its initial value with consequent effects on tax rates — and so, other things being equal, the stance of fiscal policy. Table 1 illustrates the effect of changes in the taxation parameter.

These rates could be changed within a pay period or so for PAYE and indirect tax. Tax which is paid less frequently, such as provisional and company tax, could be adjusted *pro rata* for any period during which there was a change in the taxation parameter. (*Pro-rata* changes in the taxation parameter would create some scope for tax avoidance, but because changes in the parameter are unlikely to produce changes in the tax rate of more than a percentage point or two, this effect is unlikely to be major.) There would also be compliance costs involved in establishing such a system; but it does not seem to me that they would be large.

Table 1: The taxation parameter and tax rates (%)

Taxation parameter	*Company tax rate*	*Income tax rate below threshold*	*Income tax rate above tax-free threshold*	*Sales tax rate*
1	30	0	30	20
.98	29.4	0	29.4	19.6
1.02	30.6	0	30.6	20.4

The setting of the fiscal parameter provides policy-makers with a mechanism for setting the stance of fiscal policy which is analogous to the setting of short-term interest rates. The extent to which the taxation parameter was set independently of government would then depend on the degree of control the CFA had over the parameter. The CFA could set the taxation parameter entirely independently of the government (presumably subject to performance goals set by government and/or the legislature). Alternatively, arrangements analogous to those under Sections 11(4) and (7) of the Reserve Bank Act could be made. Under such arrangements, the CFA could be free to set the parameter subject to some ultimate right of executive government to overrule it publicly with its own instructions.

Further, a narrow or a broad approach could be adopted in specifying the fiscal goals the CFA would be required to pursue. The CFA's task could be defined narrowly according to a fairly tightly defined rule or more broadly, according to a range of criteria. The first approach might see the CFA charged with the task of balancing the budget over the business cycle. The second approach could involve setting out a range of criteria for the CFA to consider, including for instance, the level of economic activity, the level of government net worth and the demands of intergenerational equity. To some extent, the choice between the two approaches mirrors the choice between rule-based and discretionary policy-making. The first option has more of the advantages of a rule, even though it allows for some discretion in the way the rule is satisfied. But it is also subject to some of the drawbacks of rules: for example, the rule involving budget balance over the cycle could allow a

government to manipulate fiscal accounts in a variety of ways even with accrual accounting (Robinson, 1996:425).

These arrangements would not confine changes in fiscal policy to tax changes through changes in the taxation parameter. As is now the case with monetary policy, governments and central agencies would consult closely in bringing about mutually desired outcomes (Fraser, 1993). Thus, if a government wished to change the stance of fiscal policy by action on outlays rather than taxes, or preferred this to changes in the taxation parameter that the CFA thought were otherwise appropriate, it would inform the authority of this and so obviate the need for any tax changes. The government might also wish, for political or economic reasons, to amend the stance of fiscal policy with changes to certain taxes and not others; it could do this also by ensuring proper coordination with the CFA.

Although the CFA has been envisaged here as a new, separate agency, it would be important for fiscal policy and monetary policy to be integrated. In this regard, its functions would be well suited to the Reserve Bank (with any appropriate augmentation of the Bank's areas of professional expertise).

Economic Consequences

In several respects, the advantages of distancing the stance of fiscal policy from day-to-day government are analogous to the advantages of distancing monetary policy from governments. Assuming that, in principle, discretionary changes in the stance of policy can beneficially dampen the volatility of the business cycle, removing control from day-to-day government would enable policy to be adjusted to emerging economic circumstances more *closely*, more *quickly*, and more *credibly*. These points may be taken in turn.

First, the stance of fiscal policy could be more closely aligned to emerging economic circumstances because the CFA would be far more insulated from day-to-day party political concerns than governments of the day. Changes in the stance of fiscal policy invariably have political implications; and; certainly in Australia; it is common practice for changes in the stance of fiscal policy to reflect the undesirable influence of the short-term political impact of such measures.

Second, changes in fiscal policy must often be negotiated through legislatures. Of the discretionary fiscal expansions implemented as a response to recession in post-war America, none was finally enacted before the recession they were intended to address had technically ended (Keech, 1995:161ff). Institutional arrangements in Australia provide the executive with somewhat greater fiscal autonomy than this, but tax changes and various changes in outlays continue to require ratification from parliament, which delays their implementation.

Currently, monetary policy is the principal means by which governments seek to moderate the excesses of the business cycle, at least in the short term, not because monetary policy is inherently superior as a counter-cyclical instrument, but because institutional arrangements prevent rapid changes of fiscal policy. Indeed, if changes to the stance of fiscal policy could be implemented rapidly, they would have important advantages over monetary policy: they can influence the economy

more quickly and in a less sector-specific way than monetary policy, which has very uneven effects concentrated in investment, capital-intensive consumption and traded-sector activity. Improving the timeliness of fiscal policy would thus make for more effective management of the business cycle. Fiscal policy could take substantial weight off monetary policy and broaden the base of counter-cyclical policy.

Third, as with monetary policy, greater policy independence could improve not only the policy settings chosen but also their effectiveness, by enhancing policy credibility. The cost of financing discretionary fiscal expansion would depend on the credibility of its officially temporary status. If lenders believe claims that fiscal expansion is temporary, they will be prepared to finance it at lower (interest) cost than if they expected expansion to be the prelude to higher government borrowing and indebtedness over the longer term. Greater credibility also enhances the speed with which policy changes can take effect as markets anticipate the effects of policy changes (Scott, 1995:7).

In this respect, the Australian monetary easings of August and November 1996 can be contrasted with the fiscal easing of February 1992. Other things being equal, an increase in short-term interest rates could be expected to *raise* long-term rates (by increasing the expected rate of growth and therefore inflation). Yet the monetary easings announced by the Reserve Bank in 1996 were greeted with *falls* in long-term rates: a sign of the market's confidence in the RBA's judgment that monetary easing was appropriate. Compare this with the nervousness of the money market about the modest fiscal expansion of February 1992. Certainly, other things being equal, a fiscal expansion could be expected to expand the government's call on borrowed funds and thus drive up bond rates; but had that expansion been sponsored by institutions at greater distance from party politics — institutions capable of reversing the expansion at a time they considered appropriate — the market is likely to have funded any given amount of fiscal expansion at lower interest cost than it did. Enhanced fiscal policy credibility would accordingly be likely to allow greater fiscal policy flexibility when it was needed.

Political Consequences

The arrangements discussed here would have some interesting and salutary effects on the politics of fiscal policy. The structure of the tax system — for example, the extent to which revenue came from taxes on individuals' incomes, companies' incomes and consumption; the extent to which revenue was forgone in various tax concessions, and so forth — would continue to be determined politically; politicians would be free to make whatever tax promises they wished to whomever they wished. But there would be important changes of emphasis. Under present monetary policy institutions, politicians routinely claim that their own party will deliver lower interest rates than their opponents. But they respect the institutions of independence by not promising that they will lower them directly under s.11 of the Reserve Bank Act, or that they will dismantle the institutions of monetary independence. This has a salutary effect: politicians who want to argue convincingly that interest rates will be lower under *them* must demonstrate that their policies would

create the economic circumstances which would permit an independent expert body to ease monetary policy.

Mutatis mutandis, something similar can be expected in the area of fiscal policy. An independent body setting the stance of fiscal policy would make it harder for politicians to promise a tax cut without explaining how it will be funded. The existence of the CFA would shift the focus of attention to the capacity of a party's policies to deliver economic circumstances capable of allowing the desired tax cut. A party seeking to 'sell' a tax cut to the voters must also persuade them that it will be possible without an equal and opposite movement in other taxes — courtesy of the CFA mandating changes in the taxation parameter.

The CFA would enable politicians to rely less on what might be called 'populist fiscal rectitude' to counterbalance fiscal profligacy. My earlier claim that there may be an expansionist bias in democratic policy making is something of a simplification. The texture of politics seems undoubtedly to be expansionist in its smaller details: individual spending increases and tax reductions are almost invariably welcomed by the polity, their opposites regretted. Yet, where deficits mount, electors become sympathetic to political promises which offer solutions to this problem. In the United States, the fiscal anxiety of the electorate is underscored by the politics of balanced budget amendments. In Australia, the electorates' anxieties about fiscal profligacy have been addressed with targets such as the Hawke Government's 'trilogy' of fiscal commitments in 1984-87, and several State governments' medium- and long-term debt reduction targets. Much of this is a healthy reflection of the electorate's economic common sense. Certainly it has been the Australian experience that re-election to government is not incompatible with substantial fiscal tightening.[3]

Nevertheless, the arrangements set out here might offer some protection against the excesses of populist fiscal rectitude. For example, generally speaking, decisions on whether infrastructure assets should be privately or publicly owned should be made on the grounds of microeconomic efficiency and/or the effect of such decisions on government net worth. However well-meaning it might be, a commitment to reducing debt which does not pay full regard to the assets such debt may help fund and/or the capacity of those assets to service that debt tends to bias decisions about the ownership of assets away from the most important considerations. As the Auditor General of New South Wales has commented concerning the funding of the M2 motorway between Lane Cove and the Hills district of Sydney:

> Here no public alternative to the private tollway was considered, because it was said the Treasury had no capacity to fund the motorway. This is decidedly odd reasoning. The private sector funded the road in

[3] For instance, the Hawke Government was returned in 1987 after substantial fiscal tightening in 1986; and the Kennett Government was returned with a large majority in Victoria in 1996 after similarly tightening fiscal policy.

> anticipation of the stream of income it would produce. The same funding options were open to the Government. (Harris, 1997)

A CFA would be in a position to reassure not just financial markets but also the public that the government was not sliding towards an unsustainable or unhealthy debt position and that steps would be taken to resist any move in that direction. It is to be hoped that, in such circumstances, decisions about the ownership of infrastructure assets could focus more fully on the fundamentals of economic efficiency.

It might be argued that the arrangements set out here are less democratic than existing arrangements. In one sense, this is clearly true. The tax *mix* and the *level* of outlays and the particular programs which are supported by government would all be determined as before. But the determination of the overall *stance* of fiscal policy would be less directly democratic, in the same way that monetary policy and indeed judicial decisions are determined at one remove from the government of the day. The philosophical justification for this is analogous to the justification for constraining democracy in areas such as monetary policy or judicial decision making: that in such areas direct democracy can prejudice the interests of those without a vote (the young and subsequent generations) by debasing the currency and/or lead to the oppression of minorities.

On the other hand, the people appointed to make these decisions are in their turn appointed by a democratically elected assembly. As Ian Macfarlane (1996), Governor of the Reserve Bank of Australia, recently observed with regard to monetary policy independence, 'what usually goes under the rubric of ... independence' could be just as sensibly seen as 'a discussion of the optimal degree of delegation, including the circumstances in which the delegation could be withdrawn'. Recent experience might lead some to argue that government should delegate the stance of fiscal policy to a greater degree than it does at present.

Potential Problems

Such an important institutional reform as the establishment of a CFA would not be without its problems. Two are considered here.

First, although politicians are frequently blamed for 'short termism' in economic policy, they are in fact responding to popular pressure. The extent to which it is politically prudent to distance policy decisions from government is inevitably a matter of judgment. As notionally independent bodies are increasingly relied on to make or influence politically sensitive decisions, pressures can mount to make such bodies more 'responsive' and 'accountable' to community wishes. Governments will be tempted to appoint people to the 'independent' body who are sympathetic to their political objectives.

Second, it is possible that, despite their isolation from day-to-day politics and their professional expertise (or perhaps in some cases because of it), the staff of the independent agency could make worse decisions than politicians. Politicians may sometimes have an expansionist bias stemming from the incentives they face; but it

is possible that the professional culture of the CFA could come to value fiscal conservatism too highly (see for example Krugman, 1996).

With these problems in mind the arrangements canvassed here are not offered as a panacea, largely for the same reasons that constitutionally entrenched fiscal rules should not be seen as a panacea. As the Australian Treasury (1995:3) has observed, 'responsibility, whether in fiscal policy or other matters, cannot be legislated into existence'. Rather than solving the dilemma which arises wherever politicians are tempted to buy short-term popularity by sacrificing longer-term prosperity, the arrangements set out here might help manage it by providing a new institutional structure through which that dilemma might be mediated.

Substantial tension could emerge between the CFA and the government of the day. In order to proceed cautiously, and with some of the potential problems enumerated above in mind, I would favour an arrangement whereby the government had the ultimate ability to overrule the CFA under provisions analogous to s.11 of the Reserve Bank Act. But experience in monetary policy has shown that, although they do not work miracles, such institutions can be a very useful influence on democratic policy making. Although the arrangements set out here cannot legislate responsibility into existence, they might help facilitate the development of a democratic culture of fiscal responsibility in the same way that similar arrangements have encouraged the emergence of a democratic culture of monetary responsibility over the last two decades.

Postscript: Lawrence Ball's Proposed 'Macroeconomic Policy Committee'

After submitting this article to *Agenda*, I became aware that Professor Lawrence Ball had made a similar proposal in a lecture he delivered in New Zealand in November 1996. Ball (1997) proposes a 'Macroeconomic Policy Committee' staffed with professionals who are independent of government. The committee would have power to direct the Reserve Bank on monetary policy and would control the stance of fiscal policy by making proportionate changes to tax rates.

The fact that such similar ideas were produced independently is a source of some reassurance as to their relevance. Nevertheless, it is worth exploring the differences between the two proposals. Ball's proposal stems from a desire to broaden the policy base of counter-cyclical policy by giving fiscal policy a larger role alongside monetary policy. My own proposal is more ambitious because, in addition to allowing fiscal policy to assume a greater role in managing the business cycle, it seeks to moderate the incentives which politicians face to sacrifice long-term prosperity for short-term political gain.

Ball suggests that the central agency have the power to change personal income taxes but not other taxes. Leaving indirect taxes out of the net seems sensible if the central purpose is to provide an instrument which can be deployed quickly to moderate inflationary pressures. (Increases in indirect tax will reduce demand but their first-round effect will be to raise prices and so exacerbate inflation.) However, it is not clear why Ball excludes company tax from the mechanism. My own intention in subjecting all major sources of taxation at a particular level of government to the

taxation parameter was to make any change in the stance of fiscal policy as broadly based as possible. This is likely to have some economic merit, for the broader the base of fiscal discretion is, the less impact there will be on particular tax rates for any given fiscal effect. This limits the excess burden of taxation during fiscal contraction. However, the central attraction of broadening the base of discretionary fiscal policy is the political one of spreading fiscal sacrifice or largesse as widely as possible throughout the community.[4]

Second, Professor Ball (1997:7) proposes that 'the only role of the Macroeconomic Policy Committee would be to vary taxes temporarily, with increases and decreases canceling over time'. Certainly it would be desirable if this occurred; but the extent to which the Committee was remaining true to this policy at any given time would always be somewhat unclear because judgments would have to be made about the likely duration of any particular upswing or downturn which the Committee was seeking to moderate. But, however much one might want the Macroeconomic Policy Committee's fiscal adjustments to be temporary and counterbalancing, it must be understood how powerful a constraint this could be. Professor Ball's discussion of the problem of fiscal policy focuses entirely on the difficulty of *timing* fiscal policy given current institutions. My own exposition argues that there are two current problems with existing institutions: one of timing and one of a secular expansionist bias. Imagine a situation in which a government expanded fiscal policy in a manner which the Macroeconomic Policy Committee considered irresponsible. This places the Committee in an invidious position. Any resort to fiscal policy tightening in such a situation is likely to place it in a difficult situation subsequently. For at some point after it tightens fiscal policy the Committee can expect to face a situation in which it must loosen fiscal policy and lower taxes in order to honour its charter to balance its fiscal policy corrections through the cycle. This seems unsatisfactory.

In not embracing the constraint Professor Ball proposes, I hope that my proposed arrangements can address both problems. That said, it would probably be a mistake to be too categorical. Arguably, my proposals make the CFA bite off more than it can reasonably be expected to chew: that any government prepared to expand fiscal policy for electoral advantage would have few qualms about subverting

[4] That said, there are some quite good arguments against including indirect taxes in the taxation parameter mechanism. First, governments could come under pressure to make adjustments to welfare benefits when the fiscal parameter produced an increase in indirect tax. Second, anticipated changes to indirect taxes can produce perverse results where changes in indirect tax rates are implemented for counter-cyclical reasons. Thus, if people suspected an indirect tax rise was imminent because of inflationary pressures, some would bring forward purchases, thus exacerbating those pressures. The opposite would happen when a tax cut was expected. Nevertheless, the changes to tax rates anticipated here will be small – of the order of one or two percentage points to tax rates at any one time – and so one might expect the forward-pull and back-pull of demand to be similarly modest. If these arguments were considered sufficient to exclude indirect taxation from the taxation parameter arrangements, it still seems both economically and politically worthwhile to make the net of fiscal discretion as wide as possible and so to include corporate as well as personal income taxation.

the CFA either by directing it (if it had the power to) or appointing sympathetic personnel to it (if it did not). If this argument were accepted, the CFA might find that its power as a countervailing force against fiscal expansion existed *de jure* but not *de facto.* So the two proposals may not be far apart.

Yet this conclusion seems to me too pessimistic, and also inconsistent with our experience of monetary policy management over the last two decades. There would have been many occasions when it might have been expected that the Australian government would use s.11 of the Reserve Bank Act to direct the Bank. In practice it never has. Nor has a Governor ever been appointed to the Bank who was a mere political servant of the government. These facts tip the balance, I believe, towards a more rather than less ambitious proposal. Judgments would no doubt differ, but the institutional arrangements I have proposed offer the advantages of those offered by Professor Ball at the same time as providing an institutional framework which could make a major contribution towards the development of a democratic culture of fiscal responsibility.

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Unbundling Australia's Utility Regulation

B. Stephen Labson

AUSTRALIA'S national competition policy reform, as first outlined in the 1993 Report of the Independent Committee of Inquiry into National Competition Policy (Hilmer et al., 1993), reflects an appreciation of the benefits to the community of extending pro-competitive policies to sectors of the economy that have previously been exempt from them. This approach, further developed and agreed to by the States, Territories and the Commonwealth in the Competition Principles Agreement (CPA) (COAG, 1994) has been a driving force in the structural reform of Australian utilities, which, until recently, have been predominantly state-owned statutory monopolies.

A key component of this reform has been the structural separation of the state's role as shareholder from its responsibility as regulator. Previously, matters of the community interest such as pricing, customer service standards, dispute resolution, environmental impact, and social obligations were addressed primarily by the utility itself (and indirectly through ministerial oversight). Now, they are increasingly being addressed within a rather more independent and transparent regulatory structure applied to both state-owned and privatised utilities.[1]

This new regulatory framework can be seen as an 'unbundling' of the state's authority to regulate utilities in the community interest. It is not, however, to be confused with outright deregulation.[2] Nevertheless, interest groups have voiced concern that these new regulatory structures will not be sufficiently robust to ensure that the broad range of community objectives are met. To address these concerns, a number of adjunct conditions, in the form of corporate objectives or conditions of licence, have been placed on utilities as a means of gaining support for corporatisation and/or privatisation. In the process, broad policy initiatives have often become intertwined with those conditions which are sensibly placed on an enterprise as a requisite of industry participation, such as environmental, health, safety and fair trading regulations. Not surprisingly, many of the benefits associated with regulatory separation have been forgone where rebundling has occurred.

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[1] For a comprehensive survey of utility restructuring in Australia, see King and Maddock (1996).

[2] Some aspects of New Zealand's system of 'light-handed' regulation comes closer to true deregulation. For a discussion of this approach, see Bollard and Pickford (1995).

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The Basis for Structural Separation of Utility Regulation

The structural separation of the state's role as shareholder and regulator is an integral part of the broader agenda of infrastructure reform. A key component of the reform agenda has been to put public and private businesses on an equal footing. This 'competitive neutrality', as described by Councillor Stuart Hohnen (1996:15),

> aims to promote a more neutral competitive environment where the private and public sectors are in competition, so that the same rules are applied to all enterprises regardless of their ownership. The principles are implemented by removing any competitive advantages and disadvantages which a government business enjoys over its private sector rivals by virtue of its ownership. Example of such advantages might include immunity from various taxes and charges and access to finance at concessional interest rates, while requirements to provide community service obligations may confer a competitive disadvantage.

The CPA characterises the objective of competitive neutrality as the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities. In addition to the features of operational restructuring, such as corporatisation of government business enterprises and application of tax-equivalent systems and debt guarantee fees, the CPA calls for regulation to be imposed on an equivalent basis to private sector competitors. Where competition is to be introduced into the sector, regulatory functions would be relocated away from the state-owned utilities which previously had primary responsibility for them.

In some circumstances, competition may not be feasible because of natural monopoly aspects of the provision of services. If this is the case, competitive neutrality is irrelevant by definition. However, it is becoming increasingly understood that the empirical basis for judging many components of utilities as natural monopolies is less than robust. Where statutory franchise has been unwound, competition has often flourished within sectors previously thought to be immune from competitive pressures (components of telecommunications and electricity supply provide examples) and also among related markets (competing energy markets, for example). The principles of competitive neutrality may, therefore, be relevant in sectors which have historically been seen as natural monopolies, and reasonable effort should be taken to *allow* for the development of competition whether it currently appears feasible or not. In addition, regulatory separation brings with it intrinsic benefits, particularly in sectors which are not open to competition. The potential for political interference and conflict of interest in the operations of the utility are reduced, and regulation of the industry becomes more transparent and open to public debate.

The Victorian experience of utility reform provides an example of how the community can benefit from the unbundling of regulation (as well as some examples of how the aims of competitive neutrality have become perverted, which is dis-

cussed later). Dieneka Walker (1997) describes the utility-consumer relationship prior to restructuring of the Victorian electricity supply industry as one in which information about prices and the terms and conditions of supply were scattered throughout many regulatory instruments. The State Electricity Corporation of Victoria was both service provider and regulator, with ministerial oversight taking place in a manner which was not particularly amenable to public scrutiny. As a result, information was not accessible, and consumer rights and obligations were poorly defined, difficult to identify and effectively unenforceable. Under the current regulatory structure, the Office of the Regulator-General is responsible for issues arising from the monopoly status of electricity supply to franchise customers. An important aspect of this has been the development of a Supply and Sale Code, which specifies the minimum standards under which a distribution business may supply electricity to a franchise customer. Matters which monopoly service providers are now required to define clearly include the quality, reliability and safety of supply; billing schedules; credit mechanisms; disconnection policies; and dispute resolution procedures. This same basic model of regulating against the abuse of monopoly power is rapidly becoming a standard feature of the regulatory landscape in the era of microeconomic reform. For example, New South Wales has an analogous body (the Independent Pricing and Regulatory Tribunal), and other States have in place, or are developing, similar arrangements for regulating utilities.

So What's the Problem?

With the implementation of the CPA and its consequent prescription for regulatory reform, it is fair to ask what is left to discuss. Unfortunately, in many cases the newly developing structure of utility regulation in Australia retains some of the less beneficial features of the previous regime. A few examples are provided to illustrate some of the drawbacks associated with the rebundling of regulation.

Corporate objectives. Consistent with national competition policy reforms, corporatisation of state-owned utilities establishes a framework which separates the utility's role as operator from the state's role as resource manager. However, in some cases, this separation has been impaired by embedding broader public policy objectives in the operational performance of the utility. While such objectives may indeed have the support of the community and be entirely appropriate policies to pursue in themselves, making them an objective of a business enterprise can lead only to confusion of purpose on the part of management, thereby diminishing the utility's performance and value to the community.

Sydney Water provides an example in which operational and social objectives have been rebundled under corporatisation of the state-owned utility. The Water Board (Corporatisation) Act 1994 specifies objectives of the utility related to operational efficiency, environment, and protection of public health. More specifically, Section 22(3) of the Act contains a rather prescriptive set of measures which the Corporation is to have regard for in implementing the principal objectives, including:

- the reduction of environmental impacts and discharges into or on to the air, water or land substances likely to cause harm to the environment;
- minimising its creation of waste by the use of appropriate technology, practices and procedures;
- reducing its use of energy, water and other materials and substances;
- re-using and recovering energy, water and other material and substances, used or discharged by it, by the use of appropriate technology, practices and procedures;
- reducing significantly, by 30 June 2000, the combined environmental impact of the per capita amount of energy and water used by the Corporation and other materials and substances discharged by the Corporation, compared with that impact in the year ending 30 June 1994.

Whatever the merit or feasibility of these particular objectives, it is clear that they provide a poor basis on which Sydney Water could be expected to maximise its performance and value to the community as customer or shareholder. It no doubt seems pedestrian to suggest that matters of public policy be addressed by those institutions normally charged with such responsibilities; but this obvious solution has been forgone in this case. More to the point, these types of broad community objectives could be much more efficiently dealt with by a whole-of-government initiative, and probably miss their mark when allocated to one particular enterprise. This is not to suggest that the enterprise should be exempt from standard conditions of industry participation, such as compliance with environmental licence conditions, public health, occupational safety and so on. It does draw the line, however, at moving beyond what the community *generally* expects from the commercial operation of an enterprise.[3]

Conditions of licence. A rather new feature of the regulatory landscape facing utilities has been the development of industry licence arrangements. Whereas utilities previously operated under statutory authority, they now are required to comply with explicit conditions of licence. The provision of these conditions, particularly where customer choice is absent, has been seen as a means by which to protect the consumer, monitor and maintain the integrity of the system and ensure that markets operate fairly.

In restructuring its electricity supply industry, New South Wales has taken a broader view of the role of operational licensing. Under the Electricity Supply Act

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[3] The CPA is rather ambivalent to this matter, in that it prescribes that government business enterprises are to be subject to the same set of regulations as the private sector (s.3(4)(b)(iii)), but does not require jurisdictions to remove regulations from the enterprise which it deems as 'appropriate' (s.4(7)).

1995, environmental conditions have been embedded in the operating licence of retail electricity suppliers, requiring them to develop strategies for reducing greenhouse gas emissions stemming from the generation of power supplied to their customers. But the problem of greenhouse gas emissions is not unique to the electricity supply industry, and, as such, is not well addressed within the narrow confines of a state-based retail licence arrangement. Strategies based on a broader array of policy instruments are likely to provide a more efficient means for meeting community objectives. As well, where different approaches to greenhouse gas reductions are implemented on an *ad hoc* basis across related or interconnected industries, they have the potential to distort competitive market signals, leading to poor outcomes in terms of allocative and productive efficiency.

An equally important issue arises with respect to the transparency of public policy. The costs of emission reduction programs brought about by licence conditions will be embedded, most probably invisibly, in customers' electricity bills, making it difficult for the community to determine whether it is getting value for money out of these measures. Where broad community objectives are addressed within the rather narrow scope of utility regulation, issues of public policy can become hidden within the arcane structure of that utility, affording little scope for open public debate.

Concessionary pricing policies. For a variety of reasons, utilities have served as a means of transferring income between groups through the provision of uniform tariff structures. Of course, the redistribution of income as mandated by the general public is entirely consistent with the principles of competition policy. However, as James Cox (1996) points out, the redistribution of income *through pricing policies* can be inefficient, as the distribution of benefits are not often well targeted. In addition, where pricing policies are based on cross-subsidy (as opposed to direct budget funding of concessions), transparency in the development of social policy is diminished, potentially leading to programs whose purpose is unclear or inconsistent with the objectives of the community. Within the context of structural reform of utilities, the process of corporatisation has forced State governments to reconsider their approach to uniform tariffs. For the most part, the poorly targeted and opaque pricing policies of the past have been retained.

A clear example may be found (perhaps ironically) in the Victorian electricity supply industry,[4] where a uniform tariff policy to residential customers has been embedded within its Tariff Order (Governor in Council, 1995) and proposed derogations to the National Electricity Code of Conduct (NGMC, 1996). Under this system, transmission and distribution charges (which are a significant proportion of total charges facing the consumer) have been artificially adjusted, such that rural prices will be held at roughly the same level as those in metropolitan areas. While

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[4] Victoria is by no means alone in perpetuating the non-transparent delivery of uniform tariffs. It does, however, provide an interesting example of public policy objectives being rebundled with operational aspects of the market within a newly privatised system.

the mechanism for perpetuating the uniform tariff is rather complex, the matter is essentially closed to public debate. This is unfortunate, since uniform tariffs would appear to be precisely the kind of pricing policy that Cox (1996) has shown to be an inefficient means of redistributing income. Uniform tariffs redistribute income on the basis of geography, which has little relation to the dispersion of wealth across the broad community. Where prices do not reflect costs, they distort electricity consumption choices and so undermine allocative efficiency. And productive efficiency is lessened where access to the network distorts technology choices: for example, remote area power generation (either fossil-fuel based or renewable) might be a cost-effective alternative to grid power, but forgone due to pricing distortions.

Concluding Remarks

Competition policy has taken an important step forward in guiding the restructuring of utilities across Australia. The structural separation of the state's roles as shareholder and regulator has facilitated competition in sectors previously immune from competitive pressures. This new competitive environment will provide the impetus for better operational performance by state-owned utilities, providing benefits to the public both as customers and as shareholder.

Issues pertaining to the operation of an industry should remain separated from the community's broader policy objectives, regardless of how laudable those objectives may be. Several considerations support this position. First, narrowly based industry mechanisms, such as pricing policies, licence conditions or corporate objectives, provide a poor basis for implementing broad policy measures, in that constraints will be placed across related sectors in a non-uniform manner. Where this is the case, competitive neutrality across these sectors is reduced, leading to a diminution of the benefits flowing from allocative efficiency.

As well, the productive efficiency of the utility can be diminished where the objectives of corporate activity are confused with regulatory constraints. For example, management is provided with a clear focus when shareholders demand that a corporation maximise returns, subject to its acting in a responsible manner by meeting general conditions of industry participation. It is far less clear what is expected when that corporation is required to maximise a set of social objectives as well. The ambiguity of this situation can easily lead management taking decisions which are deficient in both areas.

A final consideration is related to the transparency and effectiveness of public policy. Industry-specific instruments such as operational licences can provide an effective means by which to regulate aspects of an industry *unique to itself.* Matters more generic in nature, such as environmental protection, public health, and occupational safety are better dealt with in a whole-of-government context, which allows competing interests to enter into the debate and which is more amenable to public scrutiny. This demarcation in regulatory roles also offers a more effective means of addressing the community interest in that it provides a portfolio of public policy instruments. Simply put, addressing broad issues of community concern within the confines of utility regulation would seem to be a case of the tail wagging the dog.

Utilities — indeed, all business enterprises — should function within a commercial environment that is neither sheltered nor hindered by discriminatory regulations. This precept is not nearly as bold as *laissez faire*, or even measured deregulation. It is simply a rule to enhance productive and allocative efficiency in industries where it is accepted that broader community interests should be addressed within a regulatory framework. This position is neither novel nor controversial — nor is it often adhered to in practice.

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Can Credit Unions Survive in Australia?

Kevin Davis

CREDIT unions are specialist retail financial services firms offering loan and savings facilities, transactions services and financial advice.[1] Specifically, they are *cooperative* financial institutions owned by their member/customers who satisfy some *common bond* criterion of belonging to a particular community, industrial or geographic group. Depositing members and borrowing members alike hold non-transferable shares (of nominal amount) in the cooperative, which entitle each member to one vote and an unspecified share of the accumulated net wealth of the cooperative in the event of its being wound up. The shares are redeemable at par to any member who leaves the cooperative, regardless of the accumulated net wealth of the cooperative.

Credit unions' activities and organisational form yield competitive advantages and disadvantages influencing their growth and penetration of the financial system. In the 50 years since credit unions were introduced to Australia, total assets of the sector have gradually increased to $15 billion, and membership to 3.5m. However, in recent years the number of credit unions has declined significantly, from over 600 at the start of the 1980s to 285 in late 1996, as many smaller credit unions have found independent existence in the modern financial world too hard and merged with other credit unions. This raises the more general question of the likelihood of credit unions surviving in their present form in the current Australian environment. The Wallis Inquiry (1997) recommendations, if implemented, will partly determine the answer to this question, and a preliminary assessment of the impact of those recommendations on the future of credit unions is made in following sections.

The Theory of the Credit Cooperative

The stated objective of credit unions is generally to maximise (in some sense) the welfare of their members.[2] However, their cooperative structure creates a number of financial management problems. In cooperative institutions, owners are also customers, and there is no market in claims on the cooperative's accumulated net wealth. Profit generation and accumulation of net wealth involve the transfer of financial re-

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[1] Descriptions of their activities can be found in Davis (1985) and Crapp and Skully (1985).

[2] Deshmukh et al. (1982) and Smith et al. (1981) are among the papers which focus upon credit union objectives.

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sources from private ownership to collective ownership. Financial management decisions of the cooperative involve transfers between members (as depositors, lenders, and users of services provided) and transfers between private and collective ownership. Consequently, management decisions can affect membership composition, as individuals likely to be net beneficiaries from cross subsidisation and wealth transfers are attracted to join and those who are potential net losers tend to leave. However, restrictions on eligibility for membership arising from the 'common bond' requirement limit, to some degree, the operation of such 'clientele' effects.

In analysing cooperative financial management, it is necessary to understand the determinants of individual member preferences between private ownership and collective ownership of financial resources. Trying to identify a collective objective function to guide management decisions runs into similar problems of interpersonal comparisons and aggregation to those identified by studies of social welfare functions. Various studies have attempted to examine empirically whether management decisions favour borrower or depositor members (Patin & McNeil, 1991).

Further complications arise from the divorce between ownership and control and the consequent agency problems. On the one hand, the coincidence of owners and creditors (the depositor/members are the owners) eliminates the agency costs associated with debt and equity. With profit-oriented institutions, creditors/depositors are exposed to the possibility that owners will increase the riskiness of the institution's activities, since whereas the owners reap the entire benefits of favourable outcomes from risk-taking, creditors/depositors bear a significant part of the cost of unfavourable outcomes. This gives cooperatives a potential competitive advantage over profit-oriented institutions.[3] On the other hand, severe agency problems can arise in credit unions from the divergent objectives of management and owners. The one-member-one-vote rule limits the ability of members of a cooperative to generate concentrations of voting power, thereby increasing managers' job security and their ability to award themselves excessive remuneration. Nevertheless, in practice, as Rasmusen (1988) points out, this may help explain the emergence of mutual and cooperative financial institutions.[4] To the extent that managers of cooperatives are constrained in their ability to convert life-time above-normal remuneration into short-term gains, they have an incentive to minimise the risk of institutional failure and termination of their above-normal income stream.[5] Uninformed depositors may prefer mutuals or cooperatives to other finan-

[3] This potential advantage is, however, removed if other financial institutions, such as banks, can provide depositors with a guarantee of safety through deposit insurance schemes or (implicit or explicit) government guarantees, thereby removing the need for depositors to monitor the institution's activities.

[4] Mayers and Smith (1986), in a study of life insurance companies converting from stock to mutual form, suggest an alternative explanation based on the efficiency gains from lower owner-creditor agency costs outweighing increased management-owner agency costs.

[5] This argument suggests that an important feature of prudential regulation of cooperative institutions should be an emphasis upon limiting management's ability to undertake actions which involve short-term wealth transfers to itself. Provided that the rents are available to management only so long as the cooperative survives, management will have an incentive for risk-averse management.

cial institutions, since the coincidence of owners and depositors and the incentives faced by management reduce the likelihood of risk-increasing activities.

Agency issues also arise from the credit union's role as a lender. Here, relatively tight common bonds which constrain the range of eligible borrowers can serve to reduce the problems of information asymmetry and thus the costs of monitoring borrowers, as well as reducing the *ex ante* costs of assessing credit risk. These advantages may offset any cost disadvantages arising from cooperatives' small scale, although problems of risk concentration and liquidity fluctuations may become more important.

Kane and Hendershott (1994) note several features arising from the cooperative structure of credit unions which may create value in different ways from other financial institutions. They note that incentives for higher monitoring may be greater, for three reasons. First, volunteers and sponsors who contribute time and resources have incentives to monitor management, while common bonds may enhance information flows. Second, there has been greater bonding of credit union management and boards (reflecting the history of volunteer staff) by use of outside sureties than for other institutions, with providers of those sureties having strong incentives to monitor. Third, in the United States, the system of effective prepayment of deposit insurance premiums for credit unions provides incentives for individual credit unions to monitor other credit unions. Kane and Hendershott (1994) further note that common bond requirements limit the scope for managerial risk-taking by: limiting the range of products to those suitable for the membership base; inhibiting rapid growth by restricting the deposit base; and constraining the ability of management to 'buy' business by distributing surplus to particular customers, since political pressures will emerge to protect the stakes of other members.

Credit unions also tend to be relatively transparent institutions. Providers of funds can determine relatively easily the nature of the assets held and the risks involved, since those assets are primarily loans to members of the common bond. This transparency and commitment to investment in assets which are liabilities of other members of the relevant community, upon whom social pressures may exist to honour obligations, may also provide credit unions with an advantage *vis-à-vis* more opaque institutions.

Other alleged sources of credit unions' competitive advantage include 'privileged' taxation treatment (since in many countries they have not been subject to company tax); access to free or subsidised services from sponsoring companies or community members; and a 'cost of funds' advantage which arises because members do not demand a rate of return on accumulated surpluses equivalent to that demanded by providers of equity capital to a joint stock company (though Miles, 1994, argues that, unless management is willing to reduce the insurance value of reserves to existing depositors, there is no such competitive advantage).

Will these alleged advantages enable cooperative financial institutions to compete successfully with other forms of financial institutions?

Taxation of Credit Unions

Before 1995, credit unions in Australia were exempt from payment of company tax on profits (surplus) arising from business transacted with members. Since business with non-members comprised primarily the investment of liquid asset reserves in deposits and marketable securities, credit unions in effect paid no company tax. But since 1995, credit unions have become subject to company tax on their entire surplus (except those with a surplus below $50,000 a year), with a view to subjecting credit unions to the same tax treatment as other depository institutions. However, under the imputation tax system that has applied in Australia since 1987, company tax paid is, in essence, a prepayment of shareholder-level tax, provided that after-tax profits are paid out as dividends. (Such dividends are known as 'franked' dividends and carry tax credits which can be used by the shareholder to offset other tax liabilities.) The problem for credit unions is that they have no mechanism available to pay franked dividends. Unlike US credit unions, whose at-call funds are essentially share capital on which an *ex post* 'dividend' is declared at year's end, all funds raised by Australian credit unions (except for a nominal share amount from each member) take the form of deposits. Credit unions can distribute excess profits to members but only in the form of rebates of loan interest, which would not carry franking credits.

The impact of this can be seen with the aid of a simple example. Consider two institutions with identical balance sheets and interest rates; one is a cooperative and the other a joint stock company. For each, assets (A) of $100 are funded by deposits (D) of $90 and equity (accumulated surplus, E) of $10. If assets earn a return (r_a) of 12 per cent a year and the cost of deposits (r_d) is 6 per cent a year, interest income is $100 x 0.12 = $12, interest expense is $90 x 0.06 = $5.40, and (assuming for simplicity's sake that operating costs and so forth are zero) profits before company tax are thus $6.60. At a company tax rate (t_c) of 36 per cent, company tax payments are $6.60 x 0.36 = $2.376 and profits after tax are $6.60 – $2.376 = $4.224.

Assume owners of both institutions have a marginal personal tax rate (t_p) of 20 per cent. If profits after tax are fully distributed as (franked) dividends, the owners will have a grossed-up dividend income of $6.60 and a tax liability of $6.60 x 0.2 = $1.32. Since they have received tax credits of $2.376 (the amount of company tax paid) they will be able to use the remaining $1.056 of tax credits to offset other personal tax liabilities. Total tax paid arising from the institution's profit is thus $2.376 – $1.056 = $1.32. If the institution cannot distribute profits and associated franking credits, there is no use of those tax credits to offset other personal income tax liabilities of owners, and the total tax paid will be the amount of company tax paid, which is $2.376.

This example demonstrates that, if the personal tax rate of the owners is less than the company tax rate, the total tax bill will be lower for the intermediation undertaken by the organisation able to distribute dividends.[6] Thus, if credit union members are

[6] Algebraically, this can be seen by noting that profits after company tax are $P = (r_a - r_d D/A)A(1 - t_c)$ and that when these are paid out as franked dividends, the amount available to owners after personal tax payments is $P^* = (r_a - r_d D/A)A(1 - t_p)$. The government's total tax take is thus $T^* = (r_a - r_d D/A)At_p$. If

predominantly from lower-income groups (and so have marginal personal tax rates below the company tax rate), the inability of credit unions to pay dividends leads to a wastage of franking credits and a competitive bias against such organisations relative to a joint stock company with an equivalent group of owners.

Capital Requirements

Since 1992, Australian credit unions have been subject to risk-weighted capital adequacy requirements equivalent to those imposed on banks under the Basle Accord. This has a number of consequences for credit unions.

Growth constraints. Capital adequacy requirements imply that growth can occur only if the capital base also expands. This creates a particular problem for cooperatives, since the only significant source of additional capital is through operating surpluses (Amounts contributed by new members as share capital are of nominal amount only — $2 to $5 each typically — and do not constitute 'permanent' capital since they can be withdrawn when leaving the cooperative.) Rapid growth requires large surpluses, but to achieve large surpluses deposit rates must be set relatively low and loan rates relatively high — settings which are not conducive to attracting business and growing rapidly. In contrast, other financial institutions can grow rapidly if opportunities exist by attracting new capital from equity investors.[7]

Complications are also created for coping with growth opportunities. For example, a cooperative with sudden natural growth opportunities will need to achieve a higher return on investment to meet capital adequacy requirements. If, for example, growth opportunities exist because of growth in the common bond membership, existing members will bear the major burden (in the form of higher loan rates and lower deposit rates) of the higher return on investment required to permit the extension of services to new members.

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the profits cannot be distributed, the amount available to owners (as communal wealth of retained earnings) is $P = (r_a - r_d D/A)A(1 - t_c)$ and the government's total tax take is $T = (r_a - r_d D/A)At_c$.

[7] In fact, capital adequacy requirements imply a limit to the natural growth rate of credit cooperatives. Some idea of the implied limit on credit union growth rates can be gained from some simple calculations. The maximum growth rate for credit unions relying on internally generated capital to maintain a constant capital ratio is given by the ratio of profits to equity capital (known as the return on investment, ROI). An ROI of 12.5 per cent a year means that retained profits, and the resulting increase in equity capital, will amount to 12.5 per cent a year. If total assets were to grow faster than this, the capital ratio would fall. In practice, the maximum growth rate compatible with a constant capital ratio will depend on both the size of that capital ratio and the return on assets generated by the institution. For example, ROI can be rewritten as ROI = ROA (A/E) where ROA is return on total assets, A is total assets and E is equity. For credit unions ROA has typically averaged around 1 per cent a year. A capital requirement of 8 per cent is equivalent to a ratio of A/E = 12.5 (assuming all assets have a risk weighting of one). Combining, we obtain an implied value for ROI of .125 or an implied growth rate of total assets of 12.5 per cent a year. While the average risk weighting of credit union assets is less than one in practice, maintenance of a risk-weighted capital ratio of 10 per cent or more (as seems to be the tendency) means that this implied growth rate is probably not too far wide of the mark.

The Wallis Inquiry suggestion (1997:358) that 'restrictions on the classes of debt and equity that may be issued by DTIs, particularly by mutual institutions, should, as far as possible, be removed', while aimed at facilitating depositor protection, would increase the ability of credit unions to cope with such growth opportunities by raising external capital. An additional advantage of any such external fund raisings would lie in the introduction of a new class of stakeholders with strong incentives to monitor the management of the credit union.

The cost of credit union capital. 'Permanent' capital can be accumulated by credit unions only through retained surpluses from operating activities. Since members' transactions with the cooperative generate the operating profit, they bear the cost of creating such capital; but they receive ill-defined benefits.

Every dollar of surplus generated and retained by the credit union is a dollar 'lost' to individual members. They do gain something: the possibility that reserves may absorb losses while they remain members, and thus provide protection for their deposits. But the inability of members to access their contributions to the cooperative's capital if they leave the cooperative means that this benefit is bound to be worth less than the dollar given up. In effect, the cooperative is 'taxing' its current members, and the benefits will flow primarily to future members, who gain from the security implied by large accumulated surpluses generated before they joined.

One might argue that, luckily for credit union managers, most members do not recognise the extent of this tax. However, the cost is implicit in interest-rate spreads. Members will react to excessive taxation by taking their loan and deposit business elsewhere, so hastening the demise of credit unions. They might, if informed, support such a tax as part of their contribution to communal goals; but they should at least be made aware of the cost to them (and of general benefits to current and future members) of the credit union acquiring capital.

Wealth, protection and control. One consequence of capital adequacy requirements, then, is that credit unions are amassing a significant stock of wealth to which there are ill-defined ownership rights. This raises several important issues.

First, to whom does this wealth belong if the credit union is wound up or converted into an alternative form? The recent conversion of several building societies from mutual to transferable-share form has resulted in large transfers of members' wealth to those lucky enough to receive share allocations. Davis (1996) argues that the existence of accumulated surplus creates a potential conflict between older and younger members, since the former have incentives to vote for the wind-up or conversion of the cooperative in order to privatise the communal wealth, even if such actions destroy valuable social capital in the form of the cooperative enterprise. The argument is that the present value to older members of future benefits from credit union membership is lower than their potential share of communal wealth if the credit cooperative is wound up or converted to joint-stock form. But the one-person-one-vote rule common to credit unions works to inhibit such an outcome and so helps them survive.

Second, if capital adequacy regulation has the intended effect of making depositors less concerned about deposit safety, we can expect them to take even less interest in credit union affairs than they do currently. If concerned depositors do not monitor management; if the common bonds which may have kept managers' interests close to those of members are eroded; and if there is no share market discipline, what mechanisms will act to prompt efficient management? Probably none, unless the supervisory authority plays a role, or unless credit unions adapt in some way to improve oversight of management by members.

Weakening the Common Bonds

Common bonds have become restrictions on eligibility for credit union membership in name only, as criteria for membership have been relaxed significantly. This has a number of consequences for any natural advantages that credit unions may enjoy.

Credit unions with 'tight' common bonds may have significant information advantages. *Ex ante* risk assessment may be improved because of the greater information available about member characteristics. In addition, *ex post* monitoring of borrowers is enhanced because of the communal linkages. Finally, social arrangements within the common bond provide a form of 'bonding' mechanisms among borrowers, who will therefore be less willing to default on obligations to the cooperative and thus their fellow members.

Because of the relatively transparent nature of the organisation, providers of funds to credit cooperatives with tight common bonds can observe their funds being used in the form of loans to members of the communal group. But, as common bonds expand, the lack of correlation between fund providers and fund users reduces this advantage.

Credit unions are able to provide many services requiring large-scale activities because of cooperation between individual credit unions or as members of industry associations. Cooperation is aided by the absence of competition between credit unions whose common bonds do not overlap. But as common bonds are widened, and individuals become potential members of many credit unions, competition for business between credit unions may inhibit their willingness to cooperate.

Technology and Financial Innovation

The information revolution has had many effects on the financial services industry in the form of new products and new techniques. But it is also affecting some of the basic sources of the intellectual capital of financial institutions such as cooperatives.

First, financial intermediaries develop relationships with customers, who thereby gain valuable knowledge capital and so can make more informed lending decisions. But modern technology has made information data bases accessible by subscribers, so that a prior relationship with a potential borrower may now confer less information advantage. If the Wallis Inquiry recommendation 99 that 'a working party on positive credit reporting should be established' (1997:520) leads to the establishment of such positive credit databases, knowledge capital of individual institutions about credit risks

may become even less of an advantage.

Second, credit unions initially emerged as providers of small personal loans. Such loans involve high transactions and administration costs. Credit cards involving revolving credit facilities have eaten into this market and prompted credit unions to develop other loan products such as housing loans. However, the development of the mortgage securitisation market has further increased competition in this area.

Third, although not directly a result of technology, competition in financial services has led to an unbundling of financial products and a reduction in the extent of cross-subsidisation possible across customers and products. Credit unions have for many years engaged in cross-subsidisation — arguably, that is part of their *raison d'être* — as different members received benefits at different times but their long-term commitment to the credit union smoothed out the cross-subsidies over time. But as common bonds weaken; as customers become more mobile; and as competitors remove cross-subsidies, credit unions are exposed to 'cherry picking' by individuals who utilise the subsidised services only. Many observers have expressed concerns that credit unions are subject to a form of adverse selection as they attract 'expensive' customers shunned by the banks. This could result in a possible downgrading of the average quality of customer business and ultimately of services to all members, in turn prompting exit by more 'valuable' customers.

Asset Portfolio Restrictions

Common bonds restrict credit unions to particular individuals whose needs may be quite similar because of geographical, industrial or community factors. This makes possible cycles in liquidity due to demographic characteristics, as a result of which credit unions may be unable to meet the 'Prime Objects' requirement (namely, that loans to members must exceed a specified percentage, currently 60, of total assets) set down in Australian Financial Institutions Commission (AFIC) legislation.

That legislation should be amended, since it takes a product-based rather than a functional view of the role of the credit union. The economic functions of credit unions include originating and funding loans; but there is no reason why these functions need to be performed jointly, as implied by the legislation. Likewise, credit unions provide savings facilities; but there is no reason why they should be required to invest in a particular set of assets.

Regulatory Biases against Cooperatives

Regulation is biased against cooperatives in three main ways. First, credit unions in Australia are widely thought to enjoy a lower level of protection than banks and other institutions. Whereas the public assumes that bank depositors' funds are guaranteed, despite statements to the contrary by the Reserve Bank of Australia (RBA), that misconception does not apply to credit unions.

The Wallis Inquiry recommendation 36 that 'a single DTI licensing regime should be introduced' (1997:324) and the suggestion associated with recommendation 54 that 'the depositor preference mechanism that applied to banks should ... be ex-

tended to all regulated DTIs' (1997:358) could serve to place credit unions on a similar basis to other institutions in this regard. However, the suggested retention of a distinction between 'banks' and other DTIs leaves open the possibility that public perceptions of a difference in degree of protection may remain. While the Wallis Inquiry recommendations permit mutual organisations to become banks, the minimum capital requirement of $50m makes that an option only for very large credit unions.

A second possible source of bias arises from the fact that credit unions are supervised by AFIC and contribute to the costs of that supervisory body. Banks are supervised by the RBA and make no explicit contribution to the costs of that institution. They do, however, hold non-callable deposits with the RBA, which attract an interest rate five percentage points below the market rate of interest; this 'tax' on banks can be viewed as a form of contribution to supervisory costs. Bank representatives also claim that the Prime Asset Ratio requirement, requiring them to invest a proportion of assets in Commonwealth government debt, is also a 'tax', even though those assets are purchased at market rates of return, and the investment in low-risk assets would (in the absence of *de facto* guarantees) tend to lower the cost of capital for the banks.

The Wallis Inquiry recommendations to the effect that regulatory agencies should charge explicitly for the cost of their services rather than through implicit taxes such as sub-market interest rates on non-callable deposits would, if enacted, remove any existing imbalances.

Third, current AFIC legislation enshrines a 'Catch 22' barrier to the creation of new credit unions. Minimum capital requirements impose a minimum ratio of capital to risk-weighted assets, where the eligible capital can take the form only of, essentially, accumulated profits: an impossible requirement for newly established credit unions to meet. Ways around this barrier have been found, using sponsorship by already established credit unions. But the rationale for such a barrier must be questioned, and the Wallis Inquiry notes (1997:343) that, while minimum capital requirements on new entrants should be retained, a flexible and facilitative approach should be adopted by its proposed regulator the Australian Prudential Regulation Commission.

Sources of Optimism for Cooperatives

Yet although the credit unions' natural advantages have declined, other factors are working in the opposite direction.

One development of significance has been the Wallis Inquiry into the Australian financial system. As noted above, the recommendations of that inquiry hold promise for a levelling of the playing field in regard to public perceptions of safety of banks relative to other depository institutions, while the proposed rationalisation of prudential supervision could be expected to remove any regulatory imbalances. Recommendations advocating: direct participation in the payments system, the right to offer retirement savings accounts, the ability of mutual organisations to hold all classes of licences, and the possibility of access to exchange settlement accounts at the Reserve Bank, are among those holding out potential benefits for credit unions and enhancing survival.

Financial innovation also holds out the prospect of offsetting some of the disad-

vantages of credit unions, at least in principle. Securitisation makes it possible for institutions with a shortage of equity capital to provide loan origination and monitoring services, and thus to service a growing membership base demanding loans. It does not help, however, if the growth is occurring on the deposit side — although investing depositors' funds in liquid and low-risk-weighted assets can allow this demand to be met, provided the (in my view inappropriate) Prime Objects ratio requirement is not breached. New instruments such as credit derivatives also provide the opportunity for diversification of credit risk, allowing credit unions based in particular industries or geographical areas to reduce overall credit risk. In practice, the use of such new financial products is limited by the inability of management of small credit unions to understand them fully and by cost impediments to the creation of small-scale credit derivatives.

Electronic commerce also raises interesting possibilities for the future of credit unions. Provided access to the electronic networks is available, the ability of customers to access funds at locations remote from physical premises of the credit union reduces one of the potential disadvantages of small credit unions. This is an area in which the role of the Australian Competition and Consumer Commission is crucial in ensuring fairly priced access to common-use facilities such as the electronic network.

Clarifying Ownership Rights

Perhaps the greatest problem for credit unions is the inherent incompatibility of the accumulation of capital reserves with a cooperative institution. It seems unlikely that governments will back away from depositor protection based on capital requirements; and this raises the question of the suitability of the current organisational form of credit unions to the modern financial prudential-regulation framework. Continued growth of accumulated reserves may simply serve to increase the incentives for exploitative behaviour aimed at converting communal wealth into private wealth. Capital requirements, aimed at protecting depositors in credit unions, may paradoxically lead to the demise of credit unions.

It therefore seems appropriate for credit unions to endeavour to find a new institutional form consistent with the new environment. In some respects, the solution is straightforward. Since the main problem revolves around the lack of ownership rights attaching to accumulated surpluses, a form which provides such rights would make sense. For example, all members could be credited with a 'share account' to which their share of retained earnings for that year is credited. On leaving the credit union, members would, after some qualifying period, be able to withdraw the funds in the share account. Under such an arrangement, the credit cooperative would face fewer constraints in accumulating capital, would have a relatively stable (although not permanent) capital base, and would retain the cooperative principle as the basis of its activities. Another option is to issue an alternative form of 'semi-permanent' capital (perhaps some form of redeemable preference shares) which qualifies as 'second tier' capital for regulatory purposes, provides a means for distributing franking credits, and carries limited voting rights, thereby maintaining the cooperative nature of the institution. Naturally, providers of such capital would have strong incentives to monitor

management actions, thus enhancing the efficiency and safety of credit unions. Already, several Australian credit unions have raised second-tier capital of such a form.

It seems likely that further developments of this type will occur as the organisational form of credit unions continues to evolve to cope with the changing nature of the financial system. The Wallis Inquiry recommendations have widened the options for credit unions. However, by reducing some institutional impediments to competition (such as allowing for the possibility of commercial firms, like retailers and communications firms, to establish deposit-taking subsidiaries) they may have made the competitive pressures on credit unions even more severe. If that is so, a continuing decline in the number of credit unions could occur, as boards and managers of small credit unions decide that continued separate existence in such an environment is too hard and elect for the merger option. This could lead to a small number of large credit unions, adhering to the mutuality principal but losing most of the benefits which originally gave rise to the case for that organisational form.

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New Zealand's First MMP Election

Alan McRobie

IN a binding referendum held in 1993, a clear majority of New Zealand voters supported a proposal to replace the first-past-the-post (FPP) electoral system — used since 1853 — with the mixed-member-proportional (MMP) electoral system. MMP, which was closely modelled on the West German post-World War II electoral system and is often referred to as an 'additional member system' (Kaase, 1984:164), had been recommended by the Royal Commission on the Electoral System in 1986. The first MMP general election was held on 12 October 1996.

The Politics of Electoral Change

The path to electoral change, which centred for the most part on the notion of 'fair representation', was a response to three main factors. First, at the 1978 election Social Credit, a third party in New Zealand's mainly two-party system, won 16.1 per cent of the total votes cast but only 1.1 per cent of the parliamentary seats. Henceforth, with the notable exception of the 1987 election, a significant proportion of the total vote in each election was cast for parties other than the Labour and the National parties even though these two parties continued to win nearly all seats.

Second, the electorate became increasingly disenchanted after 1984 when both main parties, in turn, broke solemn commitments not to tamper with the basic infrastructure of New Zealand society (McRobie, 1991; 1992:404-11). According to the Heylen polls, the public's trust and confidence in parliament and its members plummeted from 32 per cent in 1975 to 4 per cent in 1992 (Heylen Research Centre, 1992).

Third, in both 1978 and 1981 Labour won more votes overall than National but failed to win office (James & McRobie, 1993:310). As a result, Labour promised that, once in power, it would establish a Royal Commission to examine the existing electoral system with a view to recommending change. The Commission was appointed in 1985 and presented its report to the Governor-General in December 1986.

The Commission's Report recommended that MMP should be adopted following extensive public debate, but only if a majority of voters approved the proposed change through a binding referendum to be held no later than the general election scheduled for 1990 (RCES, 1986: 64-5). Predictably, this radical proposal won virtually no support from sitting MPs, and it was not until the 1990 election approached that a bipartisan consensus emerged in favour of a referendum. The vic-

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torious National Party later abandoned its commitment to hold a binding referendum prior to the 1993 election, and instead adopted a two-stage referendum process. An indicative referendum held in September 1992 strongly endorsed both the option of changing the electoral system and MMP as the preferred alternative (McRobie, 1993:57). In the November 1993 binding referendum, the adoption of MMP was endorsed by 53.9 per cent of the votes cast (Boston et al., 1996:22–3).

The Structure of MMP

The Royal Commission proposed a fully proportional electoral system in which all qualifying parties would be represented in parliament in proportion to their overall electoral support. Parliament would have 120 members, 60 elected to represent single-member constituencies (electorates) and 60 from closed, national lists prepared by registered parties.[1] Electors would have two votes — one for a political party and the other for their constituency MP — but the party vote alone would determine each party's total seat entitlement. To secure parliamentary representation, a party would have to reach a threshold of 4 per cent of the party vote or at least one constituency seat. Separate Maori constituencies, a feature of New Zealand's FPP electoral system since 1867, would be abolished and all electors registered on a single roll (RCES, 1986: 65–70).

The 1993 Electoral Act broadly followed this structure, although politicians incorporated a number of changes, of which the most important was the retention of separate Maori representation. Maori campaigned successfully to retain separate Maori representation and to ensure that the number of Maori electorates should be calculated in the same way as the number of General seats. After MMP was adopted, five Maori constituencies were established, raising the total number of constituency seats to 65 and reducing the number of list seats to 55. The threshold was set at 5 per cent in order to make it even more difficult for smaller parties to win seats under MMP.

The Royal Commission's Case for the Adoption of MMP

Early in its deliberations the Royal Commission embraced ten criteria for evaluating the advantages and drawbacks of both FPP and a range of possible alternative electoral systems. While acknowledging that no electoral system was likely to fully meet all criteria, its goal was to identify an electoral system that provided 'the most satisfactory overall balance between them' (RCES, 1986:11).

Of the ten criteria adopted (RCES, 1986:11-12), three stand out. First was *fairness between political parties.* The Commission came to the view that modern elections were first and foremost about choosing between alternative party governments. Second, there should be *effective representation for significant minority and special interest groups* and that MPs should also reflect other significant socio-

[1] The Commission accepted that overall proportionality could be maintained if there were more than 60 constituency seats and, therefore, fewer list seats.

economic characteristics making up the electorate. Third, as the indigenous people, *Maori should be fairly and effectively represented*; the Commission concluded that FPP had not served Maori well because, for more than 40 years, the dedicated Maori seats had been totally dominated by one political party.[2] Although significant, the remaining seven criteria were less important (see p. 340 below).

The Royal Commission's emphasis on the central role of political parties in modern democracies led, inevitably, to a consideration of some form of proportional representation. After examining both the West German additional member system (the Commission itself coined the term 'mixed member proportional' to describe that system) and the variants of the Single Transferable Vote system (STV) used to elect Eire's Dail and the Australian Senate, it concluded that

> ... MMP is clearly superior. It is fairer to supporters of significant *political parties* and likely to provide more *effective representation* of Maori and other *minority and special interest groups*. It is likely to provide a more *effective Parliament* and also has advantages in terms of *voter participation* and *legitimacy*. (RCES, 1986:63; emphasis added)[3]

In the Commission's view, MMP fulfilled at least six of its ten criteria. It recognised the central significance of political parties, which electoral law had almost ignored under FFP. The abolition of separate Maori electorates and the introduction of a single common roll would enhance Maori representation because all MPs, not just those representing Maori electorates, would have to take account of Maori interests and concerns. MMP would also encourage parties to nominate lists which would enhance the representation of women and other groups that, historically, were under-represented under FPP. Finally, because the party vote would determine the final composition of parliament, nearly every vote cast would contribute positively to the result.

MMP in Practice: The 1993 and 1996 General Elections Compared

How does the experience of the first MMP election measure up against the expectations held for it?

Party representation. For 60 years New Zealand elections had consistently produced single-party governments, usually with significantly inflated parliamentary majorities. Between 1935 and 1993 the victorious party won an average of 58.1 per cent of the parliamentary seats with an average of 46.6 per cent of the total vote. By

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[2] Labour won all four Maori seats at every election between 1943 and 1990. National has had at least one, and on occasions up to three, MPs of Maori descent representing General electorates.

[3] In addition to MMP and STV, the Commission examined the Supplementary Member system (a system involving the allocation of Supplementary Seats), Approval Voting, Alternative (Preferential) Voting, and a range of alternative plurality systems such as At-large Voting, the Limited Vote, Single Non-transferable Vote, Cumulative Vote, and the Second Ballot (RCES, 1986:28–38.).

contrast, all parties other than Labour and National averaged 12.0 per cent of the total vote but won only 0.1 per cent of the seats. In 1993 Labour and National together won 69.8 per cent of votes cast but 96.0 per cent of the parliamentary seats.

In 1996 their share of parliamentary seats reflected their overall electoral support much more closely: 62.0 per cent of the party vote and 67.5 per cent of the seats. New Zealand First and the Alliance,[4] both of which had contested the 1993 election with only minimal parliamentary success to show for their electoral support, also won seats proportionate to their electoral support. So did two new parties, the Association of Consumers and Taxpayers (ACT) and United, each of which won a constituency seat. In United's case this was vitally important because it meant that the 5 per cent threshold was waived. The Christian Coalition, on the other hand, won 4.3 per cent of the party vote but failed to gain parliamentary representation because it did not win at least one electorate seat. By ensuring that parliamentary seats are allocated to parties in proportion to their overall electoral support, the substantial distortions between votes won and seats gained have been eliminated. Table 1 details the results from the 1993 and 1996 general elections.

Table 1: Results of the 1993 and 1996 general elections

	1993		*1996*				
					Number of seats		
	Votes won (%)	*Seats won*	*Party votes won (%)*	*Qualifying party's share (%)***	*Electorate*	*List*	*Total*
National	35.1	50 *(50.5%)*	33.8	36.6	30 *(46.2%)*	14 *(25.5%)*	44 *(36.7%)*
Labour	34.7	45 *(45.5%)*	28.2	30.5	26 *(40.0%)*	11 *(20.0%)*	37 *(30.8%)*
NZ First	8.4	2 *(2.0%)*	13.4	14.5	6 *(9.3%)*	11 *(20.0%)*	17 *(14.2%)*
Alliance	18.2	2 *(2.0%)*	10.1	10.9	1 *(1.5%)*	12 *(21.8%)*	13 *(10.8%)*
ACT	-	-	6.1	6.6	1 *(1.5%)*	7 *(12.7%)*	8 *(6.7%)*
United	-	-	0.9	1.0	1 *(1.5%)*	0	1 *(0.8%)*
Christian Coalition*	2.0	-	4.3	-			-
Others	1.7	-	3.2	-			-

*Christian Heritage Party in 1993. **After the 7.5% of party votes cast for parties failing to reach the 5% threshold.

Source: *AJHR* (1994, 1997).

Gender representation. Historically, New Zealand's parliament has been dominated by males; the Royal Commission noted (RCES, 1986:17) that:

> (W)hile the percentage of women in New Zealand's current Parliament compares favourably with many other nations, ... the Commission share(s)

[4] The Alliance, established in 1991, is a coalition of five parties: New Labour (formed in 1989 after its leader, Jim Anderton, broke with Labour), NZ Democrats (formerly Social Credit), Mana Motuhake (formed in 1981 after its first leader, Matiu Rata, broke with Labour), Liberals (formed in 1991 by two disaffected National MPs), and the Greens.

> the concerns expressed ... about the continued under-representation of women in our political system.

The first woman MP was elected in 1933; and it was not until 1993 that the proportion of female MPs exceeded 20 per cent. Further, until 1996 most women MPs belonged to the Labour Party; only once in the last four FPP elections did Labour not have more than half of all women MPs within its ranks.

The first MMP election brought about a significant increase in the number of female MPs: from 21.1 per cent in 1993 to 29.2 per cent following the 1996 election. Although still not proportionate to total population, it represents a substantial increase on any previous parliament. MMP has not only encouraged parties to nominate a greater proportion of women candidates but it has encouraged them to rank women candidates sufficiently high on their party lists for them to have a reasonable chance of being elected (Table 2). A recent study by the Inter-Parliamentary Union (*Sunday Star-Times*, 30 March 1997) ranks New Zealand sixth (behind the Scandinavian countries and the Netherlands) in terms of its proportion of women MPs. Further, the number of women MPs is now distributed much more evenly across all parties with more than one MP in the parliament (see Table 3).

Table 2: Percentage of female candidates nominated by parties, 1993 and 1996

	National	*Labour*	*NZ First*	*Alliance*	*ACT*	*United*	*Christian Coalition**	*All others*
1993	19.4	32.3	31.0	28.3	-	-	18.6	29.4
1996	24.4	35.7	24.6	35.4	19.1	20.7	20.8	26.7

*Christian Heritage in 1993.

Source: *AJHR* (1994, 1997).

Table 3: Female representation in the 1996 parliament, by party

	Number	*%*	*Number of MPs from electorates*	*list*
National	8	18.2	4	4
Labour	13	35.1	6	7
NZ First	4	23.5	0	4
Alliance	7	53.8	0	7
ACT	3	37.5	0	3

Source: *AJHR* (1997).

Ethnic representation. The ethnic composition of the first MMP parliament is also very much closer to the proportions that each group bears to the total population (Table 4). For the first time in New Zealand's history the parliament includes MPs of Maori, Pacific Island and Asian descent.

Table 4: Ethnic composition of the 1996 parliament

	Number of MPs	*%*	*% of population (1996 census)*
European	101	84.2	78.1
Maori	15	12.5	13.5
Pacific Island	3	2.5	4.6
Asian	1	0.8	3.8

Source: *AJHR* (1997).

In addition to the five Maori electorates created under MMP, most parties included Maori candidates near the top of their party lists. As a result, 15 MPs of Maori descent were elected in 1996: five to represent the separate Maori electorates, one to represent a General electorate, and nine from party lists. MMP has, therefore, resulted in a welcome spread of Maori parliamentary representation across a range of parties (Table 5). Henceforth, all parties are likely to pay much closer attention to Maori concerns: an outcome that the Royal Commission strove to achieve when recommending MMP as its preferred alternative to FPP. The same outcome can be expected for Pacific Islanders and Asians.

Table 5: Non-European ethnic composition of 1996 parliament, by party

	Maori				*Pacific Island*				*Asian*			
	N	*%*	*Elect. MPs*	*List MPs*	*N*	*%*	*Elect. MPs*	*List MPs*	*N*	*%*	*Elect. MPs*	*List MPs*
National	1	2.3	0	1	1	2.3	0	1	1	2.3	0	1
Labour	4	10.8	0	4	2	5.4	1	1	0	-	-	-
NZ First	7	41.2	6	1	0	-	-	-	0	-	-	-
Alliance	2	15.4	0	2	0	-	-	-	0	-	-	-
ACT	1	12.5	0	1	0	-	-	-	0	-	-	-

Source: *AJHR* (1997).

Age cohort representation. The first MMP election has resulted in a broader spread of age cohorts than did the last two FFP elections. The last three FPP parliaments were dominated by MPs in the 40-44 year age cohorts but in 1996 two cohort peaks — 40-44 and 50-54 — were evident. The peak age cohort for incumbent MPs was 40-44; for newly elected MPs it was 50-54. The largest male cohort was 40-44; the largest female cohort was 45-49, followed by 50-54. Female MPs are generally older than their male counterparts. Finally, there is a marked difference between the age distributions of electorate and list MPs. The number of electorate MPs rises steadily through each cohort until the 40-44 year age group, after which it declines steadily. For list MPs, however, the number rises through each successive cohort until 50-54 before it drops away. Contrary to most expectations, the first

MMP election has significantly broadened the age structure of parliament, at least temporarily.

Geographical representation. New Zealand's FPP electoral system required each electorate's total population to fall within a range of plus or minus 5 per cent of the overall mean. Although single-member electorates remain under MMP, fears were expressed (principally by opponents of change) of unbalanced geographic representation arising from a maldistribution of list MPs. Advocates of MMP responded that it was in the interests of all parties to ensure that their party lists were geographically balanced. This expectation made an already difficult exercise even more arduous. Parties were expected not only to produce lists that took full account of gender and ethnicity, but also to ensure that their lists were also geographically balanced, so that, regardless of the election result, all parts of the country were fairly represented.

Table 6 illustrates the geographic spread of MPs. At a superficial level the distribution of representation across the two islands seems as close to fair as could be expected. On closer examination, however, this table reveals imbalances: New Zealand First, ACT and National are over-represented in the North Island, while Labour and the Alliance are over-represented in the South Island. Even within each island, representation is not always evenly distributed: for example, all four South Island Alliance MPs live in the Greater Christchurch urban area, while Otago-Southland, with 8.3 per cent of New Zealand's population, has only 5 per cent of the MPs.

Table 6: Geographic composition of the 1996 parliament, by party

Party	*North Island Number of seats*			*South Island Number of seats*		
	Electorate	*List*	*Total (%)*	*Electorate*	*List*	*Total (%)*
National	23	11	*77.3*	7	3	*22.7*
Labour	18	8	*70.3*	8	3	*29.7*
NZ First	6	8	*82.4*	0	3	*17.6*
Alliance	0	9	*69.2*	1	3	*30.8*
ACT	1	6	*87.5*	0	1	*12.5*
United	1	0	*100.0*	0	0	*0.0*
Totals	49	42	*75.8*	16**	13	*24.2*
*Population**			*75.1*			*24.9*

*1996 Census. **Includes Te Tai Tonya electorate, part of which is in the North Island.
Sources: *AJHR* (1997); Statistics New Zealand (1997).

Such are the vagaries of MMP voting. The MMP electoral system is designed to compensate parties which do not win their fair share of seats through the constituency contests by awarding them sufficient list seats to ensure that their parlia-

mentary representation fairly reflects their overall electoral support. Since parties cannot predict precisely which electorates they will win, they are unable to order the candidates on their lists to guarantee that parliament will accurately reflect the geographic distribution of the population. When considered in this light, the geographic distribution of representation in the first MMP parliament is probably as good as can be expected.

Forming the Coalition Government

The election marked the end of the first stage in the transition to the MMP environment. Since, as expected, no one party won a clear majority of the parliamentary seats, a coalition government, or perhaps a single-party minority government, had to be negotiated. The formation of the new government took nine weeks and was not completed until shortly before Christmas. Given that this was the first real experience New Zealand politicians had had of coalition formation across parties, the time taken was not unreasonable. What made the process quite unusual was that New Zealand First (the third largest party) conducted negotiations separately but simultaneously with both National and Labour Parties. Never before in the democratic world have separate coalition negotiations taken place with two different parties at the same time.

The agreement, dated 10 December 1996, confirmed the formation of a majority coalition National-New Zealand First government whose objective was 'to provide sound and stable Government for New Zealand for a three year term concluding with the 1999 General Election ...' (Coalition Agreement, 1996:5). Although it expressly acknowledged that each party would retain its own identity and organisation, it prohibited either partner from supporting

> ... any policy advanced by any other non-Coalition party or private member and, if a bill is introduced to the House, shall not vote in favour of such bill or abstain upon the vote unless and until the consent in writing has been obtained by both Parties to the Coalition. (Coalition Agreement, 1996:7)

Despite the demise of FPP and the hope that MMP would result in more consensual government, the three-line whip appears still to be alive and well.

The agreement is also noteworthy in a number of other respects. Before the election, New Zealand First argued that the size of Cabinet should not exceed 15 (New Zealand First, 1996: Democracy Policy, 9) but the agreement provides for a total ministry of 26, of which 20 are inside Cabinet. National will have three-quarters of the Cabinet seats until October 1998, but then must surrender three places to New Zealand First. A similar arrangement applies to the six ministerial positions outside Cabinet.

The resolution of disputes between the coalition partners is also provided for. 'Fundamental disputes' are defined as those 'which could lead to substantial injury to the Coalition and which appear on reasonable grounds to be incapable of satisfactory long term resolution by negotiation'. If one occurs, a Coalition Dispute

Committee, consisting of the leaders, deputy leaders and presidents of the coalition partners will be required to seek a resolution through negotiation. If agreement cannot be reached, either party may give written notice to the other 'that unless the matter is resolved within ... seven days the Coalition will be terminated' (Coalition Agreement, 1996:10-11).

Evaluation

New Zealand's first MMP election substantially met its supporters' expectations. Although electorates are now larger in both population and geographic terms, the direct link between MP and elector has been preserved and, if early arrangements by parties to deploy list MPs in regions where they are not well represented continues, may well be enhanced. With more women, Maori and Pacific Island MPs, and the election of New Zealand's first Asian MP, parliamentary representation is now more broadly based. Since most votes cast counted towards the final composition of the House of Representatives — 92.5 per cent compared with 45.0 per cent in 1993 — voter participation was judged to be more effective, thus enhancing the legitimacy of the new government. MMP is clearly fairer to significant political parties, which now win seats in proportion to their overall electoral support. The first election eventually produced a coalition majority government; with the tacit support of ACT and the sole United MP, it appears to have a comfortable majority which should allow it to implement most of its agreed policies.

So far, there is little evidence one way or the other to indicate whether MMP will result in a softening of the economic and social policies pursued over the past decade. Although New Zealand First's election campaign emphasised fiscal responsibility combined with a more 'caring' approach to social concerns, the few policy decisions to date — for example, postal services deregulation and the sale of small hydroelectric power stations to private interests — suggest that National is still very much in control. Each party, however, acknowledges that it is dependent on the other to remain in power. Maintenance of the coalition in the longer term, then, will depend on a certain amount of give and take on both sides, and this may lead, ultimately, to some softening of policy objectives.

A surprisingly large percentage of electors — approximately 37 per cent[5] — gave their electorate vote to a candidate of a different party from the one that gained their crucial party vote. This may be no more than a reflection of electors endorsing a candidate's personal qualities regardless of their preferred party. But if this pattern becomes a permanent feature of the MMP environment, electorate MPs may become even more entrenched than ever. Electorates could thus become personal fiefdoms, returning popular or respected incumbents regardless of party affiliation for as long as they choose to stand. The ultimate effect could be that elec-

[5] This figure is approximately three times larger than the equivalent figure for Germany.

toral overhang[6] becomes a permanent feature of New Zealand's MMP electoral system.

At this stage it is difficult to assess whether MMP will result in greater political integration. With the emergence of a majority coalition government, the old FPP 'us' and 'them' divisions are still very much in evidence and the consensus model still seems far off. Decisions made in the secrecy of the Cabinet room can still be forced through the parliament. Perhaps more time, and the retirement of the politicians first elected under the FPP system, are needed before a more consensual, cross-party decision-making model can emerge. Nor is there any evidence as yet that political parties will be more vibrant, vital and effective than under FPP. Party memberships in the latter years of FPP were very low and declining, and the number of activists even smaller. Any reversal of this trend will depend very much on whether citizens conclude that, under MMP, political parties again provide them with the most appropriate avenue for the expression of political opinion.

There are also machinery issues to be considered. The geographic imbalance of representation noted above could be largely rectified if the allocation of list seats were determined regionally rather than through a single national list. While this would help ensure that all parts of the country were represented by both electorate and list MPs, it would tend to undermine the key element of MMP: that the key choice for electors is between competing nationwide parties (RCES, 1986:69). And even if regional lists were to be introduced, there is no guarantee that this would prevent the potential for imbalance created by the compensatory nature of MMP.

Still to be tested is the provision, which applies to constituency seats only, for a by-election to be held whenever an electorate MP resigns of dies. This has the potential to upset the party political balance determined by the previous general election, for the Electoral Act makes no provision for any consequential adjustment to be made to the distribution of list seats. It would be clearly more appropriate for the party which originally won the seat at the last election to nominate a replacement for the remainder of the parliamentary term. While this would undoubtedly be opposed by some electors on the grounds that *they* should be the ones to elect the new MP, it is a more appropriate solution because MMP is, first and foremost, a party electoral system. In marked contrast, any list seat vacancy is simply filled by the next available person on that party's list at the previous election.[7]

Taken overall, New Zealand's first experience with MMP met most expectations. Notwithstanding some poll findings, electors did understand the relative importance of the party vote and the electorate vote, and the final result was broadly

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6 The term 'overhang' (from the German *Überhangmandate*) refers to the situation where a party wins more constituency seats than the total number of seats it is entitled to overall. Where this occurs, the party retains all constituency seats won but does not share in the distribution of list seats.

7 This provision was activated unexpectedly soon after the 1996 election when Prime Minister Bolger appointed Jim Gerard, Deputy Speaker and a list MP in the new parliament, to the post of High Commissioner to Canada: a manoeuvre that helped him to fulfil the terms of the Coalition Agreement on the distribution of Cabinet seats between the governing parties.

consistent with the electorate's mood at the time of the election. What voters had not anticipated, however, was the lengthy delay in forming a government. What electors had not realised was that the transition to the MMP environment did not end with the October 1996 election; it is not likely to conclude until New Zealanders have assessed the performance of the present coalition government and passed their collective judgement at the next general election, presently scheduled for late 1999.

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First-past-the-post and the mixed-member-proportional electoral systems: a comparison of outcomes

Criterion	*FPP*	*MMP*
Fairness between political parties	**NO** — winning party over-represented at expense of all other parties.	**YES** — each qualifying party won seats in proportion to party vote share.
Effective representation for minorities and special interest groups	**NO** — women, and Pacific Island and Asian communities consistently under-represented.	**YES** — significant increase in number of women MPs; Pacific Island and Asian communities represented in broad proportion to numbers in 1996 parliament.
Effective Maori representation	**NO** — Maori consistently under-represented in terms of their total numbers.	**YES** — MPs of Maori descent broadly proportionate to total Maori population.
Political integration	**?** — adversarial system encouraged tendency for hardening of divisions between groups.	**?** — too early to tell whether MMP will be more integrative (early signs not promising).
Effective representation of constituents	**YES** — single-member electorates provided clearly identifiable representation for individuals.	**YES** — single-member electorates remain an integral part of the MMP electoral system.
Effective voter participation	**NO** — FPP led to large numbers of 'wasted' votes; especially in so-called 'safe' electorates.	**YES** — party vote determines composition of parliament — nearly all party votes contribute to final result.
Effective government	**YES** — FPP and single-party governments able to act swiftly and decisively when necessary.	**?** — coalition governments likely to be the norm; this likely to slow decision-making process.
Effective parliament	**NO** — under FPP the Executive was dominant — Cabinet generally got its way.	**Possibly** — since no party has an absolute majority, coalitions of support will need to be built up in parliament.
Effective parties	**Probably** — although only minute numbers of citizens belonged to parties and fewer still were active.	**Possibly** — depends on whether citizens believe that parties provide the most appropriate avenue for the expression of political opinion.
Legitimacy	**YES** — the result of FPP elections accepted as producing legitimate governments with right to govern.	**Probably** — some years must elapse before we can be sure that the electorate at large accepts results of MMP elections.

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REVIEW ARTICLES

Complexity and the Law: Richard Epstein's Profound Case for Simplicity

Suri Ratnapala

*Richard Epstein, **Simple Rules for a Complex World**, Harvard University Press, Cambridge, Mass., 1995*

ONCE upon a time, human societies were simple, consisting of a single family or a small group of families. Everyone knew everyone else, and hence also their needs, desires and habits. Technology was simple and so were the lifestyle and the law. As technology advanced, societies became larger, more prosperous and more complex. They grew to the point where most members of a society were strangers to one another, but remained associated through recognition of common rules. Until our own age, such rules remained relatively simple and few. In our age, the law has grown exponentially in volume, density and complexity.

The popular theory is that the complexity of the law is the natural consequence of the complexity of society: as society becomes larger and more technologically advanced, the old simple laws become inadequate. In *Simple Rules for a Complex World,* Richard Epstein, a professor of law at the University of Chicago, offers a powerful refutation of this theory.

Epstein's objection to the theory is not new. For example, F. A. Hayek argues in his seminal three-volume work, *Law Legislation and Liberty,* published in the 1970s, that the idea that complex orders can be sustained only by complex laws is a logical and empirical fallacy. He demonstrates that the very complexity of the modern 'Great Society' means that we cannot preserve it by directing its members, but only indirectly by enforcing and improving the abstract rules upon which spontaneous order rests (Hayek, 1973:50-1). But whereas Hayek theorises in the narrative and epistemological tradition of David Hume, Bernard Mandeville, Adam Ferguson and Adam Smith, Epstein builds his case with the analytical tools of contemporary law and economics. The result, however, is the same: a devastating critique of the key assumptions underlying the welfare state.

The significance of Epstein's book is enhanced by its timing. Its publication coincides with the emergence of a new interdisciplinary research program that investigates the nature of complexity and the laws of self-organisation, using mathe-

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matical and computer tools. Epstein's book does not appear to have been pollinated by this research program. However, for reasons discussed below, it has the potential to make an important contribution to the nascent discipline.[1]

Most of the time, people prefer the simple to the complex. Why then has the law become so complex? Epstein proffers both conceptual and practical reasons. In Chapter 2, he deals with two conceptual reasons: the misconceived quest for perfect justice, and the equally misguided notion that the type of complex regulation that is possible in small voluntary associations can be duplicated in large societies. In Chapter 7, Epstein discusses the major practical cause of legal complexity, namely, the politics of redistribution. Redistribution cannot be effected with simple laws because simple laws are necessarily highly abstract and hence cannot guarantee particular outcomes. Under the rule of contract there will always be winners and losers. If wealth is to be equalised, the relative economic positions of individuals need to be constantly adjusted; and provision for such adjustments is necessarily complex. Epstein substantiates these reasons throughout the book with telling examples.

The book is in three parts. In the first part, Epstein investigates the causes of legal complexity and explodes the myth that the technological sophistication of society leads inevitably to complex rules. He draws attention to one remarkable but almost universally ignored fact of history: the last great technological revolution — the 19th-century industrial revolution — was accompanied by a simplification of legal rules (pp. 23-4). In the second part, Epstein identifies his basic rules concerning autonomy and property, contract, tort, necessity, and compensation for coercive deprivation of property. In the third part, he demonstrates how these simple rules produce more efficient results than complex legislation in areas such as the labour market, professional and product liability, corporate governance and environmental protection (where legislative interventionism is at its peak).

The Paradox of Complexity and the Futile Quest for Perfect Justice

Epstein argues that perfect justice is unachievable and the pursuit of it does great harm. Justice, like everything else, is subject to the law of diminishing returns. Initial improvements, such as the observance the rules of natural justice (rules promoting fair hearings and impartiality of adjudicators), lead to major gains. However, perfect justice requires rooting out every error in the individual case. Simple rules cannot achieve this end, for they are necessarily general. They will work only 90-95 per cent of the time. The effort to clean up the last 5 per cent of cases unravels the legal system in so far as it governs the other 95 per cent, since the complexity required to cater to the individual case will generate greater opportunity for deceit. Complex laws score high on aspiration but low on achievement.

Epstein offers many examples to expose the folly of perfectionism. The clearest concerns the simple rule which requires real-estate contracts to be in writing.

[1] At present, its leading edge is represented by researchers at the Santa Fe Institute, New Mexico, who include the Nobel Prize-winning physicist Murray Gell-Mann (1995) and Stuart Kauffman (1995).

The absence of writing will defeat some legitimate expectations based on oral agreement. But, if oral agreements were enforced, intolerable uncertainty would be created concerning alleged conversations: 'the great engine of cross-examination cannot keep pace with a prepackaged lie' (p. 39). The requirement that real-estate contracts be written does not achieve perfect justice, but it advances the security of the vast majority of routine real-estate transactions.

The power of Epstein's argument for simplicity lies in its own simplicity. Yet, as Hayek demonstrated, there is a more fundamental reason why, in a dynamic order of actions, only certain expectations can be protected. It is only by systematically disappointing some expectations that we can maximise the number of expectations that will be fulfilled (Hayek, 1973:102-3). A society which protected all expectations of all persons would be completely static and non-adaptive. No person would be allowed to respond to a change in her circumstances, since this would be bound to defeat the expectations of some others. I would not be able to change my greengrocer, hairdresser or newsagent because they all rely to some extent on my business. Likewise, these traders would not be allowed to adjust the prices of their goods and services because that would defeat my expectations. Applied universally, this policy would soon bring society to a standstill. Thus, perfect justice is not a real-world option. In an adaptive social order, the law selects those expectations which are to be protected. Since it cannot cater to all concrete situations without impairing the ability of the community to adapt, the laws of a complex order are necessarily abstract and hence simple.

Epstein adopts Peter Schuck's (1992:3) definition of legal complexity with an important additional element. Schuck proposes the qualities of density, technicality, differentiation and indeterminacy as the variables which measure legal complexity. Epstein points out that this test of complexity leaves out the most significant indicator, namely, the cost of compliance. He concludes: 'The fewer and the more accessible the inputs needed to make any legal decision, the simpler the legal system and, all other things being equal, the better its operation' (p. 29).

Epstein's thesis receives support from an unexpected quarter, namely, scientists investigating physical complexity. They are discovering that complex systems in nature function with simple rules. Complexity is not chaos, for in a chaotic situation there is no system at all. Since we are talking about adaptive communities of living beings, complexity in a living system must be a state in between chaos and fixity. Stuart Kauffman (1995:90) thinks that complexity occurs at the 'edge of chaos'. Complex living systems also display the capacity to coordinate complex behaviour of distant elements: that is, to maintain stability while allowing flexible and unpredictable behaviour on the part of its elements. This is what Kauffman (1995) means by complexity. In a simple system such as a family, coordination is easy as all the members know one another and are aware of one another's needs, aspirations, abilities and so forth. Each can reasonably predict the others' behaviour. In contrast, most members of large societies are mutual strangers who cannot predict one another's behaviour except in the most general terms. Yet society can coordinate the activities of these millions of strangers. The actions of thousands of indi-

viduals working in production, transportation, wholesaling and retailing are coordinated with my own action when I buy a cake of soap at the supermarket. This coordination is achieved by a very simple rule of law which requires parties to voluntary agreements to honour them.

It is a startling paradox that complexity is made possible by the simplicity of laws. If there is no law at all, my prospects of buying a cake of soap at the supermarket, or indeed the prospects of the supermarket existing, would be zero. But if the law were complex and dictated the behaviour of each person in great detail, the capacity of the system to utilise each individual's knowledge about his or her own circumstances and wishes would diminish, along with the system's capacity to coordinate the actions of countless strangers. Such a system would be less, not more, complex. This is a point which Hayek first made in *Rules and Order* (1973:49). More than two decades on, scientists investigating complexity and the laws of self-organisation are coming to similar conclusions on experimental data.[2]

Of course, it is not physically possible for the governments to regulate in detail all aspects of social and economic life. Instead, they control particular aspects and interfere continually in private transactions to produce specific outcomes. Even this kind of intervention seriously dislocates a complex order. As Hayek (1973:51) pointed out, 'the reason why such isolated commands requiring specific actions by members of the spontaneous order can never improve but must disrupt that order is that they will refer to a part of a system of interdependent actions determined by information and guided by purposes known only to the several acting persons but not to the directing authority'.

The Family of Humanity and the Communitarian Fallacy

When John Donne wrote the immortal words 'any mans *death diminishes* me, because I am involved with *Mankinde*; And therefore never send to know for whom the *bell tolls; It tolls for* thee', he captured an essential attribute of what it is to be human. *Homo sapiens* is a social (as opposed to a solitary) species which survived, and now thrives, through cooperation. No thinker of any ideological persuasion will seriously question this proposition; the differences among ideologies concern how this cooperation is achieved. Classical liberalism holds that human beings can collaborate most effectively under a regime of abstract impersonal laws securing domains of individual autonomy. Anti-liberal ideologies maintain that governments and legislators have a positive role in determining and enforcing the shape and detail of cooperation. Epstein detects, behind this drive for complex regulation, the error of attempting to transpose on to the Great Society the type of regulation that occurs in small groups such as the family and voluntary associations. Hayek (1976:88) made a similar point when he speculated that the intuitive extension of the model of intimate personal arrangements to the Great Society is dictated by atavistic instincts inherited from our tribal past when most members of the group

[2] See, for example, the experiments using lattices with light bulbs governed by Boolean functions described by Kauffman (1995:86-92). See also Pearce (1994:102).

knew one another. Epstein argues that a current source of the misconception is the success of the family unit.

The family contains complex arrangements concerning when, how and by whom the necessary activities are to be accomplished. Behaviour is adjusted to achieve harmony and the success of the group. The Great Society, in contrast, is characterised by the impersonal relationships that hold among strangers. One option for law makers is to develop a complex set of substantial obligations which mirrors the family arrangements: the social analogue of who washes the dishes and who pays the bills. The trouble is that the administrative cost of gathering the relevant information and of enforcing substantial obligations far exceeds the benefits that are gained through this process. Yet this is precisely the option that has been pursued, in a piecemeal way, by the welfare state.

The idea of humanity as a family found its way into 20th-century politics through socialism. As socialism has retreated in recent times, the idea has re-emerged in the shape of modern communitarianism. Communitarians, unlike socialists, do not demand material equality; indeed, many communitarians are conservatives. They support strong interventionist government to prevent what they see as the breakdown of traditional society through free markets and excessive individualism. They think that the ethic of care and concern for fellow humans must be maintained through coercion if necessary. Communitarians often argue that individuals owe part of their success to the collectivity. How can Michael Jordan earn $50m each year by playing basketball if society did not set up the game of basketball? Epstein provides simple answers to this question. The game of basketball was not created by society but by individuals freely associating to play a game they liked. Not everyone likes basketball, but those who do pay for the entertainment they get from Jordan. Each fan contributes a small amount towards Jordan's income but receives from Jordan much greater value.

There is no question that individuals for the most part are better off in social conditions than in solitary conditions. From the evolutionary viewpoint, the social form of existence is naturally selected as it confers great advantages on the socialising species.[3] There is such a thing as general welfare. But, as Hayek (1976:2) pointed out, in a society which allows individuals to make use of their knowledge for their own purposes, the general welfare can never be the sum of all the private interests, for the simple reason that these purposes, or the circumstances determining them, cannot be known to government or anyone else. Hence, in a free society, government can promote the general welfare only by helping to maintain simple rules which enable individuals to interact for mutual advantage and by providing the

[3] This is not to subscribe to a theory of group selection which holds that entire communities survive or perish according to their fit with the environment. This might have been the case in the distant past where certain communities were totally isolated. However, this is improbable in today's world where cultures impose upon and borrow from each other. There is too much cross-fertilisation for particular communities to die off. Instead, particular cultural practices or institutions are eliminated while others survive as they appear to confer advantages on those who espouse them. Thus, although group selection is unlikely, social structures themselves continue to be fashioned by selection pressures.

narrow range of public goods demanded by most members, but which cannot be provided through private treaty. Reallocation of wealth from one group to another achieves no more than redistribution from one group to another: it does not promote the general welfare.

Epstein presents his most telling argument against communitarian coercion when he points out that it is destructive of community. No one can quarrel with the call for a more concerned and caring community. The objection is to the *coercion* of individuals to care for other members of society who are essentially strangers. The intervention of the state to re-order personal relationships disrupts the true communitarian institutions which are products of voluntary cooperation. The intrusion of the state inhibits the spread of these voluntary associations. Epstein points out that 'communities can be destroyed from without, but they cannot be created from without; they must be built from within' (p. 324).

Epstein identifies the politics of redistribution as the major practical cause of legal complexity. Politicians do not like to make budgetary transfers because that exposes the fact that they are taking from some people to pay others. So they often resort to invisible transfers by regulating the behaviour of some groups to benefit others. Instead of making transparent payments, governments impose mandates on employers, landlords, and traders to provide benefits.

Seven Simple Rules

According to H. L. A. Hart, a developed legal system comprises two types of rules: primary rules of obligation, which form the basic rules of conduct of any society, and secondary rules, which determine how primary rules are conclusively ascertained, introduced, eliminated, varied, and the fact of their violation conclusively determined (Hart, 1994:94). Secondary rules define the powers and procedures of the authorities which declare and enforce the law (courts and other officials) and which make and unmake law (legislatures). They are, broadly speaking, constitutional rules. Epstein's book is about primary rules of obligation. Insofar as it touches secondary rules, it seeks to persuade legislators and judges of the virtue of keeping primary rules simple. However, I argue later that the solution to the problem of complex laws which Epstein expounds lies ultimately in the reform of secondary rules.

Epstein argues that all societies display four basic rules. The first rule recognises self ownership: a degree of personal integrity and autonomy, including the ownership of one's labour. The second recognises personal property. The third sanctifies and enforces solemnly made voluntary agreements (contract). The fourth outlaws the causing of harm to person and property (tort). The specific content of these rules differs from community to community, but it is hard to imagine a functioning society which does not minimally recognise them.

According to Epstein, these four rules will take care of the coordination needs of a society most of the time. There is no society where all members are equally endowed with abilities and property. But simple rules which secure to individuals their labour and property and allow them to deal with one another freely for their

own purposes are likely to produce better solutions to social problems than the complex redistributive mechanisms of the welfare state.

It is said that a system of simple rules which allows individuals to resolve their problems through private arrangements will lead to the systematic exploitation of the poor by the rich. This is an understandable intuitive objection, but Epstein believes that it does not stand up to economic analysis. The 'exploitation argument' equates market power with wealth. But market power has more to do with the absence of competition on the relevant side of the market. In fact, wealth can be a disadvantage in the bargaining process. Experienced tourists know that street vendors in developing countries often have two prices: one for tourists bearing hard currency and the other for locals. Similarly, an employee who knows that her employer's business is booming is likely to demand a bigger pay rise. On the other side of the ledger, even where a negotiating party has a short-term bargaining advantage, the market places limits on the extent to which it can be used in the longer term. Workers who are paid too little leave for other employment and workers who demand too much make themselves redundant as the employers scale down their operations or make them more capital intensive. Governments should be looking to remove barriers to the entry of rivals instead of increasing regulatory burdens which reduce competition.

Take and Pay

The four basic rules work where there are multiple actors on both the demand and the supply sides of the market. However, in some situations the market process fails for want of multiple actors. Epstein therefore acknowledges the need for three further simple rules which derogate from the first four. These deal with situations of private necessity, the acquisition of private property for public purposes, and taxation to provide genuine public goods.

Epstein gives a number of graphic examples of private necessity. The most explicit is the case of the dying man in the desert who meets someone with a bottle of water who demands the man's entire wealth in return for the life-saving drink. Another situation is where a sculptor mistakenly uses someone else's block of wood to make a statue. Yet another is where a marriage breaks down and the spouses try to hold out against each other for the best divorce settlement. In all of these situations, the four basic rules will not produce happy outcomes.

The common law tended towards a simple rule in such cases. It gave judgment in favour of the party who valued the object more, subject to that party paying compensation to the other. But how is compensation assessed in the absence of a real market? The simple rule favours awarding to the person parting with something its subjective value to that person. In the case of the drink and the piece of wood, that value would generally be indicated by what the owner paid for it. In the case of divorce, the simple rule will favour divorce on demand subject to alimony and support. The principle is: 'take and pay'. Epstein applies this principle to cases of public necessity. The resources which the state needs for public purposes can usually be procured at the marketplace. However, when the state needs a particular

asset such as a specific piece of land to build a bridge or a road, the only just solution is to take it and pay for it. What is important here is that the compensation for takings be just, as is required by the federal constitutions of the United States and Australia. Determining what is a just payment is often difficult, as the very intention of the state to build a road or carry out public work can greatly affect the market value of the property to be acquired. The common legislative response to this problem is to estimate the market value of the property immediately before the announcement of the state's intent. This is an imperfect solution but is the closest one can get to a just outcome.

The take-and-pay principle provides Epstein the basis for his brilliant argument for the simplicity of a flat tax as against the complexity of progressive taxation. The most common way in which the state takes is through taxation. When the state taxes from the citizen, it does not take her land or chattels but her money. The state pays for this kind of taking by the reverse process of providing the citizen with goods. There are certain goods which are universally desired but which cannot be provided on a user-pays basis owing to the enormous coordination problems involved, of which the most obvious is that of the free rider. Thus, if the state must provide a public good, such as national security or domestic law enforcement, the simple solution is to extract a tax. Clearly, even genuinely public goods are used to varying extents by individual taxpayers. Yet, in the long term, the benefits from genuine public goods tend to even out. Hence, a flat tax makes more sense than a progressive tax. The trouble is that the modern state appears to be more concerned with redistributing wealth than with providing universal public goods. But, Epstein argues, even if we must redistribute, we should prefer the simplicity and transparency of a flat tax which eliminates the political discretion, policing costs and the disincentives which unavoidably attend progressive tax arrangements.

The question of what constitutes genuine public goods, however, remains problematic. The financing of public goods with tax revenue alleviates the problem of free riders but creates the problem of 'forced riders' who are compelled to pay for goods that they do not want. Radical libertarians argue that even collective security and law enforcement are matters that should be left to private arrangements. Epstein does not go this far, but he argues that many of the so-called public goods are in fact redistributory devices which ought to be recognised as such.

Consequential Rules

It is important to understand that when Epstein says that a society needs only seven simple rules, he does not mean that the law can be written down in seven simple sentences. The recognition of any one of Epstein's simple rules entails the acceptance of many consequential rules. Consider the rule that requires contracts to be observed. To enforce this rule, we need to know how a binding contract is formed (offer and acceptance, serious intent, consideration, and so forth), what factors will vitiate it (mistake, misrepresentation, and so on), how it is terminated by breach, and how damages are to be assessed. The critical issue is whether the sub-rules which govern these matters serve or subvert the simple meta-rule. The sub-rule that

a mistake vitiates the contract serves the meta-rule which enforces only genuine agreements. In contrast, the Australian High Court's readiness to set aside a contract on the grounds of 'unconscionable' terms, if it can be called a rule at all, derogates from the meta-rule, for it has nothing to do with genuine agreement. Epstein's thesis would have been more complete and more attractive if it contained a theory of consequential rules.

An intuitive question is why Epstein excludes criminal law from his simple rules. Epstein is right to exclude criminal liability. He limits himself to rules which have '*pervasive application* across routine social activities' as against rules 'directed solely to the dangerous activities of people who live at the margins of society' (pp. 28-9; emphasis in original). This reason is sound. We could add that the major common law crimes such as murder, assault, robbery, theft and rape enforce Epstein's simple rules, while the trivial statutory offences (like failure to fill a form) are merely regulatory devices that are part of the problem of legal complexity.

Conclusion

Epstein's book accomplishes several things. It makes an important contribution to our knowledge of complexity by demonstrating that the success of complex social systems depends not on the complexity of their laws but on their simplicity. Scientists studying complexity have discovered that complex orders in nature are sustained not by detailed circuitry but by general laws produced spontaneously. Coming from a very different direction, Epstein has shown that this is as true of the cultural world of human interaction as it is of the biological and physical worlds. While scientists have been inspired by evolutionary biology and computation, Epstein's intellectual tools comprise practical reason and a brand of sophisticated utilitarianism which recognises its own limitations and avoids naive constructivism.

Epstein has added a powerful new voice to the call to end the regulatory insanity of the modern state. His book provides an easy introduction to the discipline of economic analysis of law. Epstein makes a compelling case for efficiency analysis as a means of identifying and dealing with the coordination problems of society, without the aid of mathematics and visual aids which would alienate many lawyers. In the process he slaughters many sacred cows of public policy, including progressive taxation, the law against unjust dismissal, anti-discrimination laws, product liability, and laws against insider trading .

Epstein challenges, I think successfully, the intellectual arguments for complex laws. But how can the political system be restrained from generating legal complexity? In earlier books, Epstein argued that the takings clause and the doctrine of unconstitutional conditions offer constitutional safeguards in the United States.[4] In

[4] On the takings clause, see Epstein (1985); on unconstitutional conditions, Epstein (1993). The takings clause prohibits the state from appropriating private property without paying just compensation. The doctrine of unconstitutional conditions prevents the state from imposing on citizens conditions for the use of property which have the effect of limiting the citizen's constitutional rights. For example, a

the past, the takings clause compelled the state to compensate persons for outright dispossession, but did not support claims for losses caused by the regulation of property use. Thanks to the efforts of lawyers like Epstein, the clause now supports claims for compensation where regulations cause a significant loss of value. If governments are forced to pay for such losses, there will be less regulation. Regulation is also generated by the monopoly power of the state to give certain types of benefits. Epstein argued in *Bargaining with the State* (1993) that the state's power to coerce citizens by placing conditions on its largesse can be curbed by a more realistic application of the doctrine of unconstitutional conditions.

Epstein's versions of the takings clause and the doctrine of unconstitutional conditions, if implemented, would no doubt inhibit redistributory politics. However, the disease is so deep-seated that we must look further. While continuing to test the efficiency of specific legal rules, we should also investigate the structural reasons which make our higher-order institutions (Hart's secondary rules) produce inefficient laws. This is where the international research program in constitutional economics has so much to offer. This movement, which embraces evolutionary legal theory, public choice theory, the Freiburg School of Ordo-liberalism, property rights theory, institutional economics and other related disciplines, has opened up a new frontier in constitutional theory focusing on the efficiency of the higher-order constitutional rules which govern the generation of lower-order specific rules.

This is not a criticism of Epstein's book, which has splendidly achieved its objective. It is a plea to lawyers to turn their attention to the problem of institutional decay. Richard Epstein's book has made a great contribution to legal and judicial education. To advance this education, the legal community must be introduced to the international discourse on constitutional economics.

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condition which requires welfare recipients to forgo their free-speech rights in order to receive benefits would be clearly unconstitutional under this doctrine.

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The New Zealand Model of Economic Reform: A Review

Winton Bates

*Brian Silverstone, Alan Bollard and Ralph Lattimore (eds), **A Study of Economic Reform: The Case of New Zealand**, North-Holland, Amsterdam, 1996*

*Lewis Evans, Arthur Grimes and Bryce Wilkinson with David Teece, 'Economic Reform in New Zealand 1984-95: The Pursuit of Efficiency', **Journal of Economic Literature**, Volume 34 (December 1996), pp. 1856-1902*

THE recent flurry of publications by New Zealand economists about the recent economic reforms in that country is presumably a response to strong international interest. As David Henderson, formerly Head of the Economics and Statistics Department of the OECD, has pointed out, the New Zealand reforms undertaken since 1984 have amounted to 'one of the most notable episodes of liberalisation that economic history has to offer' (Henderson, 1995:13). He has since elaborated as follows: 'In no other OECD country has there been so systematic an attempt at the same time (1) to redefine and limit the role of government, and (2) to make public agencies and their operations more effective, more transparent, and more accountable' (Henderson, 1996:13). Yet the attention these reforms have attracted outside New Zealand has not all been favourable. A common view in Australia is that the New Zealand reforms 'exceeded the speed limits'. For example, Fred Argy (1996:93) claims that 'the short-term social costs of the New Zealand reform program have been so great that the overall welfare effects of the program are at best ambiguous and at worst negative'.

The publications under review make reliable information about the New Zealand reforms more readily accessible. The book edited by Silverstone, Bollard and Lattimore incorporates contributions from 19 economists from universities, research institutes and financial institutions. The editors aimed to produce a set of integrated chapters, covering economic outcomes, sectors and policies. Contributors were requested to use appropriate theory, policy and evidence to analyse the reforms and to draw lessons from the experience. They were asked specifically to link experience during the reform period with the experience in the pre-reform period.

The article by Evans, Grimes, Wilkinson and Teece represents an attempt to review the main features of the reforms and to comment selectively on aspects

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which the authors consider are likely to be of international interest. A more detailed account of the material covered in the article has since been published as a monograph (Evans et al., 1996).[1]

Characteristics of the New Zealand Model of Reform

The authors do not define precisely what they mean by 'economic reform'. Silverstone et al. identify what they describe as a 'reformist agenda' that has spread quickly from one country to another from 'liberalisation experiments' that 'began in the early 1970s in Chile and, subsequently, in the United Kingdom and the United States' (p. 6). Evans et al. list 33 different reforms covering a wide range of areas, including the change to a proportional representation system of voting and cuts to government expenditure.

In his contribution to Silverstone et al. (p. 136), Brian Easton questions whether the 'reforms' should be viewed as consisting solely of market liberalisation or whether they also include macroeconomic stabilisation policies. In my view, the approach to macroeconomic policy adopted from the mid-1980s did involve a substantial departure from previous policies adopted. Among other things, macroeconomic stabilisation in New Zealand involved substantial changes in formal institutions, including changes to the Reserve Bank Act that were directed toward enhancing the credibility of anti-inflation policies. Indeed, one of the important characteristics of the New Zealand reforms is the extent to which they have involved changes in rules made by the governments that influence incentives faced by individuals.[2] But important changes of approach also occurred that did not require changes in formal rules, such as, for example, governments generally refraining from attempting to use fiscal policy for short-term demand management since 1984.

Evans et al. and Silverstone et al. agree that the reforms were characterised by the application of new conceptual frameworks incorporating advances in microeconomic theory (contestability, principal-agency and public choice) and the new classical macroeconomics (rational expectations, transparency, credibility and an expectations-augmented Phillips curve). Evans et al. (p. 1862) suggest that the reforms 'might be characterised as the pursuit of: coherent policies on a broad front; credibility and time consistency; a comparative institutional approach; and efficient contracting arrangements'. Silverstone et al. (p. 11) describe the approach adopted as 'classic "big bang" reform' involving rapid implementation over a wide area of policy, with little consultation, limited concern for the transitional period and typically little compensation for the losers from the changes.

This description is, I think, only partly correct. By OECD standards, many of the reforms occurred quickly. But trade liberalisation has occurred gradually and predictably. The major reforms in the labour market did not begin until 1991. Reforms in the social welfare area began even later and were quite moderate: they did

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[1] Subsequent references to Evans et al. refer to the article under review rather than the monograph.

[2] To use the terminology of the new institutional economics, many of the reforms involve changes in 'formal institutions'. See for example North (1990) and Alston et al. (1996).

not even wind back the expansion of the welfare state that occurred during the 1970s. Reforms in many areas were preceded by publication of reports that provided opportunities for public comment.

In my view, the reforms are more accurately characterised by their emphasis on the need for credible commitment by government than by a 'big bang' approach. The principles of economic reform espoused by Sir Roger Douglas, the minister most responsible for initiating the reforms, certainly emphasise the desirability of quantum leaps, large packages, speed and maintaining momentum; but they also stress the need to maintain public confidence through credibility and consistency of approach, to provide advance notice to encourage adjustment and to keep the electorate informed (Douglas, 1993:220-3). The heavy emphasis on policy transparency is evident in the ease with which the contributors to these publications are able to identify aspects of economic theory that were influencing policy-makers in introducing the reforms.

Was There an Alternative to Reform?

Is it realistic to view the reforms as an experiment by a prosperous and stable welfare state to sacrifice some equity in the hope of achieving greater efficiency? Alternatively, was the New Zealand welfare state of the 1970s a 'fools paradise' that was becoming increasingly difficult to sustain?

Information provided in some of the contributions to Silverstone et al. goes a fair way toward providing answers.

- New Zealand recorded one of the worst real GDP and per capita growth rate performances of any OECD country in the post-war period (chapter by Viv Hall).

- Trade protection levels remained high over the period 1970-85, isolating New Zealand from the potential for cost reductions in manufacturing and contributing to a decline in export competitiveness in international markets — which occurred despite increasing export assistance and agricultural subsidies (chapter by Ralph Lattimore and Paul Wooding).

- State enterprises had come to account for 20 per cent of gross investment by the early 1980s and were characterised by poor returns on capital, high costs and a high level of political involvement in decision-making (chapter by Ian Duncan).

- New Zealand's inflation rate was on an almost unbroken upward trend between 1970 and 1982, and considerably higher than that of its main trading partners (chapter by Arthur Grimes).

- Income support payments grew rapidly during the 1970s and 1980s as a result of increased unemployment and an expansion in the entitlements of aged persons and single parents (chapter by Graeme Wells).

- The ratio of net public debt to GDP rose from 5 per cent to 32 per cent of GDP in the decade to 1984 and peaked at 52 per cent in 1991-92 (chapter by Graeme Wells).

Evans et al. present a similar picture of declining economic performance in the decade preceding the reforms.

One factor relevant to consideration of the sustainability of previous policies, which does not receive much attention in these publications, was the net migration of people from New Zealand to seek employment in Australia from the mid-1970s to the late 1980s. Losses due to net migration varied from year to year, apparently reflecting labour market conditions relative to Australia's, but amounted to more than 1 per cent of population in some years.

Policies implemented in the late 1970s and early 1980s were starting to show signs of desperation. For example, stringent controls were applied to the amount of money that people were permitted to spend on overseas visits. Growing amounts of industry assistance were provided to the export sector in a futile attempt to compensate for effects of import barriers in taxing exports.[3] A 'think big' development program was implemented in the early 1980s to reduce dependence on imported liquid fuels and to boost exports from energy intensive industries. Extensive wage and price controls were introduced in 1982.

The foreign exchange and constitutional crises that accompanied and followed the general election of June 1984 probably strengthened the hands of reformers by making the electorate more receptive to the substantial reforms that followed (Dalziel & Lattimore, 1996:21-3). But radical reform was not the only alternative available to the new Labour government. For example, the government could have made the minimum changes needed to cope with immediate problems and continued with previous policies until the next crisis arose. Progressive deterioration in performance could have continued until reforms were imposed externally as a condition for obtaining assistance from the IMF.

The Transitional Costs of Reform

Poverty and inequality. Despite efforts to protect low-income earners, some reforms probably did result in hardship for some people, at least in the short run. Since economic reforms typically involve the removal of interventions that shield incumbents in particular industries, firms, public-sector organisations, unions, and so on, from competition, it is almost inevitable that those made worse off in the short run by any reform will include some low-income earners. At the same time, and as acknowledged by Brian Easton in the chapter on income distribution in Sil-

[3] My view that this compensatory assistance was futile is based on the fact that the cutting edge of protection from import competition was provided by means of import licences which were administered with a view to avoiding a substantial transfer of resources out of protected industries. The provision of compensatory assistance can be successful only if it results in a reallocation of resources favouring lightly assisted industries at the expense of heavily assisted industries (Syntec, 1984).

verstone et al., 'these microeconomic changes need not accumulate to a macroeconomic change of the aggregate distributions' (p. 133). Under a broadly based reform program such as that undertaken in New Zealand, people who are disadvantaged by one policy change are likely to be among the beneficiaries of other policy changes.

Easton suggests that the economic reforms of the 1980s and 1990s did result in some increase in economic inequality, but this conclusion appears to be quite sensitive to the time period considered and the way poverty is measured. The results of one analysis quoted by Easton suggest that the proportion of income going to the bottom four deciles of households rose in the period 1981/82–1987/88. As might be expected, the cuts in welfare support of 1990 and 1991, combined with the sharp recession at that time, resulted in an increase in the proportion of households falling below various poverty lines. Evidence provided in the Treasury's (1996) briefing to the incoming government suggests, however, that the proportion of the population in hardship, relative to fixed real-income levels, has declined in recent years. This is in line with the growth of the economy and the decline in unemployment rate from 10.9 per cent in September quarter 1991 to 5.9 per cent in December quarter 1996.[4]

Some commentators argue that transitional costs could have been reduced if reforms had been pursued differently. Fred Argy's comment to the effect that the overall welfare effects of the New Zealand reforms may be negative was based on his view that some of the New Zealand reforms, particularly those of the labour market, 'have probably contributed only little to its strong economic performance and yet entailed a high social cost' (Argy, 1996:90-1). However, Argy's representation of the New Zealand labour market reforms is at variance with the facts as presented in the publications under review as well as with accounts provided by Wolfgang Kasper (1996) and the OECD (1994). Argy refers to a 'sharp lowering in minimum wages and conditions' and a 'weakening of the arbitral and grievance redress machinery' (1996:91). In fact, the Employment Contracts Act (ECA) left in place statutory minimum wages; and, rather than being weakened, the ECA's grievance redress machinery has placed great emphasis on procedural correctness in dismissals and on 'fairness' even when dismissed workers have been manifestly negligent or incompetent (Evans et al., p. 1880).

Unemployment. Employment opportunities were obviously scarce during much of the period over which the reforms were taking place. The unemployment rate more than doubled during 1987-91. But can this be attributed to the reforms? It is easy to see why many New Zealanders think so. The total combined jobs lost in corporatised and privatised government departments between 1987 and 1994 is

[4] The evidence that recent economic growth in New Zealand is expanding the opportunities available to the poorest members of the community is consistent with the international evidence of an association between growth in average incomes and the opportunities available to the poor to improve their lot in an absolute sense (Bates, 1996).

equivalent to nearly half of the rise in total unemployment (Silverstone et al., p. 156). However, this comparison looks at only one side of the picture: it overlooks the indirect effects of the reforms in increasing private sector employment opportunities by reducing business costs and taxes.

Tests of the hypothesis that increased unemployment was attributable to structural change, reported in the chapter on unemployment in Silverstone et al. by Simon Chapple, Richard Harris and Brian Silverstone, do not support the popular view. If structural changes were an important source of rising unemployment, they could be expected to be associated with a major increase in occupational and regional mismatches. In fact, increased occupational and regional mismatches accounted for only a minor part of the overall increase in unemployment. The authors' econometric results suggest that the increase in unemployment during the reform period was attributable to 'shocks from aggregate demand' (p. 168).

This seems to put the blame for increased unemployment squarely in the court of the monetary policies that were used to wind back inflation from 13 per cent in 1985 to 1 per cent in 1993. Yet even this conclusion is simplistic. Viv Hall's analysis in Silverstone et al. suggests that New Zealand's sacrifice ratio (a measure of the output forgone to reduce inflation by 1 percentage point) was higher than Australia's. His simulation analysis suggests that it would have been substantially smaller if New Zealand's wage setting institutions had been more flexible in 1985: that is to say, if labour market reforms had been introduced sooner. Real wages rose substantially after the end of the pre-reform wage and price freeze (nominal wage rates rose by 22 per cent during the year to December 1996, resulting in a 14 per cent rise in real wages relative to producer prices for outputs); and this was unwound only partially in subsequent years despite rising unemployment (Evans et al., pp. 1870, 1880).

Arthur Grimes's discussion of monetary policy suggests that economic adjustments to policy tightening during the 1980s were delayed because the Reserve Bank 'had no established anti-inflationary credentials' (Silverstone et al., p. 256). During the disinflation period, actual inflation was typically half expected levels, reflecting a widespread view that the Reserve Bank, given the multiple objectives that it had before 1989, was likely to revert to a more expansionary stance once unemployment levels started to rise.

An appropriate conclusion to draw is that high unemployment during the reform period was a hangover from pre-reform labour market and monetary policies rather than a consequence of the reforms themselves.

Sequencing of reforms. Evans et al. make a case, in terms of theoretical principles of sequencing, that the costs of reform could have been reduced if the labour market and fiscal reforms had taken place at an earlier stage in the reform process. They argue that this could have 'induced lower real interest and exchange rates and lower real wages through the reform period' (p. 1871). Silverstone et al. have some sympathy for this view. They argue that 'the importance of political support in in-

fluencing the sequence of reforms in New Zealand may have added to the transition costs in terms of lower growth and higher unemployment' (p. 22).

The response that Sir Roger Douglas has given, as a practitioner of reform, to the question of optimal sequencing is worth noting in this context:

> I find the question fundamentally irrelevant. Before you can plan your perfect move in the perfect way at the perfect time, the situation has already changed. Instead of a perfect result you end up with a missed opportunity... If there is an opportunity to implement a reform that makes sense in the medium term, grab it before the moment passes. When an economy is stalling and failing, what matters is to get it moving toward a better future as soon as possible. (Douglas, 1993:224)

Could the costs of reform in New Zealand have been reduced if a more gradual and tentative approach to labour market reform had been adopted, as in Australia? A comparison of Australian and New Zealand unemployment rates since 1970 shows that only during 1989-91 were unemployment rates in New Zealand higher than in Australia. In those three years, the difference in favour of Australia was substantially smaller than the difference in favour of New Zealand has been in subsequent years (Silverstone et al., p. 206). Evidence presented by Tim Maloney and John Savage suggests that New Zealand's labour market reforms are at least partly responsible for the strong employment growth in that country in recent years (Silverstone et al., pp. 210-11).

The counterfactual. What would have happened if New Zealand had not reformed during the 1980s? The publications under review do not address this question, but Grant Scobie and John Janssen, among others, have argued that 'it is altogether too naive to assume that the old order would have simply continued' in the absence of reform (1993:6). A strong case can be made that the most likely outcome would have been a continued deterioration in economic performance, with more painful reforms being required at a later stage.

Anyone with a genuine interest in the well-being of low-income earners in New Zealand should be pleased that a substantial change in policy direction occurred without major social trauma. The recent history of the former centrally planned economies, as well as of some economies in Latin America, shows that social safety nets constructed by governments provide little protection to the poor when unsustainable economic policies are followed to the point where a collapse in economic activity becomes unavoidable (World Bank, 1995:103-8).

How Much Has Economic Performance Improved?

Real GDP growth in New Zealand averaged 3.8 per cent a year over the four years to 1996. In its briefing to the incoming government elected in 1996, the Treasury fo.ecast that, on current policy settings, growth would average 3.2 per cent a year over the four years to 2000 (Treasury, 1996).

Although Silverstone et al. are cautiously optimistic, they suggest that it is 'too early to conclude firmly whether New Zealand's improved economic performance is sustainable' (p. 21). Their caution is based partly on the difficulty, discussed particularly in Viv Hall's chapter, of distinguishing between cyclical and structural components in the strong economic growth experienced in recent years. Evans et al. acknowledge that there is still room for debate about the degree to which the recovery is structural rather than cyclical, but conclude more positively that 'New Zealand appears to be on a trajectory to maintain its economy as a consistent high performer among the OECD' (pp. 1893-5).

On balance, I think that the contributions to Silverstone et al. would have supported a less equivocal conclusion along the lines of that reached by Evans et al..

- The growth of recent years has been occurring in a context of a sound fiscal situation (generation of budget surpluses) and low inflation (chapters by Graeme Wells and Arthur Grimes).

- There is evidence that the reforms have had a positive effect on the rate of growth in total factor productivity (TFP). The results reported in the chapter by Rolf Fare, Shawna Grosskopf and Dimitri Margaritis indicate that TFP growth rose from 0.7 per cent a year during 1973-84 to 2.4 per cent during 1984-1994. Qualifications always attach to measurement of TFP growth, but this appears to represent a substantial improvement, particularly in view of the fact that some important reforms were initiated only toward the end of this period. The authors also suggest that their methodology may tend to underestimate productivity growth because the capital stock series they use (calculated using the perpetual inventory method) tends to overstate capital stocks during a period of economic reform.

- The analysis of international trade by Ralph Lattimore and Paul Wooding suggests that policy change has resulted in a more rapid expansion of trade, particularly since 1988. Agricultural exports have been reoriented following the removal of discriminatory subsidies, and smaller manufacturing firms in food processing, metal fabrication and textiles have been oriented increasingly toward exports.

- Tim Hazledine and Andrew Murphy, in their chapter on manufacturing industry, find a modest improvement in an indicator of allocative efficiency for the manufacturing sector as a whole during 1984-92, but these gains occurred largely in two major primary processing industries. The apparent lack of evidence of widespread efficiency gains may be attributable to the fact that the indicator of allocative efficiency used in this study does not reflect efficiency of resource use in production and to the study's data cut-off point in 1992, which is at the start of the recovery period.

- The corporatisation of public enterprises generated major gains in productive efficiency through large-scale job-shedding, and business and household consumers benefited directly from improved services (chapter by Ian Duncan).

- Labour market reforms appear to have contributed significantly to the growth in employment since 1992, although the expected positive effect of these reforms on average labour productivity is not yet evident in the aggregate statistics (chapter by Tim Maloney and John Savage).

Although there has been some dispute over the question of how rapidly labour productivity has been rising since the ECA came into effect (Evans et al., p. 1881), the more important question is what has been happening to TFP. Viv Hall suggests that, while there is as yet no clear evidence that TFP growth rates have been higher recently than for periods before the mid-1980s, there is 'a reasonable possibility that full cycle figures for the currently incomplete business cycle could register better news for both TFP and labour input growth' (Silverstone et al., p. 65).

Business surveys provide some supporting evidence of an improvement in productivity performance of the New Zealand economy in recent years. Evans et al. summarise results of a business survey by John Savage and David Cooling, which suggest that, following the introduction of the ECA, employment contract negotiations have included a strong emphasis on productivity improvement. The survey responses indicate the use of more flexible work practices, reduced demarcation disputes, increased multi-skilling, greater use of performance-based pay and increases in ordinary-time pay rates, in addition to cost-reducing measures such as reducing overtime rates of pay (Evans et al., p. 1883).

John Yeabsley and John Savage (1996) have pointed to strong supporting evidence provided by the quarterly survey of business opinion undertaken by the New Zealand Institute of Economic Research. The proportion of survey firms reporting higher productivity has been substantially greater since 1991 than in earlier subperiods. For example, in the expansion phase from June quarter 1991 to March quarter 1996 an average of 30.2 per cent of firms reported higher productivity, compared with only 14.2 per cent in the expansion phase from June quarter 1978 to Septemer quarter 1986.

New Zealand's Prospects

Are the reforms likely to enable New Zealand to become a 'growth success story'? The New Zealand Business Roundtable (1996:3) has argued that 'the New Zealand economy is capable of moving into the "fast lane" provided the momentum is maintained'. The Business Roundtable suggests, however, that to maintain momentum 'New Zealand will need to embrace continuing change' (1996:1).

Table 1

Changes in economic freedom and economic growth in selected countries

	Averages for nine high-growth reformers (including Chile)	*Averages for eight low-growth reformers (including NZ)*	*New Zealand*	*Chile*
Change in economic freedom rating: 1975-1990	1.8	1.7	1.7	2.9
Annual % growth of per capita GDP 1985-94	4.6	1.4	0.8	4.8
Per capita GDP in 1980 ($US)	4,458	7,124	10,362	3,892
Average freedom rating 1975-90	5.2	4.5	4.8	4.1
Change in freedom rating during 1985-90 as % of total change in freedom rating from 1975 to 1990	31	64	112	55
Annual % growth of per capita GDP 1970-80	4.1	2.4	0.9	0.2

Note: Freedom ratings are measured on a scale of 0 to 10, with higher numbers denoting greater levels of economic freedom.

Sources: Gwartney et al. (1996); World Bank (1995).

The publications under review contain little discussion of the international evidence relevant to this question. However, Viv Hall quotes the views of David Henderson that economic reforms in OECD countries have prevented a deterioration in performance so 'there is a positive balance [relative to the possible consequences of a 'failure to act'] ... even if some of the main indicators show, for a period at least, little signs of improvement' (Silverstone et al., p. 67). Henderson (1995:79) observes that 'there are few if any OECD economies where it is clear that reforms have already brought, or are in course of bringing, substantial quantifiable

gains across the system as a whole in terms of either productivity growth or levels of unemployment'.

At first sight, Henderson's observation for OECD countries seems to conflict with the evidence for a wider group economies of a strong positive relationship between improvements in economic freedom and improved growth performance. I refer, for example, to the evidence provided by the Fraser Institute's study of the comparative economic freedom of different countries (Gwartney et al., 1996:97-104). The results for individual countries indicate, however, that the high-income countries that undertook substantial reforms during the 1980s (including the United States and United Kingdom as well as New Zealand) were not alone among the reformers to experience low growth during the period 1985-94. Of the 17 economies identified as having the greatest increases in economic freedom during 1975-90, eight had annual per capita growth rates of less than 2.5 per cent during 1985-94; but half of these had per capita incomes less than 25 per cent of the US level in 1980. In addition, some high-income countries that experienced substantial improvements in economic freedom during the 1980s (most notably Singapore and Japan) had higher annual per capita growth rates than 2.5 per cent during 1985-94.

Further examination suggests that the lack of clear evidence of economic benefits in some countries that have undertaken economic reforms in the 1980s can be attributed partly to the time required for new policy directions to become embedded and for adjustment to occur. Some relevant characteristics of reforming countries which experienced high and low growth rates over the period 1985-94 are shown in Table 1. It is apparent that, although the reformers experiencing low growth rates tended to have higher per capita incomes than the high growth reformers, they also tended to have a high proportion of reforms occurring recently, lower average freedom ratings, and a history of low growth rates in the 1970s.

Viv Hall draws attention to the two decades that Chile has taken to move from poor performance to a sustainably higher growth path, and suggests that there are some similarities with the situation in New Zealand:

> Our evidence suggests that, as in Chile from 1981 to 1983, New Zealand has encountered at least one period of major setback (1987-92) and this has contributed to the long transition period. Nevertheless, it is also clear that during the overall period since 1984, sound progress has been made on reducing macroeconomic imbalances, thereby setting up the required macroeconomic platform for efficiency gains and sustained economic growth rates to emerge more strongly. (Silverstone et al., p. 67)

It is not difficult to understand why it may take a decade or more for many countries to complete the transition from poor performance to a sustainable high growth rate. Profound changes in behaviour, including changes in the willingness of individuals to learn new skills and business practices, are required as people respond to the incentives that policy reforms provide. It takes time even for the most innovative firms and individuals to accept that new market incentives are likely to be sus-

tained and to develop and implement new strategies. Widespread adoption requires sufficient time for these new strategies to become demonstrably successful.

These considerations provide grounds for confidence that New Zealand will become a growth success story as the reforms become fully entrenched. How successful will depend, of course, on the future directions of policy, including the extent to which further reforms are undertaken in areas such as education, health and welfare. Robert Stephens concludes his chapter on social services by noting that the welfare state has been more enduring and resilient than many observers thought it would be in 1991 when some reductions in social welfare expenditure occurred (Silverstone et al., p. 490). Evans et al. argue (p. 1894) that the reforms are incomplete and that further action in areas such as education, health and welfare are likely to be necessary if New Zealand is to achieve its potential.

Concluding Remarks

Which of these publications would I recommend? That depends on what readers are looking for. In my view, Evans et al. provide a balanced summary of the reforms. Their analysis of the effects of the reforms is also quite good as far as it goes, but it does seem to skirt around some important issues. For example, although the article is explicitly concerned with efficiency, it could have said more about the distributional effects of the reforms. In addition, while it devotes space to the reforms in the core public service, it does not offer many clues about the extent to which any changes of substance have occurred in relationships between ministers and departments as a result of the adoption of formal contracting processes, or about the implications that such changes might have in the new political environment.

Silverstone et al. give a summary of the reforms in their introductory chapter, but include little discussion of some important aspects, such as the core public sector reforms. As might be expected from the length of this book (518 pages) and the number of contributors, it provides useful in-depth analyses of many aspects of the reforms. The chapter on economic growth is of a particularly high standard. The chapter on productivity growth is also impressive, although the value of the attempt to split TFP into efficiency change and technological change components when the rate of technological change is assumed to be the same in all industries is of doubtful value.[5] Other particularly useful chapters are those on unemployment, labour markets, fiscal policy, monetary policy and international trade.

Although some of the contributors to Silverstone et al. have been hostile to the reforms, they have by and large confined themselves in this volume to objective analytical contributions. One exception is the assertion by Robert Stephens that 'governments have been attempting to curb expenditure growth through a reduction in the quality of education'. This is supported only by the observation: 'In tertiary education, staff/student ratios have risen from 1:12 in 1986 to 1:18 in 1992, and average government funding per student has fallen' (p. 461). It is not obvious why

[5] I am grateful to an anonymous referee for drawing this to my attention.

an increase in the number of students per staff member or a reduction in government funding per student should necessarily be interpreted as reflecting a reduction in quality of education: such changes may reflect increased productivity and increased private funding.

The 'selected bibliography' provided by Silverstone et al. is not very helpful as a guide to further reading. One notable omission is the lack of references to publications by the New Zealand Business Roundtable. This is unfortunate in view of the major contribution that that organisation has made in commissioning high-quality policy analysis of many issues and the impact of this work in raising the standard of public debate over the past decade. It is also odd that the selected bibliography provided by Silverstone et al. does not refer to any publications by Lewis Evans, Arthur Grimes, Bryce Wilkinson or David Teece.

Neither of the publications sheds a great deal of light on the processes of policy development and implementation. Some commentators might argue that to do this would have taken the authors beyond the realm of economics. However, it seems likely that these processes may have been important in influencing expectations about the sustainability of changes in policy directions and hence the willingness of people to respond to changes in the incentive environment. The fact that radical reforms have been sustained in New Zealand must owe a lot to the way policy development has occurred in New Zealand since 1984. Its distinguishing characteristics include:

- a policy agenda which focussed on the 'big issues' rather than on finding short-term 'solutions' to a host of minor problems;
- the attention given by the government to problem definition and 'state-of-the-art' analysis, drawing widely on experiences of other countries but often developing a distinctively New Zealand approach; and
- processes that made the analytical basis for policy change available for public scrutiny and debate.

Finally, it is regrettable that the publications under review do not shed more light on the extent to which the reforms have lifted the productivity performance of the New Zealand economy. This is more a criticism of the current state of applied economics than of the authors; but the shortcomings of our economic measurement techniques become very obvious when we consider that, 13 years after major reforms began, leading New Zealand economists are still unable to provide policy-makers and citizens with reliable measurements of progress toward the goal of lifting the long-term productivity performance of the New Zealand economy. Serious efforts should be made, using firm surveys for example, to develop leading indicators of secular productivity change so that the process of adjustment can be monitored more satisfactorily.

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NOTES AND TOPICS

A Vision of Trans-Tasman Cooperation

Roger Hallam

AUSTRALIA and New Zealand have long enjoyed a close relationship. For a short period until 1841 we had one and the same government based in Sydney. Our armed forces fought side by side in a number of major conflicts. We enjoy free movement of citizens between our jurisdictions. Since 1922 we have had formal agreements on bilateral trade. The most recent is the Closer Economic Relations Agreement of 1983 and its subsequent protocols. There have been agreements to harmonise professional qualifications, industry, consumer and other standards, business laws and regulatory practices. Government purchasing preferences and aviation regulations have been made largely non-discriminatory.

Two-way trade in goods and services is running at almost A$12 billion a year. New Zealand is Australia's third largest trading partner and Australia is New Zealand's largest trading partner. Significantly for Victoria, over 70 per cent of exports to New Zealand are manufactures (for example, cars, plastics, paper). There is A$18 billion of two-way investments in our economies. But trans-Tasman cooperation needs to go much further if we are to realise the full potential of our partnership.

A Single Economy

As we have seen with the European Union, once economic integration begins, it does not necessarily stop with the free flow of trade, capital and labour across foreign boundaries.

My fervent hope is that in the early part of the next century New Zealand and Australia will become a single economy, with a single currency governed by a joint central bank. This would imply also the same company laws, and, one hopes, similar tax bases, even if we apply different tax rates. Close coordination of fiscal policy would also be necessary. A start in this direction could be made if the Australian federal and State governments committed themselves to the disciplines of a Fiscal Responsibility Act, as New Zealand did in 1994. Without a strong commit-

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ment to responsible financial management on both sides of the Tasman Sea, a common currency could result in one side gaining at the expense of the other. For instance, if either country were to run up a large deficit, resources would flow across the border to fill the gap, raising the risk of the central bank increasing interest rates across both jurisdictions to offset loose fiscal policy in one. This could in turn lead to a higher exchange rate, which would disadvantage exporters on both sides of the Tasman. So a common fiscal policy is a precondition for a single stable currency, which, properly managed, would bring substantial benefits.

With a single economy, we could face Asia and the rest of the global economy as a united force when it came to promoting our trade, investment and financial interests. As well, a market enlarged by economic, monetary and fiscal unification would offer our producers further economies of scale. Above all, we could benchmark every tier of endeavour — including government — without the economic distortions which currently exist.

Political integration is not a necessary ingredient of a single economy. As the world becomes more uniform and integrated economically and technically, I suspect that people within distinct locations will try to assert their uniqueness and autonomy by more sharply defining their local politics and cultures. So my vision for the future of Trans-Tasman cooperation is of a genuinely integrated economy of two nations, celebrating their distinct cultures while sharing their best practices.

Public Sector Reform

Internationally, New Zealand and Australia are generally regarded as leaders in public-sector management. In terms of administrative and financial integrity, transparency, efficiency and effectiveness, our public sectors are the envy of not only less developed countries to our north, but of all the member states of the OECD. Indeed, New Zealand is recognised as a world leader in reinventing government to meet the challenges of the future. These efforts have been watched with interest by the rest of the world — and by Victorians in particular.

Within Australia, the federal government undertook a number of economic initiatives in advance of New Zealand, such as cutting tariffs, prohibiting restrictive trade practices, floating the exchange rate, relaxing exchange controls and deregulating the financial system. As well, New South Wales introduced audited consolidated financial statements for its public sector in advance of New Zealand or any other jurisdiction. But in general, governments within Australia have followed rather than led New Zealand on public policy and management reforms.

We in Victoria have unashamedly followed the New Zealand lead, but, more important, we have used that lead to articulate and justify much of our reform agenda. And while New South Wales under Premier Nick Greiner was the recognised pacesetter in Australia between 1988 and 1993, the Kennett Government of Victoria has since forged ahead as the most reformist government in the country.

The New Zealand Model

In Victoria we freely admit that many of our public policy and management initiatives are based on what is often referred to as the New Zealand model.

These include:

- Honest, transparent and accountable government by adhering to professional accounting standards and publishing meaningful service performance indicators.
- Responsible financial management through balancing the budget and reducing debt and contingent liabilities to a tolerable level.
- Holding government to its core purpose: which is to serve social ends, not run businesses when they could be better managed privately.
- Promoting a tax regime which is simple, equitable and efficient so that workers, investors and managers have an incentive to add to net wealth, not subtract from it.
- Having ministers act as 'purchasers' of services rather than 'providers' so that they can exercise choice over suppliers and products.
- Regulating the economy so that there is equal opportunity to engage in economic transactions, without some players — whether government instrumentalities, private businesses or unions — gaining a monopoly or other unique privileges.
- Comprehensible and credible financial reporting.

As we head towards the third millennium, I see Australia's States increasingly looking to New Zealand for inspiration on how to get better value for money from their public sectors and restore competition and incentives in the private sector. Alternatively, they may even turn to Victoria for ideas on how to make the New Zealand model work in an Australian setting. 'Benchmarking' will become the most important avenue of government reform over the next few years. A logical place to start would be with New Zealand participation in the Australian Productivity Commission's annual reports on the key performance measure of government social activities, such as hospitals, schools, public housing, courts, and so on, and business ventures including electricity, water, ports, railways, and so forth, in each jurisdiction. This important initiative of the Council of Australian Governments allows Australians for the first time to make meaningful comparisons on how efficient and effective their governments are in supplying vital services to them.

Including New Zealand in this exercise — at least in the social activities part, since New Zealand has privatised most government commercial ventures — would

expose all major government bodies in our two countries to Trans-Tasman benchmark competition. The results would make fascinating reading for the general public, since it would highlight the gaps in efficiency and effectiveness between Australian public services and those of New Zealand.

Victoria's Reforms

In borrowing from the New Zealand model of public sector reform, the Victorian government embraced change more out of financial and economic necessity than out of any ideological zeal for small government and market forces.

Our over-riding objective has been to make Victoria a better place to live, to invest and to do business. At the macro level, we had to rescue Victoria from the financial crisis we inherited from the previous Labor government. At the micro level, the challenge was to lift the competitiveness of the Victorian economy. This meant restructuring the business environment to encourage industry to trade more extensively with the Asia- Pacific region.

Government policies directed at making Victoria more competitive include:

- reform of workers' compensation, which has almost halved premiums, saving around $500m for employers each year;

- major private investments in public infrastructure, like the $1.7 billion Melbourne City Link road project;

- structural reform and privatisation of the electricity industry to deliver real reductions of 16 per cent and 28 per cent in household and small business electricity prices respectively by 2000, and which has already yielded sale proceeds of $13 billion to reduce State debt;

- reform of the ports (partly through privatisation of regional ports), with reductions in charges of at least 20 per cent in Melbourne, Geelong and Portland;

- reform of local government, which led to a reduction in the number of councils from 210 to 78, the introduction of competitive tendering for services, performance-based contracts for managers, and new auditing, corporate planning and annual reporting requirements. The result is an overall reduction in rates of 20 per cent: an average saving of $159 per Victorian household; and

- streamlining business regulations.

As the responsible Minister, I was closely involved with workers compensation and local government. Though I did not exactly follow the New Zealand route in each case, visiting your country to see how you had approached these matters proved very valuable in shaping policy and justifying the change. I freely admit to stealing good ideas from many jurisdictions. Again, I stress the enormous value of

having a respected model to pirate, and to cite to one's political opponents, particularly when the example could not be challenged on partisan grounds.

Based upon the outcomes, the strategy has been successful. Since coming to office in 1992, we have virtually eliminated the budget deficit of $2.5 billion a year; reduced public sector debt from $32 billion to $19 billion; accommodated cuts in Commonwealth government grants exceeding $200m in 1996/97 without increasing taxes; increased investment in public infrastructure to around 1.25 per cent of gross state production (GSP); applied strict accrual accounting and GPS statistical standards to the public accounts and budget papers; published for the first time consolidated financial statements for the Victorian public sector; driven massive efficiencies and improvements in public service delivery by restructuring departments, re-engineering processes, upgrading and automating systems, greater contestability in service provision and measuring the results through benchmarking against world-best practice.

But Victoria's reform program is not yet complete. Over the next few years we intend to introduce even greater competition, external contracting and privatisation; reduce the level of Victoria's business taxes to those of New South Wales, our toughest State competitor; restore our credit rating to AAA; and require government agencies/departments to manage their balance sheet rather than their annual budget allocation. (This is a very brave move, and again, New Zealand can be credited with much of the inspiration for it.)

Comparisons

Our reform experiences have many similarities. Both were born out of financial and economic crises, for example. Yet there are also significant differences between the two. Victoria enjoyed robust economic recovery relatively soon after beginning reform, while New Zealand underwent prolonged economic pain before the benefits of change materialised. Victoria's reform program has (at least so far) maintained public support, judging by the government's re-election in 1996 and its standing in the opinion polls. In New Zealand, the radical reform program saw two finance ministers sacked, each of their governments lose their majorities and a popular backlash against strong executive government resulting in a new electoral system. Victoria's reforms concerned State issues, while New Zealand's reforms covered national matters of economic management (such as the exchange rate, tariffs, and monetary policy) in addition to other matters.

To be fair, the extent of the economic turnaround in Victoria was not as great as in New Zealand because much of Australia's economic restructuring had already occurred before the election of the Kennett government in 1992. Tariffs had been cut and restrictive trade practices prohibited under the Whitlam Government of 1972-75. The Australian dollar had been floated, exchange controls relaxed and the financial system deregulated when Paul Keating was Treasurer in the 1980s. Nevertheless, tough measures associated with bringing the State budget into balance and reducing government debt should have provoked an electoral backlash. These measures included large cuts to government spending, changes to taxes (including

temporary surcharges), public service retrenchments, asset sales, utility privatisations, contracting-out of government services and rationalisation of some benefits. Yet public support for the Victorian government has remained solid. Why?

The Politics of Reform

An answer, perhaps, can be found in Roger Douglas's book *Unfinished Business* (1993). In Douglas's view, structural reform will be successful if conducted rapidly on a broad front, and if the government is confident about what it is doing and communicates its objectives to the public. Douglas makes the interesting point that both Labour and the Nationals rode highest in the opinion polls when they were promoting their reforms with gusto and enjoyed internal unity. It was only when each government called for a 'breather' in its reform initiatives, in the belief that some people needed time to catch up, that the opponents of reform got the opportunity to marshall their forces and launch a counter attack.

I think the result demonstrated the greatest risk to a reformist government, namely, internal polarisation between those who want to advance the process of reform a stage further, to bring even better results, and those who want to placate the critics. A stalemate developed. The public lost confidence in the direction of policy and, sadly, turned on its heroes of yesterday. To quote Douglas:

> In my view, there is one force which is always capable of undermining the process of structural reform — the government itself when it loses sight of its own primary objectives. If the discipline of collective cabinet decision making and collective cabinet responsibility breaks down, the way is open for interest groups to regain control of the game. (1993:237-8)

In Victoria, I think we have been bold and clear in our vision and program, but, more important, we have been united and consistent in communicating and promoting reforms — and we have been able to cite respected models as the source of that vision and program.

The Vision

So I leave with you the vision, and offer the challenge to think broader, larger and longer. Don't be satisfied with the contemporary wisdom that says that the best we can do is to remove any barriers to trade across the Tasman. This sells us all short. We need to look at what could be achieved if we were prepared to *really* co-operate: to marshall our collective strength and put it out in the market place. The untapped potential lies in the synergy which would spring from genuine benchmarking and even greater exchange of experience and skills.

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Electronic Money and Regulatory Responses

Stephen Rimmer and Ravi Prasad

RAPIDLY evolving technologies are leading to innovations in banking and in the way goods and services are traded. Many of these changes can be attributed to developments in global communication systems which have accelerated the integration of world markets. Australian consumers with access to a computer linked to the Internet can now purchase compact disks from the United States, gamble at casinos based in the Caribbean, and sell copyrighted publications electronically. As well, new payment systems based on electronic money have proliferated, creating scope for private institutions to issue electronic currency in competition with currencies issued by governments (Kirchner, 1996).

The regulatory responses of governments to this challenge will help determine whether the social and economic benefits available from the emergence of electronic money and commerce can be realised.

Forms of Electronic Money

Methods of exchange of money are still evolving through the use of technology to include smart cards, such as stored value cards (SVCs). The potential world market for SVCs for purchases under US$10 was estimated to be in excess of 300m cards in 1995 (Lindley, 1996:2). In addition, a range of Internet-based electronic money or digital currency (e-cash) systems using conventional currency are being developed. The Mondex system, for example, can be traded independently of the banking system. Unlike with the more common SVCs, Mondex users can transfer electronic cash amongst themselves through an electronic wallet. Mondex also allows funds to be transferred through the Internet, in the form of one of five different currencies. The Electronic Money System, like Mondex, can work on a computer network, and allows secure and immediate transfers of cash. Unlike Mondex, it will be able to handle any number of foreign currencies, exchanging them at agreed rates. Netcash uses e-mail to transfer money from one person to another. In contrast, the First Virtual e-cash system requires both parties to a transaction to have accounts at the 'bank', and First Virtual must be able to make charges against the account of the purchaser (Levy, 1995).

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E-cash can also take the form of privately issued currencies where conventional currency is used to purchase transferable e-cash, like tokens at an amusement park. Companies like Digicash and Cybercash are developing 'virtual' currencies which operate independently of, and in competition with, conventional currencies. According to Goldschlager and Harper (1996), Digicash is the closest approximation to a virtual currency payments system on the Internet. The currency is a series of digitally signed coins that can be transferred between persons. The consumer can withdraw digital coins from an Internet bank account and store them on a personal computer or vice versa. A web browser provides the interface for displaying account information, transferring digital coins between bank accounts and virtual wallets and confirming or rejecting payment requests. Digicash's security systems are based heavily on cryptography and on the efficacy of digitally signed coins (Levy, 1996:4).

As *The Economist* (26 November 1994) has put it,

> Electronic money of this type could be created in any denomination ... all it presumes is a willing buyer and a willing seller, anyone with a computer and a telephone line can become a small business; forget the hassle and expense of being approved as a credit-card-accepting merchant. . .

The Impact of E-cash

If e-cash is to be accepted by consumers as a viable alternative to paper cash, it will have to be secure, anonymous, portable, transferable, off-line capable (parties must be able to transfer funds at any time without the need for a third party to authenticate transactions), divisible, of infinite duration, widely acceptable, easy to use, readily convertible, versatile, cheap, and trustworthy. True virtual cash systems will be denominated in market determined units, which are not aligned to any national currency. However, the assets backing them will help give them value, allowing convertibility into conventional currency.[1]

In theory, anyone could provide a monetary unit, which could then be exchanged for goods and ultimately even for conventional currencies. If these new monetary units are backed by something of value and there is considerable customer confidence in them, they could even be endogenously generated, and traded for conventional currency at market determined exchange rates.

E-cash also represents a fundamental shift in payment methods because it has the potential to transfer funds instantaneously, by means which are often difficult for governments to monitor or regulate. It is this electronic exchange medium which could provide the basis for the return of free banking, whereby private organisations — or indeed State or local governments — could issue their own forms of electronic currency.

[1] Goldschlager and Harper (1996:3) envisage that e-cash could be backed up by a multitude of goods including equity mutual funds, commodity funds, metals, real estate and other forms of digital cash.

E-cash raises a number of important regulatory issues and dilemmas. It could allow consumers to choose between different currencies, providing additional incentives for governments to control inflation to ensure public confidence in government-issued currency. It could result in a loss of revenues from tax avoidance and the loss of income earned by central banks through investment of the proceeds of note issues (seigniorage).[2] It also raises important questions regarding the control of money laundering and consumer protection. Privacy is also likely to become a important issue for governments. Further, in theory the widespread use of e-cash and real time (immediate) gross settlement could render government-issued media of exchange obsolete.

The overall impact of e-cash will also depend on the pace and direction of technological change and the response to this by consumers, businesses and governments. For example, public key cryptography and encrypted data communication is essential for the effective functioning of electronic commerce. Many Western governments consider encryption technology to be a military secret. In some countries, such as France, its use is prohibited. However, advanced encryption programs, such as Pretty Good Privacy, which are difficult to decode even with the aid of super computers, are currently freely available over the Internet. Such programs allow for relatively secure communication over the Internet. However, notwithstanding the potential benefits of e-cash, it should be borne in mind that consumers often eschew the use of new technology (Levy, 1996).

International Regulatory Responses to E-cash

Currently, more than ten major international reviews of e-cash are under way (Electronic Commerce Task Force, 1996:136-9). For example, the Asia Pacific Economic Cooperation Forum Ministers for Communications have jointly agreed to promote electronic commerce through the Internet, which will require greater regulatory compatibility between countries (*Australian Financial Review*, 9 October 1996). The Society for Worldwide Interbank Financial Telecommunications has established common technical standards for international financial transactions (Financial Systems Inquiry, 1996:293, 300). The Bank for International Settlements (1996) is closely monitoring technological and regulatory developments impacting on electronic money. Some international reviews have a more specific focus, such as assessing the impact on particular areas or groups. For example, the International Organisation of Securities Commissions has established a working group to assess consumer protection issues. The Organisation for Economic Cooperation and Development (OECD) is currently developing guidelines for a global Internet tax (*Australian Financial Review*, 4 March 1997).

Many individual countries are undertaking research and seeking to institute regulatory regimes for future innovations in Internet technologies. For example, a task force established by US President Clinton to investigate e-cash has released a

[2] In Australia, the annual value of seigniorage was equal to between 1.5 and 3.5 per cent of total Commonwealth outlays in the 1980s and early 1990s (Harper & Leslie, 1996:26).

draft report titled 'A Framework for Global Electronic Commerce' which covers nine key issues, from taxation to customs and privacy. In particular, it has recommended that no new taxes be imposed on Internet commerce (*Australian Financial Review*, 9 December 1996). The Vice-Chairman of the US Federal Reserve Bank, Alan Blinder (1995), has stated that 'the Federal Reserve has not the slightest desire to inhibit the evolution of this emerging industry by regulation, nor to constrain its growth. ... [T]he Board ... will continue to encourage innovations in payments technologies that benefit consumers and businesses'. He has called on US regulators to avoid impeding introduction of electronic commerce.

While governments and international agencies broadly accept the likely growth in e-cash, they are uncertain how to design appropriate regulatory responses, and are generally adopting a wait-and-see approach to the growth of electronic commerce.

Australian Regulatory Responses to E-cash

Australia's regulatory response to e-cash comprises over 20 domestic reviews of electronic commerce. In addition, several regulators are currently investigating the likely impact of e-cash on particular sectors of the economy and on particular groups (Electronic Commerce Task Force, 1996:130-5).[3] For example, comprehensive reviews of 15 Commonwealth Acts regulating the financial sector are to occur over the next four years, in accordance with the legislation review requirements of National Competition Policy. The most significant review is the Financial Systems (Wallis) Inquiry (1996), which reported to the government in March 1997 (Financial Systems Inquiry, 1997). The terms of reference required the review to:

> ... ensure that financial system providers are well placed to develop technology, services and markets and that the financial system regulatory regime is adaptable to such innovation ... (Commonwealth Treasurer, 1996)

The Final Report of the Financial System Inquiry concluded that a purely reactive approach towards Internet regulation could inhibit the growth of electronic commerce, as many regulatory impediments to e-cash exist, such as uncertainty about the legal status of innovations like digital signatures. It recommended the removal of legislative impediments to electronic commerce, arguing that regulation should not differ between different technologies and should not favour particular types of technology or delivery system. It suggested liberalising access to clearing systems, and argued that Australia should adopt internationally recognised standards for electronic commerce. It concluded that electronic commerce should be

[3] This report lists 19 electronic commerce reviews. In addition, the Human Rights and Equal Opportunity Commission monitors the privacy implications of e-cash. The Corporate Law Economic Reform Program announced by the Treasurer in March 1997 will also consider developments in electronic commerce.

subject to regulation to ensure the safety and integrity of the payments system. It noted that a large number of regulatory and legislative changes will be required in Australia simply to allow for electronic commerce (Financial Systems Inquiry, 1997:56-64).

Moves are currently under way to remove regulatory impediments and remedy the absence of common standards. In particular, Standards Australia — a private sector accreditation organisation — has already issued a report recommending the creation of appropriate infrastructure to use a digital signature system (Financial Systems Inquiry 1996:59). In addition, amendments to legislation including Evidence Acts, to accommodate electronic commerce, are likely to be introduced into the parliament by the end of 1997.

Since e-cash can be stored on computers and transferred through e-mail systems, it may totally bypass the existing banking and financial system and the regulations requiring compulsory disclosure to the Australian Transactions Reports and Analysis Centre (AUSTRAC) of large financial transfers by specified financial institutions. The forthcoming 1998–99 Commonwealth review of the Financial Transactions Reports Act 1988 is likely to address this issue. In the interim, the Electronic Commerce Task Force (1996) prepared a report for the Commonwealth Law Enforcement Board dealing with the implications of electronic commerce for money laundering and other regulations. It assessed the technical and legal features of 'cyberpayments' systems; identified emerging law enforcement issues associated with cyberpayments; and assessed the adequacy of existing laws to regulate cyberpayments.

The Australian Tax Office (ATO) is also concerned about the potential loss of revenue which may arise from electronic commerce though the Internet. It has launched an 'Internet and Electronic Cash Project', which seeks to examine the efficacy of the existing tax structure in the light of innovations in e-cash. Specific issues to be considered include the capacity of existing tax law and administration to deal with money laundering, tax evasion and income non-disclosure, when undertaken through the Internet; the potential erosion of the tax base from commercial use of the Internet; and the extent to which compliance with tax laws may be promoted through organisations involved in Internet commerce, such as Internet Service Providers (ATO, 1997).

The Australian Competition and Consumer Commission (ACCC) has recently established a research program into the implications of electronic commerce for consumer protection. It will examine the difficulties in tracing offenders through the Internet and the jurisdictional problems which arise from the borderless nature of the Internet. It is also developing a code of conduct for on-line shopping (ACCC, 1996:93, 96).

The Australian Securities Commission (ASC) has been extending regulations to electronic commerce. It has established on-line information systems and has released several policy documents. Most notable of these is the recent policy of allowing the use of electronic prospectuses in the financial services industry. This is consistent with the attempts of the ASC to adapt to the changing technology which

is part of the Internet: 'it is important to identify principles that will help business but ensure confidence in an electronic marketplace' (ASC, 1996:34). The ASC is also working with the International Organisation of Securities Commissions to enhance its enforcement activity (ASC, 1997), and in February 1997 it helped organise a conference on electronic commerce.

Even regulatory organisations whose primary role is not to regulate e-cash are developing regulatory proposals which could impact on e-cash. For example, the Australian Broadcasting Authority (1996) reported to the Commonwealth government on 30 June 1996 on the regulation of on-line services and has proposed self-regulatory codes of practice for Internet service providers. Such codes can encompass a variety of regulatory issues, including electronic commerce.[4] Further, the Copyright Law Review Committee (CLRC), which is to report on ways to simplify and improve the design of the Copyright Act 1968 by 30 June 1998, is considering issues arising from the increasing use of the Internet. Its terms of reference require that 'In undertaking the inquiry, the CLRC will have regard to technological developments ...' (CLRC, 1997). The CLRC review has implications for electronic commerce, as many products can be transmitted electronically through the Internet — such as pictures and sound — and paid for by e-cash.

Appropriate Regulatory Responses to E-cash

According to the Financial Systems Inquiry (1997:7), 'Global retail electronic financial transactions are likely to emerge in the near future and will almost certainly flourish over the period to 2010 if the regulatory environment is accommodating'. The development of an appropriate regulatory environment can be assisted through the use of a Regulation Impact Statement (RIS) framework in reviewing existing and new regulation (Industry Commission, 1995, 1996). This approach can significantly enhance the quality of regulation reviews by utilising an analytical framework that seeks to establish a clear rationale and goal for regulation; identification of alternative ways to achieve such goals; an analysis of the impact, costs and benefits of each alternative; transparent consultation processes; and a clear recommendation for an appropriate regulatory response, including processes for the sunsetting or future review of regulation. The Financial Systems Inquiry and other reviews of existing legislation are obliged, under the Competition Principles Agreement between the Commonwealth, States and territories, to employ a RIS framework.

Yet, while some reviews and regulators, such as the ASC, appear to have strong links with international organisations, there is a lack of coordination of reviews within Australia. With the exception of the Financial Systems Inquiry, existing reviews, like that conducted by the ATO, have narrow terms of reference and focus. The Council of Financial Supervisors, which is the main coordinating body for financial sector regulators, does not include among its members important regulators currently assessing e-cash, such as the ATO, AUSTRAC and the ACCC.

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[4] See Senate Select Committee on Community Standards Relevant to the Supply of Services Utilising Electronic Technologies (1995) for discussion of regulation of on-line services.

There is a need in Australia for a whole-of-government response, similar to the response of the US Presidential task force, to bring together each of the separate e-cash reviews and ensure that any regulatory response by governments is well informed, transparent and coordinated. Indeed, in recent months both the Electronic Commerce Task Force (1996) and the President of the Australian Law Reform Commission (1997) have called for improved coordination and cooperation between the large number of Australian e-cash reviews. Clearly, without better coordination there is a greater risk that, as existing regulatory impediments to e-cash are removed, new and unnecessary regulatory impediments to e-cash will be introduced by governments.

Conclusion

The development and use of electronic commerce, including privately issued e-cash, will depend on the pace and development of technological change, its acceptance by consumers and businesses, and the responses of government regulators in Australia and overseas.

According to the Bank for International Settlements (1996), the overall impact of e-cash is likely to be modest, unless its use represents a significant proportion of total economic activity. However, e-cash is likely to result in significant changes in the way economies operate. The value of global transactions over the Internet is estimated to reach US$600 billion by 2000, and US$1,250 billion by 2006 (Financial Systems Inquiry, 1996:85).

Governments have incentives to retain their monopoly over the issuing of currency, chiefly to ensure stability of the financial system, while they also benefit from additional revenues from seigniorage and, in some cases, inflation. They also have incentives to reform regulations to encourage the use of e-money, while also ensuring that it does not have unintended consequences such as undermining the tax base. However, poorly designed regulatory responses by governments could unnecessarily impede the use of e-cash, resulting in the loss of economic activity in the financial, retailing and other sectors, and a loss of tax revenues to countries with better regulatory environments.

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REVIEWS

Not Filling the Gap

*Stephen King and Rodney Maddock, **Unlocking the Infrastructure: The Reform of Public Utilities in Australia**, Allen & Unwin, Sydney, 1996*

*Reviewed by **Robert Albon***

MY expectations of this book were substantial: two distinguished economists, one (King) a member of The Australian National University, the other (Maddock) of La Trobe University, with considerable experience in the infrastructure area tackling problems of great national importance in a very timely publication. Unfortunately, it appears I was overly sanguine.

The depth, breadth and quality of coverage of different topics are uneven, and discussions of particular topics are almost arbitrarily spread over the ten chapters (examples are considered below). One gains the impression that the authors may have been under some pressure to get the book out quickly, and may have devoted too little attention to the time-consuming and tedious aspects of good publishing practice. The book could have been so much better if more attention had been paid to structure and presentation, leading to tighter and more focused analyses of key topics.

The material on general public utility reform (principally in Chapter 2) is rather thin. There is only a cursory review of some of the major public utility industries: telecommunications, posts, water and sewerage, and electricity. While there is some discussion of the change in performance over time, there are no international comparisons of performance. International benchmarking has been very important in the debates about key Australian public utilities. The work of the Bureau of Industry Economics on international performance indicators (covering all important public utility industries) is overlooked completely. The accounts of events in New Zealand and Britain are too brief (about a page and a half each) to be of much use, especially as they are almost totally unsupported by references.

Chapter 3 on the origins and development of the national competition policy is a handy guide to the Hilmer reforms that emphasises the fundamental nature of the changes.

Public utility pricing theory and regulation are treated in Chapter 4. There are several problems with the approach adopted. First, the discussion does not really capture the essence of the public utility pricing problem, namely, the conflict between the efficiency benefits of pricing at marginal cost on the one hand, and of covering total variable and fixed costs on the other. Second, here and elsewhere, the authors do not completely come to grips with the different concepts of 'marginal cost' relevant to public utility pricing analyses. Third, the review of the public utility

pricing literature is far from complete, although two-part pricing and peak-load pricing are covered later (in Chapters 5 and 7 respectively). The authors move on quickly to regulation of prices, covering topics such as asymmetric information, rate-of-return regulation and price caps. The chapter concludes with discussions of contestability analysis and the role of competition by access in achieving efficient outcomes.

Chapter 5 deals with 'natural monopoly and essential facilities'. Natural monopoly is covered in a rather interesting way, although I have some difficulty with the statement that 'natural monopoly does not refer to an industry structure but rather to a form of cost-minimising technology' (p. 72). There is a good discussion of 'essentiality', and this idea is neatly related to the approach in Australia's competition policy reforms.

Chapter 6 is about access to essential facilities. This is an interesting chapter. Surprisingly, however, it does not contain a clear statement of Baumol and Willig's 'efficient component pricing rule' (ECPR), an idea which has excited much interest in a variety of access discussions. Indeed, while this rule is referred to in a number of places, nowhere in this book is the ECPR clearly defined or discussed in any detail. The ECPR is endorsed for the postal industry (pp. 150-1), but rejected for telecommunications in favour of 'directly attributable incremental cost' with an up-front charge (pp. 141-2). The lack of detail and indecision on this key issue is a major weakness of the book.

The issue of vertical separation arises in Chapter 6, specifically in relation to fears of double marginalisation and loss of economies of scope arising from separation. Vertical separation is also discussed in Chapter 8. The authors display strong scepticism about separation, especially as a general approach. The discussion would have been better if it had been more integrated and more closely related to concrete cases such as electricity and telecommunications.

Access and investment are covered in Chapter 7. This includes an account of peak-load pricing principles, including under uncertainty. However, Oliver Williamson's (1966) seminal paper (including his handy 'demand-for-capacity schedule') is not referred to; and there are the recurring problems with marginal cost concepts, including in relation to Figure 7.2 (discussed below). The theory is related to the approach taken in the national competition reforms. The conclusion is sobering: 'there are no simple solutions to investment issues' (p. 123).

Case studies of three industries — telecommunications, posts and gas — are presented in Chapter 9. The treatment of telecommunications is useful, although not all of the issues raised in previous chapters are canvassed. The inclusion of the postal industry, which is so often overlooked, is welcome in this book. The authors broadly favour a case-by-case approach rather than the national approach being adopted in Australia. Chapter 10 contains a rather pessimistic overall conclusion, suggesting that these reforms will not bring 'widespread benefits' (p. 175).

There are two further areas of broad concern with the book. First, there are some technical deficiencies. As mentioned, concepts of marginal cost are not always clearly defined or explained, and impossible relationships between short-run

and long-run marginal costs are proffered (in Figure 7.2, for example, where the two schedules are parallel). Where marginal revenue is drawn, it is in all but one case presented in a way that could not possibly be derived from the underlying demand curve. Further, where there are price and quantity numbers on axes these are all scale-defective, in many cases very clearly so. These latter two problems come together in Figure 6.1 (p. 89), where the marginal revenue curve is drawn far too steeply, leading to the scaling problem where 99 appears to be about one-third of 198 instead of one-half. Of the eleven diagrams, eight have at least one defect.

Second, there are substantial problems with the referencing. The reference list is not as comprehensive as it might be, reflecting gaps in the book's coverage of both theoretical and empirical materials. The poor editing is reflected in at least eight items referred to in the text — for example, Hackett (1993), Perry (1989) and Taparell (1995) — being completely absent from the reference list. Further, there are many mistakes — *not* typing errors — in the reference list.

Given all these concerns, the book may be a useful primer for a wider readership less interested in technical details, but will be of less value to more experienced practitioners and advanced students. Of course, there are some valuable discussions, but there are others that cannot be recommended without caveat. There are substantial gaps in both the theory and applications, and some of the technical analysis is untidy. The material is badly presented and particular discussions are difficult to find. This is not aided by a rather poor index. These defects are unfortunate given that a more advanced book of this kind would fill a clear gap in the market.

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Competition and Monopoly in Public Utilities

Megan Richardson (ed.), ***Deregulation of Public Utilities: Current Issues and Perspectives****, Centre for Corporate Law and Securities Regulation, University of Melbourne, 1996*

Reviewed by ***Alan Moran***

THIS excellent collection of papers provides both a guide to the new competition regime in Australia and insights into the practicalities of its operation in the energy and telecommunications fields.

Pride of place is given to Michael Trebilcock and Michal Gal's contribution on the theory, which they discuss in the context of a study of deregulation of electricity and gas in Ontario. Electricity developments of Ontario Hydro (quaintly named in view of the fact that 60 per cent of its output is nuclear) lag behind those of Victoria, Australia. However, Ontario confronts the same problem of how to create a competitive system where some parts are natural monopolies and some vertical integration could lead to lower-cost production.

Trebilcock and Gal offer references to suggest that, in static terms, the savings from integrating electricity could approach 12 per cent of total costs. This finding will not impress contemporary policy-makers in North America, the United Kingdom or the Antipodes, where disaggregation is the favoured approach on the basis that vertical integration could thwart the creation of savings stemming from the dynamics of competition. Around the edges of that basic stance, many issues remain to be resolved, such as the degree of disaggregation and the need for disaggregation at the local level in distribution and retailing of electricity, where there are economies of customer interaction but the advantages held by incumbents pose obstacles to new players. (Curiously, Philip Williams, in one of his two contributions to this collection, dismisses out of hand the possibility that such economies are possible and enthusiastically advocates enforced structural separation at the retail/distribution level.) There are also issues of reintegration, convergence of carriers and marketers of gas, telecommunications and electricity, mergers between rival suppliers, and the price of access to main distribution facilities, a matter which is highly contentious in New South Wales at present.

Greater insights for Australian readers emerge from the paper's treatment of gas, in which Australia has no experience of trading. It is difficult to see how competitive rivalry such as exists in North America, with its swaps and posted prices, can emerge in the Australian industry with its monopoly suppliers. Moreover, there is the issue of long-term contracts signed at a time when monopoly provision was assured and potentially undermined by new supplies.

Frances Hanks's Spartan introduction manages succinctly to review the book's contributions and provides insights into the reasons for, and shortcomings of, recent amendments to the Trade Practices Act (TPA). These had their origins in the *Queensland Wire* case, in which BHP was compelled to offer product as raw ma-

terial to a competing firm. Hanks, like Warren Pengilley and others, adverts to the immense difficulties faced by the court in deciding the price at which the monopolist would be compelled to sell. She points out that the Hilmer Committee was naïve in its treatment of Section 46 of the TPA; but the legislation of Part IIIA shows even less inhibition and arrogates to the Australian Competition and Consumer Commission (ACCC) wide powers to determine the policy on access and to grant immunity from the court for access regimes it considers to be acceptable. Efficiency is the goal, but there are many dimensions to this: improved economies of scale, better resource utilisation, or rivalry that generates Schumpeterian gains. The guidelines give very broad scope to the ACCC and its sister agency, the National Competition Council, to decide which of these to apply.

This matter is taken up in the commentary by Jim Holmes, who notes that regulators tend to seek and amass whatever power they can and need to be constrained if light-handed regulation is not to disappear.

Part IIIA of the TPA was carefully limited to service industries, in recognition of the fact (notwithstanding the *Queensland Wire* case) that it would be inappropriate for a car manufacturer or a newsprint mill to be compelled to supply competitors. But (though Hanks does not address it) the exclusion of 'production processes' from the Act's ambit is qualified by the phrase 'except to the extent that it is integral but subsidiary to the service'. This opens a yawning gap that many would like to use to compel owners of gas-processing plants to open them to competing supplies of raw gas on terms ultimately determined by the regulator. Beneficial though this might be in the short term, the outcome could create a new dimension of sovereign risk that would inhibit future investment.

Stephen King's article on asset valuation carefully disassembles the different bases on which asset prices can be established as the foundation for a regulated access price. King has published his analysis in a number of places. His conclusion that historical costs should be the fall-back position where agreement is not voluntarily reached pleases many users but begs many questions. If historical costs are the basis for charging, should output from fully depreciated assets be free? If so, on what basis should access be determined where there are many suitors for it? If the allocation is to the users in place and the capacity is tradable, as it surely should be, the beneficial ownership has migrated from the original owner to the customer. It is unlikely that this directs the incentives for building new links to the appropriate party. Moreover, by analogy with other industries, if historical costs are the correct basis for charging, it would seem that ICI should give away its ethylene from its older plants!

Henry Ergas's essay contrasts the very light-handed approach to telecommunications regulation in New Zealand with that practised in Australia. He concludes that New Zealand has achieved the better outcome, at a quarter of the cost to the public purse. According to Ergas, NZ Telecom has achieved much faster productivity gains than Telstra (some of which, he acknowledges, are a matter of catching up). He concludes that New Zealand prices are now lower than those in Australia, and that NZ Telecom has lost market share no more slowly than Telstra.

Naturally enough, this view of the world is hotly contested by AUSTEL (though unfortunately not in this collection). One important consideration is that the bulk of NZ Telecom's gains were established under the reformed monopoly prior to the establishment of the light-handed regulation. In other fora, Neil Tuckwell of AUSTEL has argued that New Zealand is better placed to achieve lower prices because of the structure of its market in both local and international calls; but, even so, Australian prices are no higher. However, the benchmark that Tuckwell uses — calls between New Zealand and Australia — shows New Zealand's rates to be lower. It is also true that Telstra has been inhibited in achieving management downsizing by political constraints.

A sour note is injected into the collection by Philip Williams, who is a much better economic historian than an economist. Williams takes issue with the Industry Commission's (IC) pioneering 1989 paper on electricity, *Energy Generation and Distribution*, which was arguably the crucible in which the present approach was forged, at least in Australia. He suggests that the IC view that there should be a 'law of one price' reflects poorly on the training of economists in Australia. As a long-standing teacher in the profession, Williams would be aware of how poorly the subject is taught. While, as he says, there is nothing wrong with price discrimination — it allows cost-effective theatre matinees to be shown and cheap tickets to the ballet for the indigent — it does not promote efficiency where it stems from regulatory fiat. The 'law of one price' does not mean a single price; time considerations, quality differences and other matters are likely to mean several prices for different products.

Ramsey pricing, which Williams advocates, is based on prices (on taxes, in its original formulation) that defray costs in proportion to the strength of demand for each of the total product's joint outputs. Market-based variations of this are found in products as diverse as motor cars, alcohol and hotel rooms, where suppliers are able to obtain a higher contribution to their profits from the more luxurious goods in the range. Their ability to do so is, however, constrained by competition. A perverted form of Ramsey pricing was applied to monopoly electricity supplies so that commercial businesses (which were tied to their location) were milked, consumers who are able to exercise political power received relatively advantageous prices, and footloose major users could negotiate highly favourable prices. None of this is possible with homogenous products like electricity once arbitrage is permitted. Those benefiting from low prices would sell their contracts until an equilibrium law of one price prevailed. Ramsey prices are therefore consigned to the dustbin of economic history once a free market is created.

The papers in general add up to a first-class review of the issues arising from deregulation of services with monopoly elements and provide a good fusion of the theory and its practical applications.

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Conservatives or Radicals?

*Ernest Gellner, **Anthropology and Politics: Revolutions in the Sacred Grove**, Blackwell, Oxford, 1995*

*Reviewed by **Roger Sandall***

THE natural politics of anthropology are conservative. Conservatives believe that our inherited social arrangements embody the accumulated wisdom of the past, that they express the unique spirit of different nations and peoples, and that the modernising impulse should be strictly curbed. Since this is exactly what anthropologists say about primitive cultures, it surely follows that anthropology promotes a conservative world view. Yet anyone who has met anthropologists in the flesh will soon have noticed that their political temper is usually radical. At home, within the cramping limits of an academic jurisdiction, they seek to undermine the legitimacy of the culture that gives them bed and board; abroad, they often ally themselves with revolutionary causes. These essays by the late Ernest Gellner, who held chairs in both philosophy and anthropology in the UK, help to explain this paradox.

In his paper 'Culture, Constraint, and Community', Gellner gives us a glimpse of the conservative nexus. First written for a long view of humanity over the last few million years, it emphasises how 'volatile' we are behaviorally, how genetically underdetermined and underprogrammed and unpredictable — at least by comparison with the rest of the animal kingdom where genes do the work of direction and control. Men and women are rather too imaginative for their own good. Bewitched by unending possibilities, they must be firmly told what to do; and that is the role of culture. Common sense must be taught. Moral rules most be imposed. And Gellner's important and original point is that systems of moral rules must therefore have been there from our very beginnings. The 'under-programmed' nature of human nature means that, right from the start, when we first stopped having orangutans home to dinner, 'genetic underprogramming must have been linked to the presence of a compensating system of cultural/linguistic restriction. . .' (p. 61). Optimistic liberals are inclined to regard genetic underprogramming as mankind's greatest glory, our biological charter of liberation. But there's a downside too. Precisely because of the absence of 'built-in' controls, the addition of 'built-on' systems of discipline and coercion is imperative. Genetic looseness and tight cultural controls are the two equally necessary sides of being human. Without the one, no progress. Without the other, chaos.

'De Maistre observed that the executioner is the foundation of social order' (p. 58), writes Gellner, noting that while this is part of the political story it is only a part. But with the lessons of De Maistre's executioner and Hobbes's fear of chaos seeming to grow so naturally out of anthropological soil, how is it that on their home ground most anthropologists are inveterate pull-downers, dismemberers, upheavers of all that is secure? And, more amazingly, how can such a radical cast of

mind simultaneously admire the primitive and the ancient, where harsh coercion enforcing every sort of cognitive absurdity has widely prevailed? Does it reflect merely the Romantic triumph of hope over experience, or could there be more to it than that?

In the essays 'Past and Present' and 'Anthropology and Europe', Gellner locates the immensely influential Polish anthropologist Bronislaw Malinowski within the decline of Habsburg rule and 'an age of irredentist nationalisms [where] the limits of a culture were soon to become the limits of the territorial claims of the state which found its *raison d'être* in protecting that culture' (p. 95). In this setting, Romantic idealisations of 'culture' certainly made themselves felt, and Malinowski's anthropology, which defined cultures as institutionally interrelated organic wholes, can be seen as a natural enough intellectual reflection of this environment. This conception of the internal unity of cultural systems descends in an unbroken line from the 18th-century pioneers of romantic nationalism, Herder and Hamann.

So far, perhaps, so Romantic. Yet there was nothing Romantic about Malinowski's interest in the positivism of Ernst Mach, or the thesis he wrote on that topic which was honoured by the Emperor Franz Josef himself. Nor did he feel driven to romanticise cultures, however whole and organic, where the ordinary life of the native might not have been 'solitary', in Hobbes's phrase, but was all too often 'poor, nasty, brutal and short'. British anthropologists in the Malinowskian mode by and large called a spear a spear, took a clear-eyed empirical look at even the most curious beliefs and practices, and never found the increasing moral and cognitive relativism of their American colleagues entirely convincing.

So where does today's nonsense come from: the view that all cultures are equal — cognitively, morally, aesthetically, and all the rest? Gellner's attempt to fix the blame on American naiveté and ethnocentrism is funny and not wholly implausible. According to him, three centuries of life as independent farmers and small businessmen had given Americans the impression that the way they lived was the way everyone lived: that the 'truths' announced in the Declaration of Independence were indeed 'self-evident'. Then in the 20th century 'the idea of culture' came along and knocked them head over heels. Gellner claims that the effect of such a discovery on unprepared minds will be 'wildly exciting, intoxicating and utterly vertiginous. It will be addictive and constitute a revelation' (pp. 19, 20). It will lead to the liberating conviction that nothing whatever is self-evident and that anything goes, and to the relativism now so pervasive in academic circles.

It's a nice try. Certainly Gellner is on to something. What he is describing is perhaps best exemplified by the missionary conversion phenomenon: the frequency with which, after the culture shock of sitting down with savages, Christian priests and missionaries became persuaded that the moral world of the primitive was superior to their own. But whatever may be true of America, the influence of large numbers of quasi-religious members of the anthropological fraternity will take us only so far in explaining the general appeal of radicalism within the profession. Much more important has been the painful discovery on the Left that the industrial working class would never effect the change to socialism, the need for someone else on

whom to fasten one's millenarian hopes, and the resulting idealisation of pre-industrial cultures and ways of life. In England, intellectuals with classy accents and a taste for Marx long ago discovered how much more comfortable they felt sitting down with African chiefs than with Manchester mill workers. They never were happy with ordinary workmen. Eventually, as disenchantment with the working class became general, the adoration of Third World cultures replaced the worship of the proletariat in virtually all progressive minds. This became modern anthropology's radical nexus.

Gellner has interesting things to say about modernisation, about Freud's treatment of the origins of conscience and society, about Sir James Frazer's influence on T. S. Eliot, about the future of warfare — and much, much else. The two pages where he explains why he believes it unnecessary to impose a formal Prohibition of Hermeneutics are funnier than anything I have read from an anthropologist in a long time, and the range of his commentary is a saddening reminder that with his recent death the last great cosmopolitan intellect in anthropology has passed away. But the essays of most interest to the educated general reader are likely to be the first and the last: 'The Uniqueness of Truth' and 'The Coming *Fin de Millénaire*'. Here he directly confronts the epistemological folly so popular today, which has seen one-time Departments of Anthropology turned overnight into Departments for the Defence of the Absurd. Scientific knowledge, which Hermann Eutic and his mates have perversely tried to relativise out of existence, is now a universal feature of modernity and 'the most important single fact about our world. To deny it, under the delusion that this furthers the cause of human equality, is at best an absurd self-indulgence' (p. 4). As for Professor Geertz's claim that 'anti-relativists' are men afraid of their own shadows, Gellner has this to say:

> The truth is quite different. It is only a failure to understand the issues which permits such debonair nonchalance. Cognitive relativism is non-sense, moral relativism is tragic. You cannot understand the human condition if you ignore or deny its total transformation by the success of the scientific revolution [which] in no way involves unequal treatment of people — quite the reverse. . .

To grasp the nature of the modern world one must start 'from the indisputable fact that genuine knowledge of nature is possible and has occurred, totally transforming the terms of reference in which human societies operate'. To pretend otherwise is an irresponsible affectation. 'The *fin de millénaire* should have its fireworks', he concludes, 'but let it not deprive us of our sense of reality' (p. 252).

After teaching in the Department of Anthropology at the University of Sydney for 20 years, Roger Sandall retired in 1994.

Agenda, Volume 4, Number 3, 1997, pages 389-90

CORRESPONDENCE

From Ross Parish

IN advocating the lifting of the export ban on Australian native birds, Brendan Moyle ('Saving Australia's Parrots from the Export Ban', *Agenda,* Volume 4, Number 1, 1997, pages 127-132) argues that 'it is not obvious that lifting the export ban would result in a greater traffic of rare species; quite possibly, fewer rare species would be exported, since legal exports may depress prices'.

But how could this be? Legalising exports would not reduce the demand: if anything, it would increase it, since some potential buyers may currently be inhibited from participating in a dubious trade. Legalisation would depress prices all right, but only by reducing the scarcity of bids, that is, inducing an increase in supply.

***Brendan Moyle** responds:*

MY statement needs some elaboration. On the face of it, it is contrary to economic logic. The fall in price should follow from an increase in the legal exports. Hence, it does not seem possible that legalising the export trade would lead to lower exports.

Yet it is quite conceivable that legalising the trade would lower both prices and exports, for three reasons. The first reason relates to the pricing rules in the legal and the black markets. In a legal market, arbitrage will tend to bring all prices down to a market clearing price. In a black market, smugglers can practise full price discrimination. They can discover the maximum price a collector is willing to pay for a parrot and charge this (Hoser, 1993:23). The collector is unable to shop around for a better price as this increases the likelihood of being caught. The return in a black market is therefore higher than in a legal market, prompting a higher level of exports. Legalising the market lowers the profitability of each bird.

The second reason is related to the collecting impulse. Part of the demand for rare parrots is related to their rarity. In the Australian case, this rarity is created by the export ban. Owning an Australian parrot signals to other aviculturists a superior breeding skill or collecting ability. If the export ban were lifted, some of the demand for Australian parrots would ebb as this signal would no longer be given.

The third reason is that aviculturists in the importing country will try to meet some of the (now) legal demand for Australian parrots. Currently, smugglers do not encourage their consumers to breed from the stock they provide. It has been alleged that smugglers even sterilise their stock (by radiation) to discourage their market from building up a breeding population (Hoser, 1993:8, 26). However, aviculturists in the export market can and will acquire skills in breeding these birds (in much the same way that New Zealand breeders already have). So some of the de-

mand for Australian parrots would be met by domestic breeders who compete some of the legalised market away from Australian exporters.

It is, therefore, not obvious that relaxing an export ban would lead to a greater traffic of rare species. If the effects described above dominate, the level of legal exports could be lower than the present illegal level. The real conservation gain from legalising exports is that it could prompt a supply-side response by landowners to preserve parrot habitat (Vardon et al., 1997). After all, the loss of habitat to encroaching agriculture is a much greater threat to most wildlife than illegal harvesting (McNeely et al., 1990).

References

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From ***Peter Urban***

I would like to endorse the criticisms of the Development Import Finance Facility (DIFF) that Ross McLeod and Sandy Cuthbertson made in their recent article ('The DIFF: An Obituary', *Agenda*, Volume 3, Number 4, 1996, pages 517-522). If anything, the benefit-cost ratio they give is overly favourable to the DIFF.

Using their example, imagine a market for clinics in the recipient country, with supply perfectly elastic at the world price of $80,000 per clinic and demand downward sloping. If the demand curve intersects supply at a point where the recipient country would, in the absence of the DIFF, establish fewer than a further 286 clinics (most countries will establish some clinics even without aid funds), the value of the marginal clinic will be less than the $80,000 that McLeod and Cuthbertson assume, and the benefit-cost ratio with DIFF will be even less than the .43 they calculate. The value of the marginal clinic could easily be only $65,000 in the recipient country, implying a benefit-cost ratio, at the margin, of zero and, depending on the slope of the demand curve, an average benefit-cost ratio of less than .3.

A major argument used to justify the DIFF and now to support a 'soft loan' replacement for it is that the DIFF allowed AusAID to leverage up the size of its aid projects. Yet the bigger a project is, the more likely it is that its benefit-cost ratio will not be much greater under a soft-loan scheme than under the DIFF, even if the soft loan is untied. (Using the example of McLeod and Cuthbertson, and assuming that in the absence of the aid the recipient country would establish fewer than 286 more clinics, we can derive a benefit-cost ratio of .675 or less for an untied soft-loan scheme.) One can only hope that the government is very careful in the design of any replacement for the DIFF.

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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)

Censorship and Maturity

Michael Warby

ON 28 January, my family suffered a terrible tragedy. At the 'Billabah' property near Narrendera, New South Wales, Sarah Warby (aged 62) and her daughter Amy (23) were attacked and murdered. It was Amy's birthday. The details of the family horror need not be dwelled upon, but it was a particularly vile example of human criminality.

The reason you have not heard of this event is that it took place in 1911. Sarah Warby was my great-great-grandmother. Two labourers were convicted of the crime — the jury took a mere 15 minutes to return a guilty verdict — and hanged. As we shall see, claims about the effects of words and pictures on impressionable minds were raised at the trial. Confronted with the reality of human evil, particularly within one's own society, there is a great temptation to attribute blame according to one's personal prejudices or obsessions, especially if they conform to popular taboos. A ritual exorcism can make us feel better. Censorship is one such example.

There are signs that society is becoming more censorious. For example, the debate over pornography on the Internet, particularly in the early stages, showed every sign of being a classic moral panic. Both New South Wales and Western Australia have sought to censor Internet access, despite the considerable difficulties involved and the existence of products allowing parents to control the Internet products that home computers can access. As well, in 1997 the Commonwealth government considered restricting the supply of X-rated videos to Australians. The

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suggested new category of non-violent erotica (NVE) would probably be more restrictive than the previous X-rating. For example, the presentation of adults as if they were under age would be banned, and all persons appearing would be 18 or more years of age. The boundaries would be determined by official rulings on what is 'demeaning' or 'offensive to community standards'.

Order and Discipline versus Freedom and Responsibility

The central and abiding issue at stake in the debate about censorship is whether people are to be treated as adults. It is about the clash between the order-discipline view of society and the freedom-responsibility view.

These competing paradigms of society are deeply embedded in Western history. At the heart of the order-discipline paradigm is the desire for a unified collective purpose, for community. The ultimate, yet degenerate, expression of this paradigm is totalitarianism, in which the demand for the total discipline required to forge a common purpose from diverse human beings becomes self-defeating as powerholders reject the constraints that a commitment to genuine order requires. At the heart of the freedom-responsibility paradigm, meanwhile, is the ideal of the autonomous individual, of liberty. Its ultimate and degenerate manifestation is antinomianism, in which the demand for total freedom subverts any serious sense of responsibility or personal restraint. During the 1930s, the totalitarian temptation beckoned and corrupted Western intellectuals. Since the 1960s, the antinomian temptation has been the dominant temptation and corrupter.

When arguing across paradigms, there is a natural tendency to see one's opponents as incipiently defenders of the ultimate, degenerate, case of their paradigm. Advocates of censorship are seen by their opponents as incipient totalitarians; advocates of liberty appear to their opponents as incipient amoralists. This is a temptation to be resisted.

Arguments for Censorship

Pornography harms the consumer of it. Advocates of censorship typically claim that one must be harmed by looking at pictures or films of people engaged in the sexual act. But if one finds that sex is fun, and that watching people having fun is fun, the notion of being harmed by pornography is problematic. The claim that it is harmful begins to make sense only if the ground is shifted to the more perverse forms of pornography. Anti-pornography activists like to characterise all pornography in terms of the contents of some pornography.

Let me be quite clear here. The capturing on film or other mediums of actual criminal acts (murder, rape, assault) committed for the purpose is a criminal act. The suppliers and viewers of such are accessories after the fact and the law should treat them accordingly. This is not an argument for censorship but for taking criminality seriously. It recognises the distinction between using the law to protect individuals and using it to enforce sexual mores and taboos. However, this distinction is irrelevant in the case of simulated criminality: otherwise, most films, all mur-

der mysteries, most novels and so on would have to be banned. Indeed, if censorship was based on a proven connection between incitement to violence and violent behaviour, then we would have to ban the Bible, the Koran, the collected works of Marx, Engels and Lenin. Compared with the level of violence and destruction that the ideas in those books have inspired, the impact of pornography is trivial indeed. (One of the reasons we do not ban such books is that religion and politics are not deeply taboo subjects, so one is allowed to argue for their good points and to be taken seriously.)

What is crucial here is how one views other people. Anyone who thinks people are harmed by consuming pornography is free to recommend that they abstain from it. That is how adults talks to one another. To argue that the criminal law should be used to stop people harming themselves, especially when it is debatable whether they really are harming themselves, is to treat adults like children. Adults persuade; children are forbidden. It is utterly foolish, and a misuse and diminution of the high purpose of criminal law, to criminalise the visual or other representation of non-criminal acts.

Sexual offenders are often consumers of pornography. As to the claim that committers of sexual violence are often consumers of pornography, one would be very surprised if the sexually obsessed did not use pornography. But it does not follow from this that pornography causes or aggravates their disorders. Still less does it follow that pornography causes or aggravates sexual disorder more than it provides enjoyment or relief. The capacity of pornography to provide catharsis and diversion of sexual desire is quite significant. The vast majority of consumers of pornography use it for this purpose and do not become sexual offenders. Japan, for example, has both a high level of consumption of pornography and a low rate of sexual crime. The evidence cited below about the rate of surveyed rape is certainly compatible with the hypothesis that catharsis is greater than incitement.

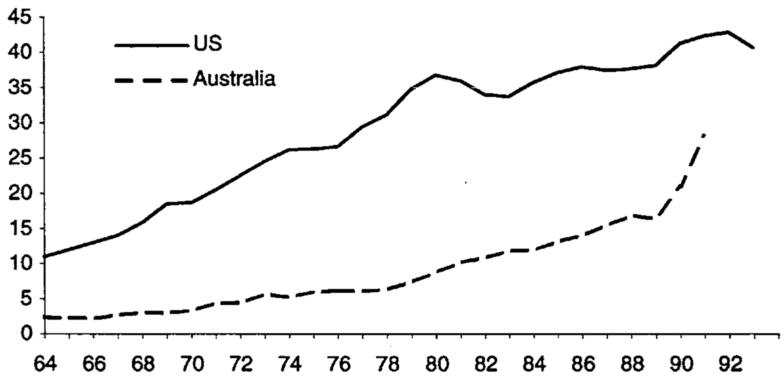
The increasing consumption of pornography is responsible for the rising incidence of sexual crime. Even if the great majority of consumers of pornography do not offend, it could still be the case that readily available pornography is causally associated with the rising rate of sexual crime.

The trouble with this argument is that it is very uncertain whether any such sexual crime wave is taking place. There has indeed been a steady upward movement in rapes reported to police, in both the United States and Australia during the last three decades, as Figure 1 indicates.

Walk away proof that sexual violence is on the increase? Hardly. The degree to which incidents of sexual violence are reported depends on the willingness of the victims to contact the police, and all the extra trauma that involves. To infer from increases in reported crime that actual crime has increased is to assume the rate at which crimes are reported has not increased (a sad case of facts not speaking for themselves).

Figure 1

Rapes reported, US and Australia, 1964-93
Rate per 100,000 women

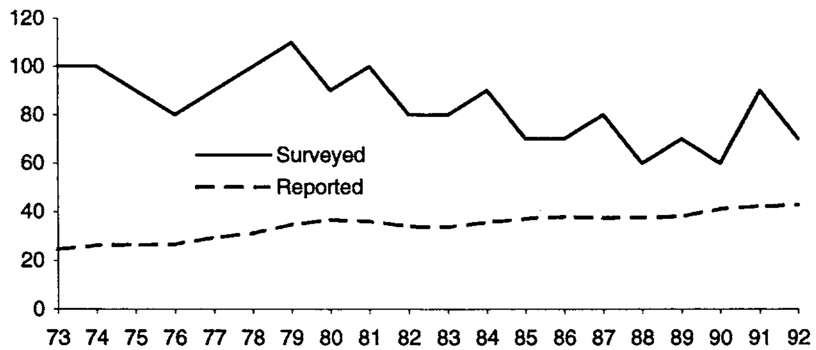


Sources: Statistical Abstracts of the United States; Australian Institute of Criminology.

Does that mean we can say nothing about the real level of sexual violence? Fortunately, no. Since 1973, the US Department of Justice has conducted every year a survey of about 59,000 households to find out the real levels of crime in the US (see Figure 2). This provides some regular indication of, amongst other things, the level of actual rape in American society.

Figure 2

Surveyed and reported rape, US, 1973-92
Rate per 100,000 women



Source: Statistical Abstract of the United States.

It appears that whereas in the mid-1970s only about one in three rapes in America was reported to police, now about two in every three rapes are reported.

Meanwhile, the number of rapes actually occurring has apparently been generally falling.

Should we take these figures at face value? It would be very strange if an increase in the number of rapes reported to police was accompanied by a greatly decreased willingness to report being raped to a confidential survey. We can surely take it that the survey respondents are being truthful. So it is very likely that the real incidence of rape in the United States is, indeed, falling.

Unfortunately, comparable Australian data are very limited. Such data as are available provide no evidence of an increase in the real incidence of sexual violence since the mid-1970s (Walker, 1993). Given that the upward trend of rape reports in Australia is very similar to the US pattern, we have no reason to presume that Australia is very different from the US and so we cannot infer from more reported rapes to more actual rapes.

But how could the level of sexual violence be static or even decreasing while the level of willingness to report it increased? For fairly simple and straightforward reasons. As the fears, ignorance and taboos about sex break down, the stigma attached to being a victim of a taboo-breaking crime — taboos by their nature being a non-rational shunning and mystification of a subject and all to do with it — decreases. A greater willingness to report is accompanied by a great willingness to believe, to help and to not blame the victim. At the same time, the status of women has been rising. As social pressure for women to be treated as truly independent entities entitled to full sexual expression increases, there are more restraints on male behaviour to women.

The Case for Responsibility

The entire notion of causality adopted by advocates of censorship must be treated with scepticism. Consider again why we do not ban the Bible, the Koran or the collected works of Marx, Engels and Lenin, despite the violence that these publications have inspired. We refrain from censoring them because we understand that it is people who act; and we hold them accountable for their actions regardless of what they have been reading. The notion that their behaviour is 'caused' by what they read or watch undermines any serious notion of responsibility or self-control.

Worse than that: it knocks away a mighty constraint on action. It is to say that sex is such a powerful force that it overwhelms personal discipline: that people who are subject to strong sexual stimulation are not to be held responsible for their actions. So not only do advocates of censorship implicitly characterise men as uncontrolled sexual beasts, but they provide an excuse for them to be such. Making images, rather than actions, wicked thus provides another relief from the burdens of responsibility and adulthood. Conversely, an emphasis on the importance of personal restraint, and of social mechanisms of restraint, tends to point away from censorship.

Bans and Corruption

In a free society, distinctions are maintained between the approved-and-legal, the disapproved-and-legal and the disapproved-and-illegal. Legal compulsion is limited and used sparingly, since overreach both maximises failure and undermines legitimacy. But censorship invests the officeholders of the state with a moral power and reach which is entirely inappropriate, beyond their real capacities, dangerous and corrupting.

In any area where there is a high demand for a product, particularly a product the banning of which conveys the message that adults are not to be regarded as owning themselves, prohibition does not raise the question of whether the market for that product will be abolished or not. It raises the question whether the market will be a white market or a black one: how much corrupt income will become available for harvesting by police, politicians and other officials, whether normal legal sanctions for product quality will apply, whether workers in that market will have normal legal protections, whether witnesses are more easily available without fear of self-incrimination, and so on. Continuing corruption in Australian police forces stems inevitably and predictably from futile attempts to ban narcotics and commercialised sex for adults. When this is generally realised, such prohibition is likely to be abandoned.

Bans can work, however, when they are narrow enough to be enforceable. This enables us to deal intelligently with issues like the supply of pornography and violent video games to minors. Banning for minors while permitting for adults does not treat adults as children but conveys disapproval, minimises the size of any black market, and maximises the efficacy of the ban by directing it specifically to the supply of pornography rather than its consumption. It also maximises the disincentive to supply to minors.

Concluding Comment

According to the *Riverine Grazier* (7 April 1911), at the trial of the murderers of Sarah and Amy Warby, counsel for one of the defendants argued that the other defendant's 'mind was inflamed with the stories [and] horrible pictures in the book Australian Bushranging'. Technology marches on, so moral panic now focuses on videos and the Internet, but no more sensibly. We should not promote yet another of the denials of personal responsibility our age is so prone to.

Living in a highly censored society did nothing to save Sarah and Amy Warby. Let us not confuse ritual acts of rejection with serious attempts to tackle the problem of evil.

Reference

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