Agenda, Volume 1, Number 2, 1994

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Has Macroeconomic Policy Failed Australia?

Garry M. White

Should the Australian government's macroeconomic policies embody the less interventionist approach that has successfully characterised its microeconomic policies?

Economic outcomes throughout the late 1980s and early 1990s were generally disappointing. High unemployment and an extended period of low growth were not the outcomes targeted by macroeconomic policy. True, the rapid fall in inflation to negligible levels was welcome; but it too was beyond the intentions of the government. The Australian government's highly active approach to monetary and fiscal policy during that period seems therefore to have had only a marginal effect in a world in which most major economies also experienced low growth, high unemployment and (toward the end of the period) lower inflation. Indeed, to the extent that macroeconomic policy has had any effect at all, this has probably served to exaggerate rather than ameliorate the latest turn of the business cycle.

Policy Objectives

Commonwealth Budget Papers for the period from 1988 indicate that macroeconomic policy was directed at a number of targets, particularly external balance, inflation, employment, growth and saving. The emphasis shifted after 1989 from external balance to growth and employment. As well, the framework within which the external balance issue was addressed shifted during this period from a concern about excess domestic demand to concern about the level of domestic saving. Economists should know that these are essentially different ways of saying the same thing within a general equilibrium framework. But the rhetoric surrounding policy decisions at this time suggests that many policy advisers and commentators thought within relatively partial frameworks.

The following quotations illustrate the government's shifting policy priorities throughout the period.

Garry White is Executive Director of Corporate Economics Australia Pty Ltd.

Table 1

Shifting policy priorities: Quotations from Budget Statement No. 2 (1988/89 to 1994/95)

1988/89	*Economic policies in 1987/88 continued to focus on Australia's current account deficit and external debt position. Sustained growth in output and employment and lower inflation remained important objectives.* (p.9)
1989/90	*The adverse consequences of the exceptional demand growth for inflationary pressures and the external accounts prompted further policy adjustments which were implemented progressively as the strength of demand became clearer. Monetary policy had a particularly important role to play.* (p.2.8)
1990/91	*Monetary policy settings continued to be directed during 1989/90 towards overcoming excessive demand pressures, and the associated worsening of inflation and the current account deficit, that had developed in 1988/89. Those settings also had regard to the underlying need to reduce, in an enduring way, Australia's high rate of inflation.* (p.2.7)
1991/92	*The Australian economy moved into recession in mid-1990 and the labour market deteriorated sharply from late 1990 onwards. The downturn has been longer and more severe than forecast at the time of the 1990/91 Budget.* (p.2.2) *Activity and price developments in 1990/91 were influenced importantly by the monetary action taken in response to the overly strong expansion in 1988 and into 1989.* (p.2.15)
1992/93	*The recovery was weaker than expected at budget time. This reflected the drought, a more subdued international economic environment and continued fragile business confidence.* (p. 2.3) *Policy responded during the year to the weakness of the recovery. Additional expenditures of over $300 million were announced in November 1991. The February 1992* ***One Nation*** *Statement announced a much larger package of measures to boost the recovery process together with structural reforms in a number of key areas. Official short-term interest rates were also lowered significantly during the year, consistent with the marked improvement in the inflation outlook.* (p.2.4)
1993/94	*Reducing unemployment is the main policy challenge facing Australia.* (p.2.30)
1994/95	*The extent of any increase in the current account deficit and in external debt as the recovery progresses will depend on the strength of the pick-up in investment relative to the success in lifting national saving.* (p.2.33)

Forecasts vs Outcomes

Official forecasts can be interpreted not only as forecasts in the traditional sense, but also as statements of how the government thinks its policy settings affect economic outcomes. They include consideration not only of the impact of external influences but also of the anticipated impact of policy.

Table 2

Budget forecasts and subsequent outcomes, 1988-93

	1988/89	1989/90	1990/91	1991/92	1992/93
GDP growth (%)					
Forecast	3.5	2.75	2.0	1.5	3.0
Outcome	4.8	3.3	-0.6	0.7	3.0
CPI increase (%)					
Forecast	5.5	7.5	6.25	3.0	2.0
Outcome	7.4	8.0	5.3	1.9	1.0
Unemployment rate (%)					
Forecast	7.25	6.25	7.25	10.5	10.5
Outcome	6.6	6.2	8.4	10.4	11.0
Current account deficit (% GDP)					
Forecast	3.0	5.0	4.5	3.5	3.75
Outcome	5.2	5.6	4.1	3.2	3.8

Source: Australian Bureau of Statistics, Cat. Nos. 5204.0, 6401.0, 6202.0, 5301.0.

Changes in GDP growth and unemployment were poorly forecast. The economy was stronger than expected in 1988/89 and 1989/90 and then weaker than expected in the subsequent two years. These forecasting errors seem explicable by reference to the pervasive impact of external developments (as discussed below) and the long lag between monetary policy decisions and their effects.

Inflation fell much faster than expected. The only overestimate (in 1989/90) was largely due to the impact of higher mortgage interest rates on the Consumer Price Index (CPI). Net of the impact of interest rates, the inflation rate in 1989/90 was 6.6 per cent.

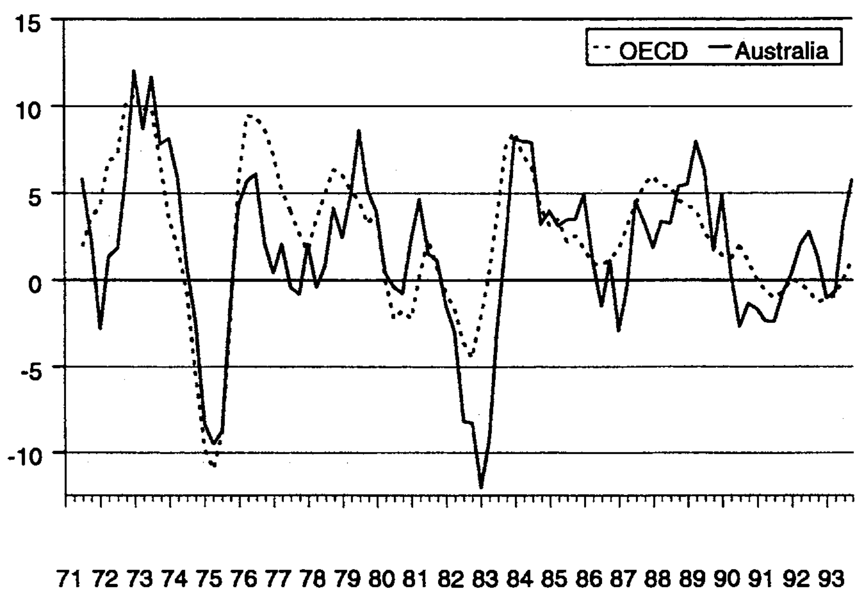
The current account deficit was much bigger than the government expected in 1988/89, when the higher interest rates of that year attracted strong capital inflows (Bewley & White, 1990). Monetary policy takes a long time to affect activity, but it is very quick to affect international capital movements.

The Australian Experience in International Context

Australia was far from unique in experiencing recession during the late 1980s and facing difficulties in restoring growth. In fact, the speed of Australia's recovery has been midway between that of the United States (the first out of recession) and that of Germany (the slowest to recover). This sequence of recoveries stems largely from differential policy settings. The US eased monetary policy first, but Germany continued its tight monetary policy as the Bundesbank grappled with the expansion of monetary conditions resulting from unification with the former East Germany.

Figure 1

Australian and OECD industrial production, 1971-93: % change on a year earlier



Source: Westpac/Melbourne Institute Index, reproduced in Econdata, *RBA Bulletin Database*, Tables G.1 and I.1

Economic growth in Australia has always been strongly influenced by international economic conditions. This close relationship is illustrated in Figure 1, which shows the growth rates of industrial production in the OECD and in Australia. Since data became available to make such a comparison in the early 1970s, industrial activity in Australia has moved closely with, or followed, activity in the major world economies. Clearly, Australia is not the engine for growth in the rest of the world. The Treasury has reported an analysis using its macroeconomic model that suggests that weaker world growth and the associated commodity price decline have

reduced Australian GDP by around 3 per cent since mid-1990 (Budget Statement No. 2, 1993/94:2.34). Between mid-1990 and mid-1993 the economy expanded by around 4 per cent. So relatively depressed international conditions may well have reduced Australia's growth potential by around half. Unless macroeconomic policies have been perfectly coordinated, it is difficult to avoid concluding that economic activity in Australia has been largely determined by external events.

International economic activity influences domestic economic conditions mainly through commodity prices. The terms of trade (the ratio of export to import prices), which are widely used as an indicator of how well the world economy is treating Australia, tend to vary with commodity prices because import prices are relatively stable and Australia exports a high proportion of commodities. If the terms of trade are strong, then the world is willing to exchange a larger quantity of goods and services for the goods and services produced by Australia. If this is the case, Australians are wealthier. Conversely, if the terms of trade weaken, living standards fall.

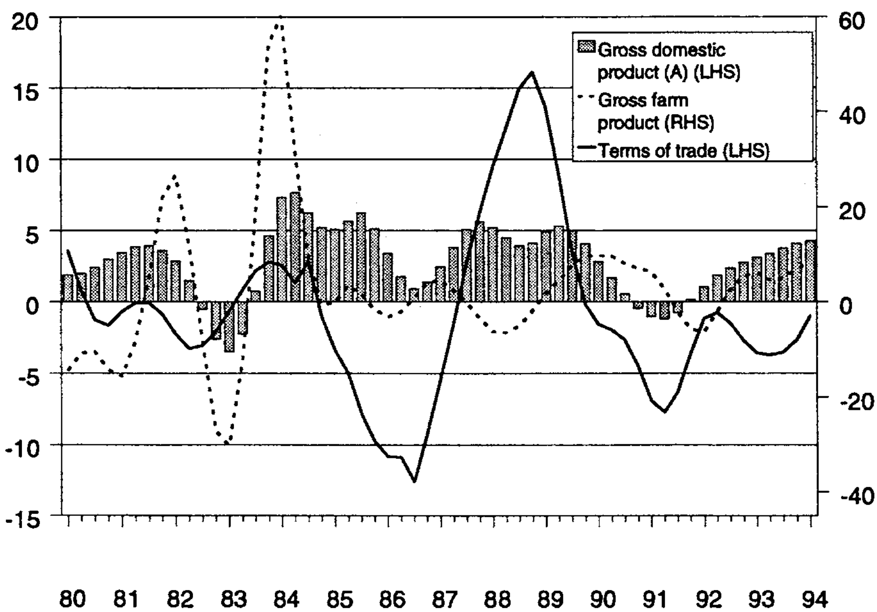
Another factor that appears to have been very important in determining economic activity is the volume of output produced by the farm sector. Farm output is volatile, since it is subject to the vagaries of seasonal conditions. Even though the farm sector represented only 3.8 per cent of national output in 1992/93 (fluctuating between 3.1 per cent and 4.5 per cent since 1980/81), the volatility of output (and linkages to other sectors of the economy) is such that it can still have a major impact on economic activity. The major drought of the early 1980s, for example, provides an explanation for one of the few disparities (in magnitude though not in direction) between the growth in Australian and OECD industrial production. In 1983/84 the direct contribution of the farm sector to growth was around one percentage point. (In view of the long production response lags in respect of price changes, the impact of the change in farm output is a supply shock, distinct from the demand shock transmitted through the terms of trade.)

Figure 2 shows the relationship between the trend growth rates of GDP, Gross Farm Product (GFP) and the terms of trade. For example, the high growth of the mid-1980s was associated with a sharp recovery from drought and a strong rise in commodity prices. Similarly, the boom conditions of the late 1980s were associated with very strong growth in commodity prices. Most recently, the recession of the early 1990s was led by a fall in commodity prices and exacerbated and extended by a fall in farm output.

Domestic policy also had a role in the swings of economic activity. However, the difficulty the government experienced in trying to slow the economy in 1988/89 and then in trying to revive it only adds to the evidence that the external economic and physical environment has a pervasive impact on economic activity.

Figure 2

Trend output, farm product and terms of trade, 1980-94: % change on a year earlier



Source: Econdata, *Time Series Statistics*, National Accounts

The Effect of Monetary Policy

Clearly, the level of economic activity in Australia is very strongly influenced by what happens in the rest of the world. Equally, the different experiences of the US and Germany suggest that (at least for large economies) policy settings can have a major impact on the relative performance of economies.

In a world of floating exchange rates and free international capital flows, monetary policy affects economies very largely through the exchange rate. Australia, for example, chose to float its currency and to liberalise international capital transactions in order to gain independent control over domestic monetary conditions. It is possible to control short-term interest rates or the exchange rate, but not both. Few central banks continue to target the growth of the monetary aggregates because of the instability of the velocity of money supply and the capacity of the financial sector to engineer money substitutes.[1]

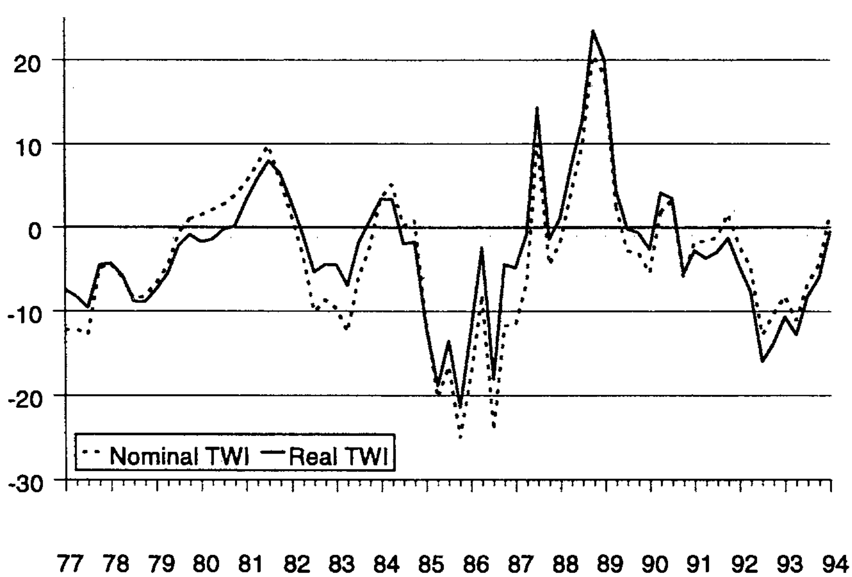
[1] In this article, a reference to a tightening of monetary policy indicates a rise in short-term interest rates rather than a change in the money supply, thus reflecting the way monetary policy is implemented in all significant economies. Nevertheless, large increases in the money supply are inevitably inflationary.

The exchange rate has a direct impact on inflation through the price of imports, import substitutes and exportables, and an indirect impact on inflation through economic activity. Changes in the nominal exchange rate usually result in a similar change in the real exchange rate with a consequent movement in the competitive position of exporters and import-competing industries. Figure 3 illustrates how, within any one year period, changes in the nominal exchange rate are only slightly offset by changes in relative inflation rates. Year-to changes in the Trade Weighted Index are compared to the same series adjusted for the CPI inflation differential between Australia and the average for OECD countries.

To put the magnitude of these changes in competitiveness into perspective, the total value of all current tariff protection is equivalent to a real exchange rate change of 6 per cent. Other forms of industry assistance are small compared to the A$12.7 billion of gross subsidy equivalent provided to industry through tariffs (Industry Commission, 1992/93:409). Figure 3 shows that annual movements in competitiveness through changes in the real exchange rate are typically more significant than government assistance to industry.

Figure 3

Nominal vs real exchange rates, 1977-94: % change on a year earlier



Source: Derived from Econdata, *RBA Bulletin Database*, Tables F9 and G2

However, the exchange rate is determined by a range of factors other than short-term interest rates, including commodity prices (especially for Australia), relative inflation rates, relative growth rates and myriad other factors that take the fancy

of the foreign-exchange market. The major transmission mechanism, therefore, is far from clean. A central bank can observe the equivalent of a tightening or loosening of monetary policy while taking no action other than deciding not to alter short-term interest rates.

Changes in the settings of monetary policy also have an impact on the balance sheets of businesses and households. However, these impacts provide offsetting effects, because households are net lenders while the business sector is a net borrower. So an increase in short-term interest rates has a first-round effect of *increasing* household disposable income and *reducing* business income. These effects can be observed from national accounts data (ABS, various years). Corporate enterprises are clearly net borrowers, and higher interest rates were a key part of the near $7 billion increase in their net interest bills from 1987/88 to 1989/90 as interest rates were raised. Similarly, the gross interest bill faced by unincorporated enterprises including farmers (the interest earned by unincorporated enterprises cannot be separated from the published household sector's accounts) increased by $4.3 billion over the same period. In contrast, the net interest position of the household sector (excluding the borrowings of unincorporated enterprises) improved by $3.6 billion from 1987/88 to 1989/90, but deteriorated by $2.8 billion as interest rates were eased.

In the short term, then, a tightening of monetary policy tends to increase demand from the household sector (higher disposable incomes plus cheaper tradable goods) and reduce output (reduced competitiveness and lower profits from which to fund investment). In the medium term, household income is reduced as lower profits and unemployment reduce the capacity and willingness to spend.

The role of asset prices in triggering inflation in consumption and investment goods remains uncertain. How policy should respond is even more problematic. If asset prices are increasing because of higher income flows from those assets, then it would be clearly inappropriate for the government to intervene. Similarly, if higher asset values reflect genuine scarcities that require changes to relative prices in order to stimulate substitution and structural adjustment within the economy, there is no case for intervention.

In sum, higher short-term interest rates have a depressing impact on activity and inflation only after a long lag. One of the reasons for the long lag is that some of the early balance sheet impacts are perverse.

Fiscal Policy and Economic Recovery

Considerable weight has also been placed on fiscal policy as a lever to encourage a higher domestic growth rate. The Commonwealth's budget balance moved from a surplus of 2.2 per cent of GDP in 1989/90 to a deficit of 3.6 per cent of GDP in 1992/93. Subsequent years are expected to show a reduction in the deficit to 1 per cent of GDP by 1997/98. Economic conditions rendered much of this movement in the budget deficit unavoidable because of lower growth in tax receipts and increased social-security outlays.

Since early 1991, the government's increasing concern about the recession led it to produce, in addition to its normal annual budgets, four major economic statements aimed largely at increasing the pace of economic recovery. This fiscal expansion involved both consumption and capital spending. Yet it had a smaller impact than was desired on growth, which started to revive only when there were signs that the world economy was recovering and the drought eased for much of the rural sector.

It has indeed been the conventional wisdom among many economists that greater government expenditure and higher public-sector deficits lead to greater economic activity. But this economic framework is applicable to a country with a fixed exchange rate — which Australia had when most of the economists who use it were trained. In reality, the impact of a given policy initiative is critically dependent on the prevailing exchange-rate regime. Table 3 shows how major macroeconomic policy shocks can be expected to affect a small country in a world characterised by perfect capital mobility. The table is derived from *Macroeconomics in the Global Economy* by Jeffrey Sachs and Felipe Larrain (1993:417-21). These authors emphasise the need to take a global approach to understanding the impact of macroeconomics.[2] In contrast, much of the economic analysis of the 20th century reflects a perspective relevant to the US, where it was thought that the rest of the world was relatively unimportant and could be neglected for the purposes of economic analysis and policy development.

Table 3

Effects of monetary policy, fiscal policy and exchange-rate policy in a small country with perfect capital mobility

	Monetary expansion		*Fiscal expansion*		*Devaluation*
Effect on:	*Fixed exch. rate*	*Flexible exch. rate*	*Fixed exch. rate*	*Flexible exch. rate*	*Fixed exch. rate*
Output	0	↑	↑	0	↑
Price level	0	↑	↑	0	↑
International reserves	↓	0	↑	0	↑
Exchange rate	0	↓	0	↑	↓

Note: The exchange-rate indicators on the bottom row show an appreciation as an ascending arrow and a depreciation as a descending arrow. This is opposite to the American exchange-rate definition used by Sachs and Larrain (1993).

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[2] The results are based on the assumption that the economy is characterised in the short run by normal Keynesian conditions such that the aggregate supply curve is upward-sloping.

The current situation in Australia is, however, very different from that of the US during earlier decades. Australia is a relatively small country with a floating exchange rate in a world characterised by volatile international capital flows. Indeed, the average daily turnover on Australian foreign exchange markets against Australian dollars has varied between A$18 billion and A$27 billion over the past year (Reserve Bank of Australia, 1994:S50). The Reserve Bank does intervene in the foreign-exchange markets at times; but these interventions are swamped by the huge size of that market. All the Bank can realistically hope to do is smooth movements in the Australian dollar against other currencies.

Sachs and Larrain would predict that a fiscal expansion (whether a cut in taxes or a rise in government spending) would boost output in a country like Australia only if it had a fixed exchange rate. Under a floating exchange rate, a fiscal expansion would fail to increase output because it would require the sale of additional government bonds, which would lead to higher domestic long-term interest rates. Higher interest rates in turn attract additional capital inflow and thereby cause the exchange rate to rise also, producing a fall in net exports. In short, the fiscal expansion is offset by a fall in net exports. But under a fixed exchange rate, fiscal expansion can stimulate activity because there is no immediate impact on international competitiveness. The sale of additional bonds can result in a rise in domestic interest rates or an increase in domestic money supply. The latter results from the central bank having to buy additional government securities and, to fund these, sell foreign-exchange reserves. The additional money supply can be expected to increase output (if there are slack resources in the economy) and to increase inflation.

An anonymous referee has raised an interesting question related to the possible equivalence of an external stimulus from stronger terms of trade (as argued above) and an expansionary fiscal policy. Why would not the currency appreciation associated with a strengthening of the terms of trade offset the direct benefits of that strengthening? The answer is that the external shock is effectively a free good, whereas a fiscal expansion must be paid for either by redirecting domestic savings from other uses or by attracting additional foreign savings (a higher current-account deficit). The currency appreciation related to a strengthening of the terms of trade is necessary to keep the current account in accord with the savings/investment balance, and it also acts to redistribute income from exporters and importers (whose margins have improved) to the rest of the economy. Most econometric studies of the relationship between the terms of trade and the exchange rate find that a given change in the former produces a less than equivalent change in the latter. That is, exporters receive a net improvement in domestic currency prices as world prices improve. At the same time, the prices of their imported and exportable inputs have fallen. An appreciation of the currency following a rise in the terms of trade also provides a net boost to the production of non-traded goods in the economy.

A monetary expansion, in contrast, has a positive impact on output under a flexible exchange rate regime but no impact if the exchange rate is fixed. Under a floating exchange rate, a monetary expansion brings lower domestic interest rates and a lower exchange rate, increasing the demand for domestically produced goods.

Under a fixed exchange rate, an attempt at monetary expansion provokes a capital outflow that offsets the initial monetary expansion. As there is no change in the price level or the exchange rate, there can be no gain in industry competitiveness through a lower real exchange rate.

The call on private domestic or foreign savings to fund a budgetary expansion must have an adverse impact on domestic investment if long-term interest rates are increased. If long-term interest rates are higher, the private sector will be reluctant to invest in any given project, and formerly marginal projects will not proceed.

It is also possible to examine particular unanticipated shocks on the market's expectation of future fiscal outcomes and the resultant change in bond yields. During the early 1990s there was a general downward trend in bond yields as inflationary expectations fell. Around this trend, however, a number of episodes can be identified during which bond yields moved in response to a range of developments. The first was news of the need for higher bond sales in 1991/92 as the budget deficit increased beyond earlier expectations. The second was the anticipation of the fiscal expansion to be delivered in the government's *One Nation* economic statement of February 1992. Third was the adverse reaction to the budget for 1992/93, which confirmed the government's support for the tax cuts announced in *One Nation*. Each of these episodes produced a sharp rise in bond yields. A subsequent episode involved news that the government would be likely to modify or delay the promised tax cuts if it meant compromising the objective of reducing the Commonwealth's deficit to 1 per cent of GDP by the late 1990s. The bond market rallied strongly on this development.

It might be argued that the structural and cyclical components of changes in the government's fiscal position should be separated. However, this is a difficult and, inevitably, an arbitrary process. In any case, the impact of greater spending on the economy should be independent of the official purposes of that spending.

It is sounder to assume that Australia's economic cycle is fundamentally determined by external economic influences, although it can be ameliorated or exacerbated by government policies. But since the floating of the Australian dollar fiscal policy has probably had relatively little influence on the level of economic activity.

Conclusion

The effects of the different arms of macroeconomic policy cannot be separated from their interactions or from the real shocks that have a pervasive impact on the Australian economy. But what happens if, as argued above, the level of economic activity is predominantly influenced by external events (the international economy and climatic factors); policy takes a long time to have an effect; and policy-makers attempt to influence economic outcomes? There is then the real possibility (depending on the length of the world economy's cycle) that policy intervention will be stimulatory when the world economy is expanding, and deflationary when it is contracting. For example, the lag with which monetary policy affects economic activity appears to be around six quarters. The dramatic tightening of monetary policy during 1988/89, when the main factor behind the rapid growth in demand was the

strength of the terms of trade, occurred on the assumption that the world economy would continue to expand. As it turned out, the world economy slowed and the earlier tightening only exacerbated the subsequent recession.

Following the arrival of the recession, monetary policy was eased and fiscal spending was increased. It is doubtful whether the latter produced any benefits, but higher budget deficits have clearly increased long-term interest rates. Fortunately, it appears that the recovery in the world economy will occur over a long period. In this context, the earlier easings of monetary policy in Australia are unlikely to coincide with a sharp world recovery, so rendering monetary policy appropriately supportive rather than inflationary — though more as a result of good luck than of good management.

Policy-makers may need to commit themselves to trying to do much less. If monetary and fiscal settings were subject to less change, economic growth would probably be higher on average. Although, as argued, fiscal policy has little impact under a floating exchange rate, policy changes always impose real costs. A much sounder approach would be to improve the flexibility with which the economies can respond to external shocks. Competitive and flexible product and labour markets would enable output to be maintained through externally generated downturns and minimise the inflationary consequences of externally generated periods of rapid expansion. So long as the government finances its activities through the sale of bonds to the private sector, and so long as domestic markets are competitive and open to foreign competition, it is difficult to see how inflation would become a problem during periods of high growth.

If the government were to pursue a less interventionist macroeconomic policy, two issues arise. What would constitute a neutral stance of monetary policy? And how can policy-makers be persuaded to resist the urge to seem to be 'doing something?'

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Comment

Barry Hughes

Garry White belongs to the school that advises governments 'don't just do something, sit there', for if things are done there is a high chance of a muck-up. However, he has made very heavy weather of restating familiar positions, partly because he wants to run three of them in the same short article, and they tend to get in the way of each other. The newest of the three is the theme of international business-cycle synchronisation. White sometimes comes close to saying that Australian activity (at least the cycles thereof) is determined exogenously by the OECD business cycle, so that there is very little independent macroeconomic policy action that we can take that would influence activity levels. But elsewhere he runs the textbook Mundell-Fleming argument from the 1960s (freshened up in the article with quotations from Sachs and Larrain) that in a regime of flexible exchange rates only monetary policy has activity potency, whereas fiscal policy is impotent through crowding-out effects. Finally, there are Milton Friedman's long and variable lags to guarantee that anything that might have been possible will be so mistimed as to generate perverse results.

I am not sure how White balances the activity implications of these three arguments, but presumably they lead to the conclusions that nothing much happens and that mistaken policy activism results in poorer current-account or inflation outcomes. The low inflation we now experience should pose something of a problem for his argument, but it is summarily dismissed as simply an unintended accident of an external era of quiescent inflation.

Low Inflation: A Policy Success?

Let us deal with inflation first. White states that the rapid fall in inflation to negligible levels was welcome; but this too was beyond the intentions of the government. Nonsense! Reducing inflation has been an important policy goal throughout the period of Labor government, with three major assaults to get the rate down to Reserve Bank Governor Bernie Fraser's current comfort ceiling of 3 per cent finally being greeted by success: wages policy in 1983-85; the events associated with the infamous 1988 'bringing home the bacon' Budget; and most recently, the events stemming from the Accord Mark VI. To say that recent disinflation was unintended makes one wonder where the author has been living over the past decade.

Barry Hughes is Professor of Economics at the University of Newcastle and chief economist with CS First Boston.

The effectiveness or otherwise (as opposed to the intent) of anti-inflation policy needs to be argued, but White does no such thing. He scarcely mentions the subject before dismissing it from the reckoning, thus leaving his account of policy over the period totally unbalanced. To be sure, domestic unemployment has had a salutary effect. But what is important here is the improvement in *relative* performance. Not only has Australian inflation been reduced, but we have rejoined the club of low-inflation countries after an absence of two decades. White no doubt believes that the firefighting of 1986-87 (quarantining currency depreciation) and 1988-90 (the easy wicket of fast growth in domestic demand) had nothing to do with today's results; but for a variable (inflation) that is generally conceded to have a major component of inertia (hence the stress on various core rates), it is necessary to *argue* the irrelevance of past efforts, instead of assuming the inheritance to have been a gift from the gods. In the absence of any such argument, the results speak for themselves, spelling out a verdict quite inconvenient to White's general message.

Fiscal Policy

White's argument elsewhere suffers also from what Fritz Machlup used to call the 'fallacy of misplaced concreteness': the tendency to assume that real-world events can occur only in conformity with one's particular theory. His view of fiscal policy is entirely conditioned by the critical Mundell-Fleming assumption that interest-rate differentials dominate the course of exchange rates (thus leading to complete crowding out of the multiplier). As far as the Aussie commodity currency is concerned, this crucial assumption of the international textbooks is seriously under threat, with precious little evidence in its support. What the evidence does suggest is that the currency is much better described as an exogenous variable (determined by global commodity prices): in which case White's major fiscal policy argument is in trouble.

The arguments against using fiscal policy for fine tuning what have turned out normally over the decades to be short-lived business cycles are persuasive on other grounds (the long and variable lags, the difficulties of changing tax rates and transfer arrangements quickly, and the inability of public services to maintain a ready shelf of projects). Yet oddly enough those commentators who are most dismissive of such usage are often among the first to suggest budgetary fine tuning to attempt saving-investment reconciliation. The Keynesian case for fiscal policy remains sensible for non-normal business cycles, for which it was originally proposed (and even most sceptics refrain from calling for the actual budget to be balanced in a downturn). There is a reasonable argument that the early 1990s provided such a case, though the national accounts are much more eloquent about the inability of the public service to mount the policy spending planned than about the repercussions of the announced policy. There is, of course, a taxation and transfer side, and the record here needs examination. Perhaps because his (Mundell) theory tells him that fiscal policy will not work, White scarcely bothers to look, and where he does (for example, his attempted put down of the structural/cyclical distinction), any

Keynesian would have no difficulty concluding that he had misunderstood the argument.

Business-Cycle Synchronisation

The extent of synchronisation of Australia's business cycle with that of the US or the OECD is a very fashionable topic, oddly enough at a time of the most desynchronised global business cycle in recent memory. Australian experience has resembled closely that of the US in the 1990s, but not that of the OECD (mainly because of the very different paths of Germany and Japan). Nevertheless, even a quick glance at the comparative GDP growth charts is very suggestive of international business-cycle links, whatever the transmission mechanisms. The most thorough local work on the topic is by Gruen and Shuetrim (1994), who indeed find strong correlations. Unlike White, they find next to no evidence that these links are driven by the terms of trade. Of more importance here, their work does not preclude an independent policy impact on domestic real activity. Indeed, they find evidence of such an impact from monetary policy, in the form of significant and important real cash interest-rate effects. Neither fiscal nor wages policy was modelled, any effects therefrom disappearing into the residuals of their equations. These latter account for over half the variance in the best-performing equations, so leaving reasonable scope for independent non-monetary policy effects, though to be fair to both Gruen & Shuetrim and White the dependent variables (quarterly changes) are of a form likely to generate only limited explanatory power. Nevertheless, this evidence suggests that although world events hold considerable sway over our fortunes, we are not helpless.

Recent Macroeconomic Policy: A Brief Preliminary Assessment

Public policy (including the various Accords) had something to do with disinflation, which is to the good. The Hawke Government's expansionary fiscal policy in 1983-85 had some influence on the ensuing recovery (compare Europe under restrictive policy with both Australia and a US under Reagan pursuing a relabelled pump-priming), which helped at the time to avert a more serious problem of long-term unemployment and the inefficiencies that result. But, compared to the European alternative of heavy sedation, it left us more exposed to poor commodity prices.

The rest of the 1980s saw the economy bouncing off various walls (the international-debt binge at a time of financial deregulation, asset-price bubbles and stock-market collapses, commodity-price roller coasters), which was a very difficult environment for any policy to confront. With the luxury of hindsight, we can see that public policy was too slow to stop an assets and goods demand boom getting out of hand, which proved to be a costly mistake. The subsequent reaction (in May 1988) started as early as that in other countries similarly affected, though clearly it could have been much stiffer in the early phases. Monetary policy was relied on, partly because fiscal policy was being used in combination with wages policy, partly because the political environment has virtually outlawed large tax increases, but mainly

because monetary policy has always been the best way of controlling this sort of boom.

The second costly mistake was the usual one of keeping interest rates very high for too long, though in fairness to the policymakers most (but by no means all) outside commentators thought there would be a soft landing, and the phase of rate reductions was widely criticised as premature, wimpish and electorally inspired. This application of monetary policy could never fix current-account problems (indeed, as White complains, it would lead to a deterioration if the currency is sensitive to interest differentials — an important assumption). All it could have done, even if applied perfectly, was to take the heat out of the boom. But there was little chance of anything fixing the current account while the domestic demand boom raged. In any event, the economy ultimately stagnated. Prime Minister Paul Keating would no doubt be relieved that there is an argument that could let him off the hook.

When more time has elapsed (and firmer data become available) the consequences of Australian macroeconomic policy in the 1990s will be subject to sensible debate. Recovery has been quite a bit stronger than many were arguing just a year ago, though inflation (to date at least) has been lower than general expectations of a similar vintage. While there are similarities with the US in both policy and outcomes (and some major differences), there are few with continental Europe or Japan.

Macroeconomic policy has a mixed record over the past decade, but human failure to achieve perfection is not a reasonable basis on which to award the beauty prize unseen to another contestant. Some argue, for example, that the licence given to greed in the 1980s was a major cause of our problems, but it would be equally unreasonable to urge regulation simply on the basis of the flaws clearly evident over this period. Nor is it sensible to urge fixed exchange rates merely because the claims of the 1960s advocates (Milton Friedman, Harry Johnson) of smoothly operating outcomes under market arrangements turned out to be very wide of the mark almost everywhere. The case for or against activism or inactivism comes down to weighing the merits and faults of both. That is an empirical matter requiring clearly articulated alternatives. Merely to demonstrate human imperfection might provide catechisms for the faithful, but it is not sufficient to prove that activism has made the economic condition generally worse. It is a rough old economy out there.

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Comment

Tony Makin

If macroeconomic policy has not failed Australia, why else is Australia's unemployment rate still so much higher than the OECD average? And why was the excessively tight monetary policy of the late 1980s (which caused the recent high unemployment in the first place) based on outdated views about a balance of payments constraint? What is really curious is that such questions, and indeed the general question raised in Garry White's paper, have not been asked more often. And if we accept that macroeconomic policy has failed, where has it failed most and what should be done about it?

Why Macroeconomic Intervention?

At the intellectual level, the reluctance to accept the evident failure of macroeconomic policy in Australia can probably be explained by the dominance of the Keynesian macroeconomic paradigm. Keynesian thinking generally presumes that monetary and fiscal policy are indispensable and work well in minimising overall fluctuations in national income. It assumes that private spending on consumption and investment would otherwise be either too low or too high to realise the macroeconomic policy objectives of full employment and low inflation.

A general tenet of microeconomic theory is that markets best allocate finite resources and maximise the incomes of the economic agents participating in those markets. The onus is therefore on policymakers to demonstrate that any public-sector intervention in individual markets is warranted (as it often is whenever externalities are clearly identified). Keynesian macroeconomics, in contrast, holds that policymakers must vigilantly monitor overall economic activity and that frequent macroeconomic intervention is necessary because some markets are inherently unproductive and unstable, especially the financial and investment markets. So whereas in microeconomics markets are, by and large, deemed innocent until proven guilty, in Keynesian macroeconomics markets in aggregate are assumed guilty until proven innocent. This reversal of proof stands out as the single greatest policy inconsistency in modern economics.

One wonders how much sense Keynesian-inspired thinking now makes for an economy that has deregulated and internationalised its financial markets on the understanding that, in general, financial markets efficiently allocate funds between savers and investors. The economy is also now much more closely integrated with interna-

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Tony Makin is Senior Lecturer in Economics at the University of Queensland.

tional goods and services markets, with the proportion of total trade (exports plus imports) to GDP now around 40 per cent. The business cycle is therefore largely determined by external developments, including fluctuations in commodity prices, foreign-investment flows and international asset prices.

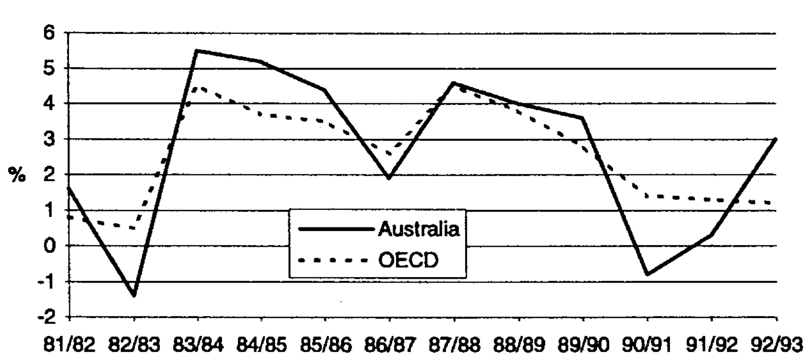
In contrast, the standard Keynesian paradigm was built on the hypothesis of a closed economy which, quite incredibly, left out exports, imports, the terms of trade, exchange rates and international capital flows: the macroeconomic variables at the heart of current economic debate. To make the Keynesian model work properly, it is necessary to seal the economy off from the rest of the world. But in reality, of course, Australia has gone the other way and further internationalised its economy, as have other OECD countries.

Improving Monetary Policy

Despite the Keynesian presumption that macroeconomic intervention is justifiable to stabilise the domestic business cycle, sharp shifts in the stance of monetary policy have not in practice achieved this. White's Figure 1 (p.138), based on a partial measure of economic activity, shows that Australia's business cycle is less variable than the OECD average. However, Figure 4 displays evidence that monetary policy has actually amplified Australia's true business cycle relative to the international business cycle. Activist monetary policy in Australia destabilises rather than stabilises overall economic activity relative to the international business cycle because sharp interest-rate changes can take up to 18 months or so to have an effect on domestic spending behaviour, by which time any downturn or upturn in the cycle may well have reversed itself.

Figure 4

Australian and OECD business cycles: annual changes in real GDP, 1981-93



Source: *Reserve Bank of Australia Bulletin* (various issues).

Interest rates are crucial for the investment process because they affect the cost of capital. Through its discretionary intervention in financial markets to influence short-term interest rates, the Reserve Bank, operating on the basis of incomplete knowledge of economic behaviour, substantially increases interest-rate uncertainty. A risk premium reflecting this uncertainty is then incorporated into interest rates. Such policy-induced uncertainty probably explains why Australia's interest rates are still higher than those of our major trading partners, despite the closely integrated nature of today's international capital markets. Excessive Reserve Bank intervention in money markets also explains why short-term rates are so often out of line with long-term rates. This has given Australia one of the most variable yield curves in the world. The related interest risk premium stymies investment expenditure, which impedes productive activity in the economy.

In addition, habitual monetary policy interventions are based on ever changing forecasts about the future path of the economy; but, as tabulated in White's paper (p.137), such forecasts often prove quite wide of the mark. In light of these failures, it is clearly time for a serious re-think about what monetary policy should be doing and exactly how it should be doing it.

An obvious solution to eliminating the additional interest-rate and inflation uncertainty induced by domestic monetary policy is simply to eliminate Reserve Bank discretion and constrain the Reserve Bank to follow a fixed money-growth rule, as has previously been proposed by many economists, including Milton Friedman (1968). A money-base rule, for instance, has the advantage that the money-base measure represents the total liabilities of the central bank. It is the money magnitude over which the Reserve Bank has monopoly power and should therefore be easiest to control.

A steady money-growth rule would represent a major change in the way monetary policy is conducted and contrast sharply with the severe year-to-year fluctuations in money-base growth over the past decade. Since 1984, money-base growth has varied substantially between 2 and 10 per cent a year. A feasible rate of money-base growth may be somewhere between 2 and 5 per cent a year, in accordance with Australia's average long-term growth of real output. This would not only automatically check domestic inflation but minimise the gyrations in the yield curve and the attendant investment uncertainty.

Fiscal Policy

In discussing the failure of fiscal policy, White relies on the standard textbook (Mundell-Fleming) model of the open economy, which predicts that, under a floating exchange rate and conditions of highly mobile international capital, fiscal expansions crowd out net exports. This model, devised independently by Mundell (1963) and Fleming (1962), also provides a mechanism for understanding how federal budget and trade deficits may be related: the so-called twin deficits hypothesis. Central to this analysis is the behaviour of the floating exchange rate, which is supposed to appreciate after fiscal expansion and depreciate after fiscal contraction.

However, the Mundell-Fleming approach has many specification problems (see Makin, 1994, for further discussion). For instance, in the Keynesian spirit, it assumes

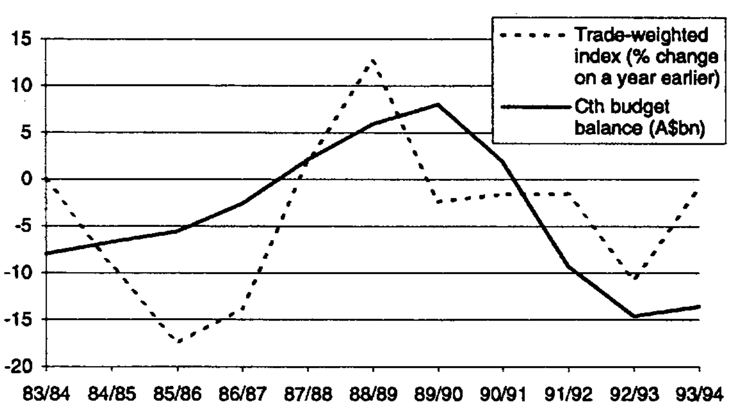
that aggregate output is entirely demand-determined; but this, among other things, fails to allow for any difference between domestic saving and investment. Additionally, there are no variations in the terms of trade, which are central to White's international business-cycle transmission mechanism.

The main practical problem with this model in the Australian context relates to exchange-rate behaviour. In reality, contrary to what the Mundell-Fleming model would predict, the Australian dollar has generally depreciated during periods of fiscal expansion, and appreciated during periods of fiscal contraction. Figure 5 below clearly demonstrates this. For instance, until the early 1980s countercyclical Commonwealth budget deficits were accompanied by a weaker, not stronger, exchange rate. With the subsequent tightening of the fiscal stance (the era of budget surpluses from 1987/88 to 1990/91), the effective exchange rate then regained some of its former strength, but subsequently weakened again following the fiscal response to the recession of the early 1990s (the return to budget deficits).

If fiscal policy had been rendered ineffective as a stabilisation instrument by floating exchange rates (as the textbook model suggests), then it cannot also exacerbate Australia's natural business cycle. However, in my view, fiscal policy still has the capacity to do this, such that it can still magnify peaks and troughs, particularly in national expenditure, relative to GDP. More theoretical and empirical work needs to be done in this area, however.

Figure 5

Fiscal policy and the exchange rate, 1983-94



Source: *Reserve Bank of Australia Bulletin* (various issues).

Conclusion

On balance, it would seem that fiscal policy has in practice been a much less significant source of macroeconomic uncertainty and destabilisation than monetary policy over recent years. In part, this may be due to the constraints imposed by the budgetary process itself. This annual process ensures that changes in the fiscal stance occur only once a year (or twice, when there are mini-budgets), whereas unannounced shifts in the monetary stance can occur at almost any time.

Moreover, because fiscal policy is subject to greater scrutiny, it has been conducted at a higher standard than monetary policy. It is outlined in great detail, and is quite transparent (if one cares to read all nine volumes of the 1994/95 Budget Papers!). By comparison, under existing arrangements, any account of what has been happening with monetary policy (as for instance outlined in the thin annual reports of the Reserve Bank) has to include an element of surmise about both its intentions and its practice. But this may be a deliberate strategy, since the Reserve Bank relies on the element of surprise in order to maximise the impact of monetary policy on the economy.

In sum, macroeconomic policy has recently failed Australia in an overall sense. But this is due mainly to excessively manipulative monetary policy, which has generated unwelcome uncertainty and exacerbated the business cycle.

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Rejoinder

Garry M. White

Barry Hughes is a true believer in the Keynesian paradigm. Yet, as Tony Makin correctly points out, this view of economics sits uneasily with an economy that is exposed to external shocks and the pervasive influence of international financial markets. In this day and age it is difficult to take seriously the policy prescriptions flowing from an economic framework that takes no explicit account of international capital flows. Getting the paradigm right is important because different economic models can lead to very different policy prescriptions. In particular, the Keynesian model suggests that a fiscal expansion will boost activity, whereas a Mundell-Fleming framework suggests that (in the presence of a flexible exchange-rate regime) a fiscal expansion will be crowded out by an increase in net imports. As well, the ways in which monetary policy might be used to achieve external balance (a misguided policy objective in any case) differ dramatically depending on which paradigm is believed to fit economic circumstances best.

Hughes sees the sharply lower inflation of recent years as a major success for macroeconomic policy and consistent with policy objectives. Lower inflation was indeed a major achievement. However, in the same way that the unemployment outcome which contributed to that lower inflation was rather higher than expected, the fall in inflation was rather greater and faster than the government or its advisers had anticipated. It is notable that the official budget forecasts for 1990/91 anticipated CPI inflation falling to 6.25 per cent (from 8 per cent in the previous year) but the outcome was 5.3 per cent. In the following year inflation was expected to fall to 3 per cent, but again policy (in combination with an adverse external environment) overachieved to reduce inflation to 1.9 per cent.

It is indisputable that lower inflation was an objective of policy through most of the 1980s. However, a review of the record demonstrates that external balance was the major reason for the tight monetary policy of the late 1980s and that inflation was a secondary priority until inflation began to fall faster than expected. The following quote from the then Treasurer provides a typical defence of the high interest rates of the period:

> high interest rates are associated with our trade circumstances . . . this is the only policy prescription to get that demand under control and to get the imports under control and it's only then that we'll see any prospect of interest rate relief. (Keating, 1989)

Hughes seems to have joined the revisionists who wish to retrospectively overemphasise the relative weight placed on those policy objectives that happen to have

coincided with policy outcomes. The only other explanation is that the public was purposely misled by the official commentary in order that the lack of a public constituency for low inflation could be overcome.

Hughes repeats the argument that monetary policy was the only policy instrument available to deal with a 'demand boom' in the late 1980s. The then Treasurer made clear his reliance on monetary policy at the time: 'monetary policy in the last couple of years had a role as a balancing instrument, and while ever we had GNE outstripping GDP by a factor of 2 to 1 obviously it did have a role' (Keating, 1990). This reliance was unavoidable because fiscal flexibility was constrained at the time by the wages policy. However, the extent of that boom was grossly overstated. It is true that, when measured in constant price terms, demand was growing at twice the pace of output during 1988/89. However, the relativity of the growth rates of demand and output was distorted by a rise in the terms of trade. In current price terms, demand was growing no faster than output. Australians had done no more than spend the additional income that a rise in the terms of trade had provided. In any case, if the concern was excessive demand growth relative to output, then tighter monetary policy was not the correct prescription as this would increase net capital inflow (as it did) and thereby increase demand relative to output (White, 1991).

If demand was growing no faster than output in 1988/89 (when correctly measured), why were the Keynesians so determined to reduce economic activity? (Or did they look at the wrong tables in the national accounts in developing their policy prescriptions?) Demand and output growth in Australia were both strong because the international economy was expanding strongly. As the world economy (inevitably) slowed, so did activity in Australia. Similarly, the asset-price inflation experienced in Australia followed closely the pattern observed in most major economies. Were the high interest rates of the late 1980s really justified if offshore developments were going to see a slowing of activity and asset-price inflation anyway? It remains a real possibility that all that was achieved was an exacerbation of the inevitable downturn.

Both commentators raise the issue of exchange-rate determination. The Mundell-Fleming model is based on the assumption that interest-rate differentials dominate the course of exchange rates. However, like most pervasive economic relationships, this assumption must be interpreted in any practical situation under *ceteris paribus* ('other things being equal') conditions. If the terms of trade fall and cause the exchange rate to depreciate, then is not unreasonable to expect that any crowding out of a fiscal expansion will occur at a lower exchange rate than that observed in the previous period. Makin's Figure 5 (p.154), indicating that the Australian dollar has generally depreciated during fiscal expansions, is easily explained. Australian fiscal expansions generally occur during periods of falling terms of trade and, therefore, a weakening exchange rate. If the impact of the external environment through the terms of trade is generally more important that the change in the fiscal balance, then a falling exchange rate should be expected. The point is that the exchange rate would have depreciated further if the fiscal balance had not decreased by as much as it did.

Fiscal policy is not something that can be set in terms of a given fiscal balance. Economic conditions (inflation and activity) have a pervasive impact on both revenues and expenditures with no explicit policy changes. The budget balance will vary with the economic cycle and result in redistributions of income that are often undesirable. The issue is whether the government actually achieves anything more than popularity by being seen to be doing something to promote growth. Hughes must admit that the multitude of economic statements and associated spending initiatives of the early 1990s achieved less growth than the government had hoped. Unjustified faith in the impact of greater spending would have been a key reason why GDP growth was over-estimated in 1990/91 and 1991/92 (see Table 2, p.137).

Makin suggests that monetary policy should be put on auto-pilot by use of a fixed money-growth rule. A problem with this prescription is that the relationships between the growth rates of any of the available measures of money supply and nominal output are highly variable. For example, the ratio of original quarterly nominal GDP to the money base has risen from around 3 in the early 1970s to around 5 in recent years. In the past three years this ratio has fluctuated between 4.8 and 5.4. As well, in all major economies monetary policy is conducted through the targeting of short-term interest rates. The targeting of interest rates has evolved because the monetary aggregates have been found to be of little practical use. What is needed is a simple decision rule based on the level of short-term interest rates (for example, the yield on short-term rates could be set in relation to bond yields or a measure of inflation).

Makin is correct in identifying the disparate approaches taken toward the onus of proof when it comes to macroeconomic policy and microeconomic policy. Macroeconomic policy decisions should be subjected to the same sort of rigorous cost-benefit analysis usually applied to microeconomic policy. Any resulting inaction would be to the benefit of the nation.

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Inflation and Monetary Monopoly: Reflections on Australia's Ten-Dollar Note

Ray Evans

In October 1993 the Reserve Bank of Australia (RBA) issued a new ten-dollar note. Like the five-dollar note issued some twelve months previously, it is made of plastic, is unpleasant to the touch, and has a singularly unattractive design. The same technology will be used to replace the 20-, 50- and 100-dollar notes in due course. Allegedly, they will last longer, and be much harder to forge, than the old paper notes.

But even if the claims made for the new notes are true, no private supplier of such a product, competing for market share, could have succeeded in persuading the public to use it. Only a monopoly supplier of bank notes could have got away with producing something so widely disdained. Yet this monopolistic character of the money supply, maintained by the state for political and revenue purposes, is assumed to be immutable.

The Great Inflation, 1975-94

It is nearly 20 years since Friedrich Hayek proposed, almost as an aside, that government monopoly in money supply should be overturned in order to bring inflation to an end.

> The politician, acting on a modified Keynesian maxim that in the long run we are all out of office, does not care if his successful cure of unemployment is bound to produce more unemployment in the future. The politicians who will be blamed for it will not be those who created the inflation but those who stopped it. . . Our only hope for a stable money is indeed now to find a way to protect money from politics. (Hayek, 1976:16)

> On the effects of the adoption of the proposal [allowing free trade in money and thus enabling banks to issue their own currency] all I will add at this point is that it is of course intended to prevent national monetary and financial authorities from doing many things politically impossible to avoid so long as they have the power to do them. These are *without exception*

Ray Evans is an executive officer of Western Mining Corporation.

> harmful and against the long-run interest of the country doing them but politically inevitable as a temporary escape from acute difficulties. (Hayek, 1978:24-5; emphasis added)

After Hayek wrote those words, inflation continued more or less unabated, until the post-1987 recession, compounded by some central banks, began to bite deep in the early 1990s.

Consider the history of money since US President Richard Nixon, who, in closing the gold window in 1971, revealed the deep contradictions embedded within the post-war Bretton Woods system. Table 1 sets out the half-life of the currencies of 23 industrialised and industrialising countries, over three periods: 1975-82, 1983-89 and 1990-93. These periods select themselves as the OPEC oil-shock period (with the alleged inflationary effects of large oil-price increases), the Reagan boom, and the post-1987 crash disinflation.

The concept of a currency half-life is useful if the period of calculation does exhibit some uniformity. New Zealand is interesting in this respect. The first period more or less coincides with the era of Prime Minister Robert Muldoon, when New Zealand had one of the shortest half-lives of any currency (5.6 years). The second period was dominated by Finance Minister Roger Douglas's rapid reforms, including the passage of the New Zealand Reserve Bank Act of 1989. In 1991 the fight against inflation unexpectedly began to bear fruit and the country suddenly acquired one of the world's strongest currencies with a half-life of nearly 26 years. (A really good currency would have a half-life of at least a century.)

The Bundesbank is arguably the world's most famous and respected central bank, and its record is the outstanding example of the unavoidable relationship between monopoly supply and sovereign risk. The three half-life figures for Germany given in Table 1 are 17.0, 45.6, and a disastrous 6.3 years. This last figure is the result of the notorious one-for-one policy (one Deutschmark for one Ostmark) imposed by Chancellor Kohl, in the face of strong Bundesbank opposition, when reunification took place in 1991.

Australia's history resembles New Zealand's, with half-lives of 7.4, 10.8 and, most recently, 21.4 years. But, unlike New Zealand, the markets do not believe that Australia's monetary institutions can hold to a low-inflation course. Although the federal government and the incumbent Governor of the RBA are (at the time of writing) dismissive of market sentiment, other RBA (or ex-RBA) people are less confident. Former Deputy Governor John Phillips drove the point home when he said in a radio interview on 18 October 1990, 'Prices in Australia in the past two decades . . . have increased by about five times. . . In that two decades we have had only one year in which the inflation rate, as measured by the Consumer Price Index, was under 5 per cent per annum. I personally don't find that a performance that, as a central banker, I am very proud of.'

Table 1

The inflation ladder: currency half-lives of 23 countries, 1975-93

1975-82		1983-89		1990-93	
Switzerland	21.0	Singapore	76.9	Switzerland	55.3
Singapore	19.3	Netherlands	59.2	Japan	30.2
Germany	17.0	Japan	57.1	NZ	25.7
Malaysia	15.1	Germany	45.6	France	25.3
India	13.9	Malaysia	42.3	Singapore	24.5
Austria	13.7	Switzerland	33.9	Netherlands	22.9
Japan	12.3	Austria	28.5	Australia	21.4
Netherlands	12.1	Thailand	27.4	Canada	20.5
Hong Kong	9.5	USA	22.2	Austria	19.7
USA	9.3	Korea	21.2	USA	18.1
Thailand	9.1	Canada	17.9	Malaysia	17.9
Canada	8.4	France	16.4	UK	13.9
Pakistan	8.0	UK	15.9	Italy	12.5
Sweden	7.9	Pakistan	13.3	Sweden	10.8
Australia	7.4	Sweden	12.8	Korea	9.9
France	7.4	Hong Kong	12.1	Indonesia	8.5
Philippines	7.2	Australia	10.8	Hong Kong	7.4
South Africa	6.5	Italy	10.3	Pakistan	7.4
UK	5.8	Indonesia	10.3	India	7.3
Indonesia	5.8	India	9.8	Thailand	6.4
NZ	5.6	NZ	8.4	Germany	6.3
Italy	5.1	Philippines	5.9	Philippines	6.1
Korea	4.9	South Africa	5.8	South Africa	5.5

Source: International Monetary Fund (1993).

Australia's Experience of Free Banking

Monetary historians suggest that the great burst in world trade and production that took place after the 1850s was due in part to the inflationary pressures that followed the great gold discoveries in California and then in eastern Australia. Activity then declined to a small degree, and the period from the 1870s to the mid-1890s was described by contemporaries as the 'Great Depression'. This relative decline is often ascribed to the decline in gold production between the petering out of the 1850s eastern Australian gold discoveries and the new discoveries in South Africa and western Australia of the late 1880s and early 1890s. However, Kevin Dowd (in a private communication) has argued that the demonetisation of silver that took place over this period is at least as important as the absence of new gold discoveries.

Australia at this time was enjoying a period of free banking. The banking industry was freely contestable and stable. Because of the gold rule, inflation was unknown. Banks issued their own notes, and operated a note clearing house (some fine collections of these notes still exist). Even the least aesthetically sophisticated of them is far superior to the new ten-dollar RBA production. Bank notes were redeemable in gold on demand. A number of localised and relatively unimportant bank runs occurred before the devastating banking crashes of the early 1890s. (In my view, the Victorian bank crashes of the 1890s are entirely due to massive overborrowing on the London market by the Victorian government during the 1880s, mostly for gold-plated railway construction. Following the Baring Bros collapse in London, these funds dried up, with predictable consequences.) These collapses, nevertheless, prepared the political ground for the monopolisation, by the Commonwealth government, of the note issue by means of the 1910 Commonwealth Bank Notes Act and the establishment of the Commonwealth Bank.

The Australian experience with free banking, which lasted from the 1830s until 1910, is one of a number of important historical examples demonstrating that a government monopoly over the money supply is not necessary for monetary or banking stability. Following Hayek's proposals in the 1970s, there has been a major rediscovery of the Scottish, Canadian, Chinese and American periods of more or less free banking and the literature is growing rapidly. Nowadays, virtually no respectable economist is prepared to argue that a state monopoly of the money supply is necessary for banking stability.

Australia in the 19th century was a major gold producer, and under the colonial monetary regime there was no possibility of controlling the quantity of base money that entered the economy: gold and money were one and the same thing. (I should add that until France hastened the process of demonetising silver in the 1870s, the mining and smelting of silver was also equivalent to printing money.) Broken Hill began its life as a silver mine, but by the end of the 1880s silver had been effectively demonetised and fell to nearly half its 1870 value. This in turn led to the attempt to remonetise silver in the US, and to William Jennings Bryan's great nominating speech, in Chicago, at the 1896 Democratic convention, which climaxed with the immortal line: 'Thou shalt not crucify mankind upon a cross of gold'.

At that time, then, Australia operated under a monetary price rule. The pound sterling was worth 113 grains of gold (7.32 grams) as defined (as the result of an arithmetical error) by Sir Isaac Newton in 1717. (1 troy oz = 480 grains = 31.1 grams.) Where there is no monopoly of note issue, a price rule is the only practicable regime. The manufacture and supply of rulers and measuring tapes, micrometers, and so on, is freely contestable, but works only because there is universal agreement on the length of the inch, the foot, and the metre.

When central banking and monopoly note issue became commonplace, the idea of quantity control made sense. Under monopoly conditions of money supply, the monopolist could conceivably measure and control the amount of money in circulation (at least notes and coins) and thus control the price level. This quantity theory goes back to the 18th-century English philosopher David Hume; and David Glasner's (1989) book on the debate between Hume and Smith is an illuminating piece of work.

Central-Bank Independence, Monetary Discretion, and Political Risk

The debate between the advocates and opponents of state monopoly is now turning on the New Zealand Reserve Bank and its Act of 1989. The argument is that if we give the central bank independence, a single purpose in life (0-2 per cent inflation), and appoint governors of the strength of character and public spiritedness of the present incumbent, Dr Don Brash, then all will be well. He will succeed where the Bundesbank has failed. However, one can never escape the problem of monopoly supply, which is the discretion that the monopolist, by definition, can never give up. And it is that discretion, bestowed by the politicians upon the central bank, that brings monetary policy into the centre of political life, and inevitably casts the shadow of sovereign risk over the currencies issued by central banks.

The fundamental purpose of a central bank is to exercise monetary discretion, formally in the interests of the general community. However, when we look at even the very best central banks, it seems impossible for governments to refrain from seeking to exercise the central bank's discretion. Governments are, after all, the final repository of responsibility. They have to go the polls; the central bank does not. Hence Australian Prime Minister Keating's justly famous remark concerning the RBA: 'They do what I say'.

The outward and visible signs of the political risk attached to the money issued by a central bank with a statutory monopoly are the yield curve and its gyrations, and the volatility and unpredictability of exchange rates. The advocates of state monopoly, when pressed, will concede the nature of the problem, but their response, apart from appeals to political impossibility, is to accuse the anti-monopolists of having failed to come up with a practical and appealing price rule that would make possible competition in money supply, within a particular jurisdiction. It is one thing to define a foot or a gallon, or a metre, or a litre, they say, but another thing to formulate a definition of the Australian dollar that is widely acceptable and free from political interference, and so usher in a golden age of zero infla-

tion, stable and flat yield curves, and interest rates based only on the time preferences of the people as a whole.

This argument cannot be brushed aside. We have a monopoly central bank, with board members, governors, deputy governors, very nice offices, and the rest. It works, albeit very badly. Attempts to dismantle the institution will not get very far until we come up with a price for the Australian dollar.

The Currency Board Option

Fixing a price for a local currency need not involve withdrawing the monopolist's privileges, at least in the first instance. A currency board is a monopoly supplier, but it issues notes that are fixed in value with respect to a metropolitan currency. Hong Kong recovered very quickly from a major currency crisis in September 1983 by pegging the HK dollar at the rate of 7.8 to the US dollar and providing 100 per cent backing for the note issue. The Bank of England was, for a very long time, a de facto monopoly issuer of currency that was redeemable, on demand, in gold. Its monopoly position resulted in crises in 1847, 1857, and 1866, but the Bank survived them, albeit with the aid of a friendly Chancellor of the Exchequer, who wrote (or promised to write) letters to the Governor of the Bank promising immunity from prosecution if the Bank exceeded its statutorily required marginal reserve requirement.

Australia could turn its Reserve Bank into a currency board and fix the Australian dollar at, say, 70 US cents. Our interest rates would then track US rates, and there would be no scope for discretionary monetary policy. Because of our dependency on commodities for export income and because commodities are very volatile in price, we would have to learn to accept much more flexible wages, that is, wages that could move with the commodity cycle. Our present labour-market arrangements render that somewhat unlikely. We appear to accept mass unemployment and underemployment far more readily than the idea of flexible wages, even with a fluctuating exchange rate that acts, in some measure, as a shock absorber in the commodity cycle.

Commodity producers, already subject to very large income swings, would have to be able to handle much larger ones. Swings in incomes result in greatly amplified swings in operating surplus and even more magnified swings in share price. There is a real problem, therefore, for commodity producers operating in an environment where the domestic currency is tied, irrevocably, to a metropolitan currency such as the US dollar. This proved to be the case in Chile soon after the Pinochet regime took over in 1973. Soon after Chile tied itself to the US dollar, the latter appreciated, disastrously from the Chilean point of view, against all other major currencies.

Instead of setting the price of the Australian dollar in US cents, we could set it in terms of gold, say, 500 Australian dollars to the ounce. Redeemability would be required, if not in gold itself, then in an outside currency such as US dollars connected through the gold price to gold.

It is easy to smile at an employee of a major gold-mining company arguing for a currency based on gold. Yet from a political point of view, it is beyond argument

that the Australian people would accept a gold-based currency much more readily than any other definition of the price of the dollar. Gold has been more stable than the US dollar over the last decade. Nevertheless, a significant argument against gold (in Australia's case) is the very large quantities stored in central-bank vaults: some 40,000 tonnes, when annual world production is approximately 2000 tonnes. The US could fix the US dollar to gold and not have to worry about the buying power of these central banks, but Australia is not in the same league.

If gold, for whatever reason, is not acceptable as a pricing mechanism, why not two or more metals? Why not bundle gold and silver together (perhaps William Jennings Bryan was right after all?). If gold and silver together will not suffice, we could go to the basket of commodities, notably the so-called ANCAP basket of ammonium nitrate, plywood, and so on, proposed by Robert Hall (1982). Since direct redeemability of notes with these commodities is impractical, indirect redeemability would have to be accepted. But this need not be a problem, provided some outside form of money is available such as the US dollar or, ultimately, gold.

Commodity Baskets and Indirect Redeemability

Kevin Dowd (1990,1994) has taken up this problem of commodity baskets and the feedbacks involved when selecting a particular basket that must influence, in unpredictable ways, the production and marketing of the particular commodities selected. The largest commodity basket available to us is the Consumer Price Index (CPI). Every quarter a new measurement is taken of changes in the CPI and the results become part of our official inflation history. Domestic labour costs are fed directly into the CPI by the inclusion of many services, such as haircuts.

How could the CPI be used to set the price of the dollar and provide us with zero inflation money, year in, year out? Dowd assumes a monopoly supplier, a central bank, which is, however, required to redeem its issue, on demand, with a new kind of financial paper. If a holder of notes or deposits becomes suspicious of the central bank's activities, he or she can immediately demand, in exchange for notes or equivalent, an IOU payable, say, in three months' time, which is worth the deposit compounded by an appropriate interest rate (the London Inter-Bank Offered Rate, or LIBOR, for example) and then multiplied by the forthcoming increase in the CPI to be announced during the ensuing quarter. Provided this IOU were not transferable, any fear of inflation would lead to a contraction in bank notes and deposits. If the RBA counterattacked, for example by reducing overnight interest rates, a further flight to Dowd paper (as we may call these certificates) would ensue. Such a mechanism would provides a negative feedback system on the money supply that would will place heavy constraints on the central bank. The system would be virtually identical to the Bank of England operating under a gold rule, with changes in the CPI replacing gold as the disciplinary force on the central bank. Interest-rate manipulation would no longer be required and would certainly not be desired.

Now, it is immediately apparent that a monopoly role for a central bank is unnecessary under his scheme, and the monopoly problem certainly gives rise to in-

stability. Any bank could issue its own notes under Dowd's redemption requirement; and a system of competitive note issue is much more stable than a system of monopoly note issue, as the crises that occurred under the Bank of England's gold regime in 1847, 1857 and 1866 demonstrate. What does become very important is the accuracy and integrity of the process of gathering and releasing CPI information.

Substantial sums would be made or lost on speculation concerning CPI movements. Considerable care would have to be given to the institutional structure and rules governing bodies such as the Australian Bureau of Statistics, which perhaps could be privatised and the industry made contestable.

A dollar that is defined in terms of the largest basket of goods and services we have would not be nearly as subject to changes in the world prices of the particular commodities that Australia exports as our present dollar. (We should not forget, however, that relative interest rates are the biggest factor in exchange-rate risk and fluctuation.)

Conclusion

In my view, Kevin Dowd has come up with a pricing regime that is practical, theoretically sound, generally understandable and politically sellable. It poses a problem for partisans of central-bank discretion along the lines of the New Zealand Reserve Bank. Inflationary expectations are currently low, and debate is now focusing on upward pressures on the exchange rate. How long that will last no one can tell. It would be an easy thing now to introduce a Dowd IOU based on CPI movements and LIBOR interest rates, and very simple to make such instruments payable on demand. The next step would be to demonopolise the Reserve Bank. This would bring an end to the issuing of distasteful plastic banknotes.

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The Fight Against Unemployment

Tom Valentine

Although Australia's unemployment is currently at its highest level since the 1930s, the public response to it has been inadequate, in two respects. First, there is a fundamental lack of concern about the situation. Politicians and commentators talk of a 'boom' and 'the best conjunction of economic fundamentals in many years'; and the Keating Government was able to win the 1993 federal election even though at the time it had no serious policies to deal with unemployment. Second, recent discussion has assumed that unemployment is a social rather than an economic problem, and gone on to explore ways of living with it rather than solving it. It is time to focus the debate on the *causes* of unemployment. Social policies are undeniably necessary to deal with the problems created by unemployment. Nevertheless, we should also be searching for long-term policies to banish unemployment.

The major cause of unemployment is an inappropriate level of labour costs. Any policy package that fails to address labour costs offers no fundamental solution to unemployment, which requires reform of wages policy and, in the short run, reduction of or at least restraint in labour costs.

This article surveys the evidence on the causal relationship between labour costs and unemployment. It goes on to evaluate the treatment of labour costs in the federal government's 1993 Green Paper on unemployment, and reconsiders the most recent case of wage reductions in Australia, namely, the reduction of award wages in the 1930s. It then considers some current explanations of unemployment that have provided rationalisations for ignoring the influence of wages policy and for underplaying the importance of the problem. It concludes by surveying present policies for dealing with unemployment, including those set out in the federal government's White Paper of May 1994.

Labour Costs and Unemployment

Mainstream economic theory has long recognised that wages have a substantial impact on employment. However, in Australia 'wages' must be defined so as to include such non-wage labour costs as payroll tax, workers' compensation insurance, provisions for various forms of leave, and the Superannuation Guarantee Charge. An increase in these non-wage labour costs will have the same effect on employment as an increase in wages proper.

Tom Valentine is Director of Financial Training and Analysis Services and Visiting Professor at Monash University.

In the Harvester case of 1907, Mr Justice Henry Higgins introduced into Australia the illusion that wages could be set on the basis of supposed fairness, or to achieve a desired distribution of income, without any reference to economic conditions. This illusion has grown over time and is now reinforced by the vested interest of the union movement and its institutionalised role in government. Although it is contrary to mainstream economics, it has become the dominant paradigm in Australian industrial relations. In view of the popularity of this illusion in Austrália, it would be worthwhile first of all to briefly rehearse the insights that economic theory provides into the relationship between employment and labour costs. (A more detailed exposition, with references, is given in Valentine, 1994.)

Consider the impact of an increase in labour costs on the amount of labour employed by an individual business. The theory of the firm indicates that the reaction to an increase in labour costs will be, first, a reduction in the firm's demand for labour arising from (in most cases) an increase in the demand for other factors (i.e. a substitution of other factors for labour) and a reduction in output (a scale effect on employment); and second, an increase in the price of the firm's output. The strength of these effects will depend on three factors: the ease with which the firm can substitute other inputs for labour; the elasticity of the demand for the final product (an increase in the cost of labour will cause a greater fall in the demand for labour the more elastic is the demand for the firm's output); and the share of labour costs in the firm's total costs. In some cases an increase in labour costs can lead to a 'corner solution': the firm ceases business altogether. Its demand for labour then drops to zero.

Consider now the macroeconomic impact of an increase in labour costs. Two arguments have been used to suggest that labour costs do not affect employment. The first is that any change in labour costs will be reflected in a corresponding change in prices so that real labour costs and therefore employment will be unaffected. This argument was advanced in *Restoring Full Employment*, the federal government's Green Paper on unemployment (Committee for Employment Opportunities, 1993) and will be discussed in some detail below. But it may be noted here that if aggregate demand is faltering, businesses cannot increase prices to absorb increased labour costs. They trim their profit margins instead and reduce their demand for labour.

The second argument is that an increase in labour costs increases aggregate expenditure. This view is accepted uncritically by many commentators, particularly those from the union movement. But increases in labour on-costs (such as superannuation payments) will not necessarily affect expenditure at all. In addition, whether or not wage increases lead to higher aggregate wage income depends on the elasticity of the demand for labour. If the demand for labour has an elasticity above unity in magnitude, the increase in wages will be more than offset by the fall in employment, so reducing aggregate wage income.

Even if this is not the case, it is not clear that a shift from profits to wage income will increase aggregate expenditure. It appears that investment expenditure is very sensitive to profits. The recent paper by Mills, Morling and Tease (1994) identifies cash flow as an important determinant of corporate investment. An increase in labour costs will reduce business cash flow. In addition, any price increase arising from the

increase in labour costs will lead to an increase in the real exchange rate, at least to the extent that the nominal exchange rate does not adjust to offset the increase in prices.

A large number of statistical studies provide support for the theoretical conclusions we have just surveyed. For example, Gregory (1993) argues that lower increases in real wages in the US than in Australia produced lower unemployment in the former. Many other commentators have cited the greater responsiveness of the US wage fixation system to economic factors as the major explanation for the lower unemployment in the US than in most other OECD countries.

Wage Flexibility

In a country, such as Australia, that depends heavily on overseas trade and financial markets, wage flexibility is important. Australia's economic position is subject to external shocks and when an unfavourable shock occurs the domestic economy must adjust to it in some way. The obvious adjustment is for wages to fall (or for their growth to be slowed). An attempt to maintain living standards in the face of a negative external shock will force adjustments in other areas. In particular, the economy will go into recession and unemployment will increase. Average living standards will have fallen. Indeed, it is likely that this adjustment process is an inefficient one, so that the fall in living standards is greater than would otherwise have been necessary. The adjustment process is inefficient because of the costs created by unemployment and because of its impact on consumer and investor sentiment, causing further falls in aggregate expenditure.

Japanese wages are flexible partly because a significant proportion of a worker's pay is in the form of a bonus whose size is related to the performance of the economy. As well, incomes in the large family employment sector are naturally sensitive to economic conditions (Layard, Nickell & Jackman, 1991:71-2). Japan's wage flexibility has helped it absorb external pressures such as oil price shocks. Australians should note that this flexibility has not led to low living standards in Japan: if anything, it has helped them rise.

Flexibility in relative wages is desirable also in order to encourage the workforce to accumulate relevant skills. If wages are free to react to supply and demand, a shortage of skills in a particular area will lead to higher incomes for those who possess that skill. The increased margin will encourage additional workers to acquire the skills in question.

It is often argued that labour costs have already been adjusted downwards because real unit labour costs are now lower (real unit labour costs are defined as output per employee divided by real labour costs). But all this means is that as workers are laid off, output per head increases for the workers who remain in employment. This outcome is not surprising because it is the marginal workers who are laid off. The fall in the real unit labour cost does not mean, therefore, that it has become more attractive to employ additional workers.

Some Sensible Policies

These considerations suggest the policies we should adopt. First, labour costs should not be allowed to increase. This raises doubts about the Superannuation Guarantee Charge, which is set to increase in future years regardless of economic conditions. This represents an increase in labour costs and it will therefore lead to higher unemployment.

Second, the wage-fixing process should be more sensitive to economic conditions. The switch to enterprise agreements is a move in this direction, but their usefulness is limited if unions are able to control them. The 'safety net' approach also means that the wages of lower income workers are raised even though such increases are not justified by the demand for labour in this category, resulting in higher unemployment among lower-income workers. Increasing minimum wages is not the most effective approach to protecting low-income families. It would be better to allow wages to adjust to provide employment for as many of these workers as possible, and if necessary to supplement their incomes through the social-security system. Maximising the number of jobs for low-income workers provides them with the most effective training for participation in the workforce. Long periods of unemployment leave the victims unable to adjust to employment. And the best way to prevent long-term unemployment is to prevent short-term unemployment.

Third, insiders (the employed) tend to increase the cost of employing outsiders (the unemployed) to protect their own position (see Lindbeck & Snower, 1986). One way of doing this is to make it costly to lay workers off once they have been employed. Recent industrial-relations legislation does this (Sloan, 1994) and is therefore likely to slow down the absorption of the unemployed as the economy expands. This problem has been recognised in recent revisions to the legislation, but it has not been entirely removed.

The Treatment of Labour Costs in *Restoring Full Employment*

The 1993 Green Paper *Restoring Full Employment* is a typical product of the current Australian debate on unemployment. It includes very little economic analysis, but concentrates on ways of reducing the pain caused by unemployment: that is, it deals with ways to treat the symptoms of the disease rather than attempting to diagnose its basic causes.

Restoring Full Employment does pay lip service to the effects summarised in the previous section. For example, it says: 'Another lesson from the 1970s and 1980s is labour costs matter. If Australia is to progress towards full employment, sound macro-economic policies will have to be supported by restraint in nominal incomes' (p.13). Again, 'Lower real unit labour costs can also improve employment while still maintaining lower inflation' (p.13). Yet the document does not suggest reforming the process that determines labour costs. Instead, it goes on:

> The Committee believes, however, that an across-the-board cut in nominal wages to solve the unemployment problem would have to be so large that it is

> not readily achievable. This is because nominal wage cuts would be more likely to lead to price reductions and would not translate readily into real wage reductions. Moreover, those jobs created by across-the-board wage cuts would be most likely to go to people other than the long-term unemployed. (pp.13-14)

The policy rejected in this statement is an extreme one, and its rejection does not justify ignoring the effect of labour costs on employment. For example, the policies for reducing or restraining wage costs discussed in the previous section warranted some consideration. And the argument that the policy might not provide jobs for the long-term unemployed is irrelevant: as already noted, the best way to prevent an increase in long-term unemployment is to reduce short-term unemployment. This view does not rule out the adoption of additional policies to help those who have become unemployed on a long-term basis because of the failure to react more promptly to short-term unemployment.

The Wage Reductions of the 1930s

One member of the Committee on Employment Opportunities that drafted *Restoring Full Employment* is the coauthor of an important study of the 1930s experiment. Gregory, Ho and McDermott (1988) conclude that wage reductions cannot have made a substantial contribution to the recovery from the Depression. However, Valentine (1988) argues that the wage reductions of the 1930s had a positive effect on the economy. There are at least two reasons why this favourable effect should have occurred. First, prices do not react to changes in wage rates immediately or, as discussed above, in full. Second, falling prices lead to a fall in the real exchange rate if the nominal exchange rate does not change. The series on the Australian real exchange rate reported by McKenzie (1986) all show a sharp fall from 1929 on.

More important, a closer examination of the events of 1929-32 suggests that the reduction in wages was not an attempt to reduce unemployment but was actually forced by a prior fall in prices. These falling prices were a result of the workings of the Sterling Exchange Standard (see Schedvin, 1970:76-8). Under this system, a reduction in the banks' London Funds caused them to reduce their advances; the contraction of credit led to a reduction in the money supply, which caused a fall in domestic income and prices; and the fall in domestic income and prices led to a reduction in imports that in the end restored the banks' London Funds.

The major steps in this process over the period 1901/02 to 1938/39 are illustrated by Figures 1, 2 and 3, which show the relationships between the changes in M1 (cash plus cheque accounts) and the changes in (respectively) London Funds, GDP, and prices (all data were obtained from Butlin, 1977). Multiple regression analyses indicate that the correlations apparent in these figures are actually significant. Another piece of evidence supporting the view that the wage reductions were a reaction to earlier and likely price reductions is that prices actually began to fall in 1929/30 although award wages were not reduced until 1930/31.

Figure 1

Annual changes in M1 and reserves, 1901/02 to 1938/39

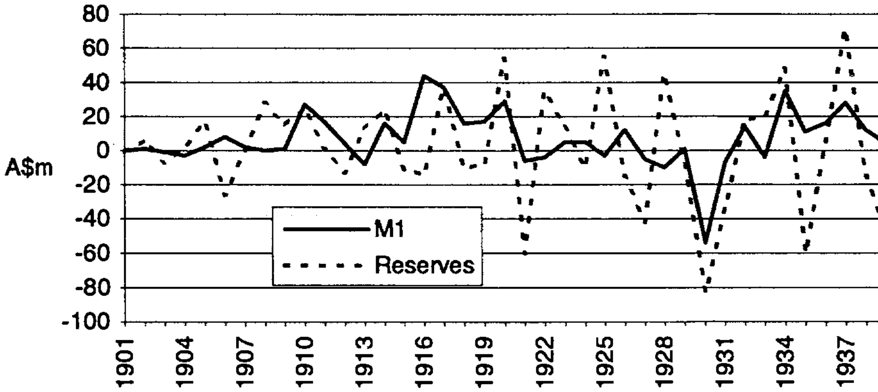


Figure 2

Annual changes in M1 and GDP, 1901/02 to 1938/39

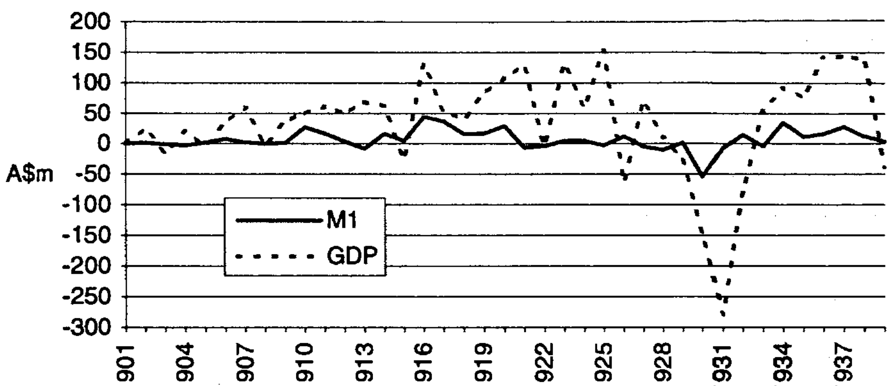
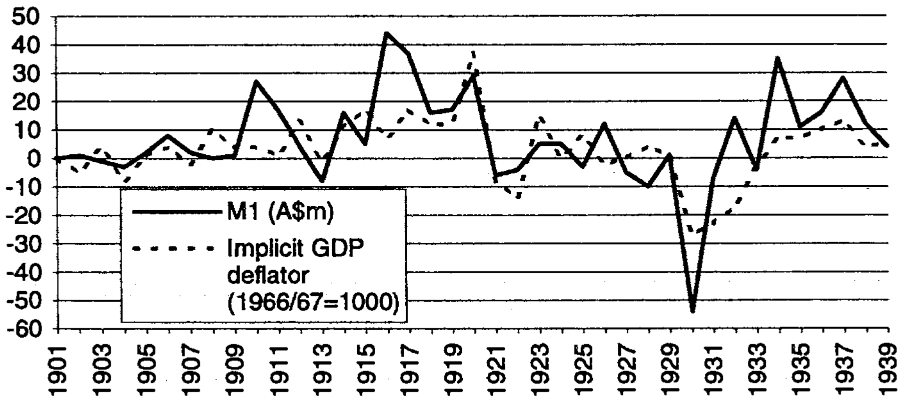


Figure 3

Annual changes in M1 and implicit GDP deflator, 1901/02 to 1938/39



Source for all Figures: Butlin (1977).

London Funds fell in 1928/29, 1929/30 and 1930/31 causing a large fall in M1 in 1929/30 and a smaller fall in 1930/31. This means that prices were bound to fall in the early 1930s. If award wages had not been reduced, there would have been a substantial increase in the real wage. The wage reduction was necessary to offset the fall in prices originating from developments in the trade sector and it was the appropriate reaction under the Sterling Exchange Standard. If it had not occurred, unemployment would have been even greater. As already noted, further wage reductions would have had a beneficial effect on the economy and the level of unemployment. Unfortunately, in the present day wages are not flexible in the downward direction and cannot react to externally generated pressures as they did in the 1930s.

Rationalisations of Unemployment

Public debate has given currency to several arguments for avoiding economic solutions to unemployment. These arguments are usually bogus.

Increased leisure, part-time employment and job-sharing. One of the most insensitive rationalisations of unemployment is the argument that it foreshadows a world of shorter working hours and increased leisure. The problem with this is that the increased leisure available in the present environment is not evenly distributed across the working population and those who 'enjoy' it do so without choice and usually without the resources to benefit from it.

Increased part-time work may be part of the long-term solution to unemployment. Nevertheless, the growth of part-time employment can be largely explained as a

reaction to the economic incentives created by Australia's industrial relations system. Requirements to provide leave, rostered days off and the high costs of terminating employment all contribute to making it more desirable for employers to offer part-time rather than full-time employment. Additional efforts to provide workers with improved conditions in these areas will lead to further increases in the proportion of jobs that are available only on a part-time basis.

Job sharing is unlikely to suit most workers. It will also be inappropriate in most areas of employment because it generally involves high switchover and disruption costs. Passing tasks to other workers is time-consuming, and interchange of information with customers or other workers is often inconvenienced by employee absence.

Economic growth. It is certainly true that higher economic growth would reduce unemployment (see Valentine, 1993). It is also true that as labour productivity rises, the wage rate that is consistent with low unemployment also rises. None of this, however, justifies ignoring the impact of wages on unemployment. Making wages more flexible would reduce the level of economic growth necessary to achieve a given rate of unemployment.

However, policies to promote higher growth are absent. In particular, the failure of private investment to contribute to the current upturn is bound to lead to a lower rate of productivity growth. And until higher economic growth and increased productivity emerge, the arguments for wage restraint remain strong.

Structural change. It is sometimes suggested that as unemployment is caused by structural change, the solution lies in some form of industry policy, involving significant government intervention, and in the retraining of workers. It seems likely that some unemployment has been caused by structural change in Australian industry, but this factor alone cannot explain the majority of job losses.

In December 1993 seasonally adjusted non-farm vacancies amounted to 38,500 as against 955,000 unemployed. Clearly, removing any mismatches (through, for example, training programs) would not substantially reduce unemployment. Again, since 1965 all substantial increases in unemployment have been associated with increases in real wages. This was the case in 1974/75, 1981/82, 1982/83, 1989/90 and 1990/91. This association suggests that at least some apparent 'structural change' resulted from high wages, which led to the substitution of capital for labour and the contraction of uncompetitive industries. In any case, the sharp increases in unemployment in the years mentioned are difficult to explain by reference to structural changes.

Earlier discussion indicates that policies that promote economic growth and wage flexibility would reduce unemployment. In particular, wage flexibility would facilitate the adjustment made necessary by structural change. Falling wages in declining professions and rising wages in expanding professions would provide appropriate incentives for workers. As well, high differentials for scarce skills would encourage workers to acquire such skills and reduce the number of mismatches. Nevertheless, these policies may not be able to reduce unemployment below a minimum level that depends in part on structural change.

Industry policy may assist in reducing it further, but this is a case in which concentration on the short term can easily lead us to adopt policies that exacerbate our long-term problems. The history of industry policy in Australia has few long-term successes to its credit.

Present Policies

Fiscal stimulus. A fiscal stimulus may be appropriate in the face of high unemployment, but its effectiveness is likely to be greatly reduced by the tendency for higher budget deficits to lead to larger current-account deficits. The high level of external debt is an important constraint on fiscal policy. If Australia's credit rating falls, debt-servicing costs will increase.

This comment raises the question of the reaction of financial markets to expansive fiscal policy. Markets do not like budget deficits, fearing that they presage higher inflation. This is a legitimate concern and markets should be free to react to it. Nevertheless, a government cannot allow its economic policy to be dictated by financial markets, which of necessity focus on very short-term outcomes. This is not to suggest that financial markets always react in a rational and well-informed way, even in the short run. Market participants focus on the deficit figure, and this leaves them open to manipulation by the government. For example, the deficit figure is reduced by asset sales, even though these sales represent as much a drain on available savings as a sale of government securities.

In addition, the deficit figure tells us nothing about the composition of government spending and taxation collections and their effect on the economy. Fiscal stimulus is currently being provided in the form of consumption, and public-capital formation is a declining proportion of GDP. Government borrowing leads to offshore borrowing, but this may be a responsible policy when the borrowings are used to expand productive capacity so that the debt can be serviced more easily. If they are used to finance consumption, the long-term effects are likely to be very unfavourable.

Training. Training has become the all-purpose solution to unemployment. It is not clear why this is so because training does not in itself create jobs. Nor is it possible to train anybody for any occupation. There will always be a need for jobs for unskilled workers.

It is the quality, rather than the quantity, of training being provided that must be questioned. Relatively little thought has been given to designing education so that its output meets the needs of employers. There is also increasing cynicism about the quality of the education system. A major obstacle to the accumulation of skills by the workforce is the inflexibility of the wage structure. Skill differentials do not adjust rapidly enough or by a sufficient magnitude to properly reflect shifts in the demands for different skills. It is only when skill differentials become sensitive to demand and supply conditions that the educational process will become sensitive to economic conditions. Similarly, educational institutions will become sensitive to the needs of their students and their potential employers only when their funding is tied to demand and adequate competition has been introduced in the educational market.

Employment programs. Working Nation: Policies and Programs, the government's White Paper on unemployment, was released in May 1994. It proposed a comprehensive program for dealing with the unemployed, but the emphasis is on easing the social pain rather than reducing unemployment. The major planks of the policy are as follows:

- programs in which employers are subsidised up to $230 a week for six months for each long-term unemployed person they hire;
- a scheme under which employers pay a lower 'training wage' and are required to provide formal training for workers;
- a 'jobs compact' in which the long-term jobless are paid $280 a week for up to six months to work on community projects and spend 40 per cent of their time on training;
- traineeships, including the Australian Traineeship System, under which trainees work for three days a week and spend two days at TAFE; and
- extensive case management increasing in intensity as the term of unemployment increases.

Although it is desirable to assist the unemployed, these policies suffer from a number of important weaknesses. First, they rely heavily on the training solution which, we argued above, is not the panacea the government assumes it to be.

Second, the programs involve significant bureaucratic activity to provide case management and to administer the various subsidy schemes. These schemes will require considerable supervision to prevent abuses, and this supervision could create compliance costs that make the programs less attractive to business.

Third, since many of the programs provide short-term jobs, they simply defer the problem. They involve marking time in the hope that jobs will come from somewhere — a domestic upturn or favourable developments overseas.

Fourth, it is quite possible that the wage subsidies and training wages in the programs will move unemployment around rather than reduce it. The workers employed on lower wages could displace other workers and they may in their turn be displaced when the subsidy runs out or the lower wage terminates.

Conclusion

The major cause of unemployment is to be found in the level and flexibility of labour costs. Policies that do not take account of the dependence of employment on wages, such as those announced in *Working Nation*, can provide only short-term relief. Necessary as these short-term policies may be, they do not remove the need to search for a lasting solution to the problem.

A solution is available only if we are prepared to take steps to make wages more sensitive to economic conditions and to allow greater flexibility in the wage structure. This means that we must surrender the illusion that was introduced by Mr Justice Higgins in 1907. Wages cannot be used both to redistribute income and to maintain high employment. Higher living standards cannot be mandated, but they can be facilitated by wage flexibility.

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Corporate Theory and Corporate Law Reform in Australia

Ian M. Ramsay

In the last few years Australian corporate law has been significantly reformed. The reforms include:

- increased duties imposed upon company directors;
- regulation of transactions between public companies and their related parties;
- increased disclosure requirements for public companies;
- new liability upon parent companies where a subsidiary trades while it is insolvent and heightened liability upon directors for the insolvent trading of their companies;
- a wider definition of insider trading; and
- increased regulation of public unit trusts.

This article evaluates some of these reforms in the light of a range of current theories of the corporation.

Two Theories of the Corporation

Recent debates about corporate law focus mainly on two contrasting theories of the corporation: the *managerialist* (or institutionalist) theory and the *contractual* theory (Symposium, 1989; Macey, 1993). The theories have different implications for corporate law and therefore corporate law reform. They are both concerned with corporate governance; in particular, they both endeavour to formulate ways to ensure that the managers of companies act in the interests of shareholders. But they differ fundamentally on how this objective is to be accomplished.

The managerialist theory of the corporation emphasises corporate management and the power that it wields. The issue is whether management holds and exercises this power legitimately (Bratton, 1989:1476). Critics of management argue that man-

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Ian Ramsay is Harold Ford Professor of Commercial Law at the University of Melbourne.

agers often exercise power without accountability to shareholders; in public companies, shareholders are unable to monitor effectively the managers of their companies, so that legal intervention is needed to protect the interests of shareholders.

In the managerialist theory, accountability is secured by the imposition of mandatory legal duties upon directors and other officers. These include the duties to act honestly, to exercise care and diligence, not to make improper use of information acquired by virtue of being an officer of the company, and not to make improper use of position as an officer of the company (see s.232 of the Corporations Law[1]). In addition, corporate managers are subject to disclosure obligations. These obligations apply generally (for example, where a director has a personal interest in a matter that is before the board of directors — ss.231 and 232A of the Corporations Law) and in specific contexts such as where the company is raising capital from investors (Chapter 7 of the Corporations Law). These legal duties and obligations may be enforced by the company itself (where the duties are owed to the company rather than to individual shareholders), by shareholders, or by the Australian Securities Commission.

In contrast, the contractual theory of the corporation emphasises the role of market forces, rather than legal rules alone, in aligning the interests of corporate managers and shareholders. The theory is based upon the works of Coase (1937), Jensen and Meckling (1976), and Fama (1980). According to the contractual theory, competitive markets are more important than mandatory legal rules in providing managers with appropriate incentives to maximise shareholder wealth. These markets include the product market, the market for corporate control and the managerial labour market. The contractual theory does not imply the absence of legal rules, but asserts that to the extent that market forces require managers to act in the interests of shareholders, there is less need to seek this outcome through mandatory corporate rules.

Clearly, the validity of the contractual theory depends upon the efficiency of the markets. As for products markets, adherents of the theory argue that management must ensure that the company competes effectively in the market for the company's goods and services; but critics stress that product markets may not always be competitive.

The market for corporate control should similarly discipline management, since any lack of efficiency should be reflected in the company's share price, thus creating an opportunity for a raider to take over the company, install more efficient managers, and thereby realise higher profits. Yet there are limits on the effectiveness of the market for corporate control. Bebchuk (1992) asserts that the market for corporate control cannot be relied upon to discourage managers from taking action that increases their wealth at the expense of shareholders. Further, Coffee (1984) argues that the market for corporate control applies only within a limited range. Companies whose management is not inefficient enough to lower the share price to the point at which it attracts a takeover bid, and companies that are so inefficient that takeovers are deterred by the risks involved, fall outside this range. The market for corporate control may represent only a weak discipline on such companies.

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[1] The Corporations Law came into effect on 1 January 1991.

The managerial labour market should operate to discipline management, since any reduction in shareholder value due to management inefficiency may reduce the employment opportunities of managers. However, there is evidence that managers typically face a very small prospect of dismissal. Summarising the results of their study of US companies, Jensen and Murphy (1990:240) claim that 'the data suggests that CEOs bear little risk of being dismissed by their boards of directors. The CEOs in our sample who leave their firms during the thirteen-year sample period hold their jobs an average of over 10 years before leaving, and most leave their position only after reaching normal retirement age'. Yet management turnover will increase in financially distressed companies (Gilson, 1989).

Since the contractual theory of the corporation relies mainly on market forces to discipline management, it envisages limiting the role of government to providing rules that deter one-off instances of management self-dealing (which cannot be prevented by market forces) and imposing standard-form contracts that reduce the transaction costs of negotiating new contracts.

Additional Liabilities on Directors and Managers

A prominent feature of recent corporate law reforms in Australia is the additional liability they impose upon directors or managers (see Redmond, 1992, for more detailed discussion). Two examples concern financial benefits to related parties of public companies and continuous disclosure obligations.

Detailed amendments to the Corporations Law designed to regulate financial benefits to related parties of public companies came into operation in February 1994. The express purpose of the amendments is to protect the resources of public companies and the interests of their shareholders by requiring that, in general, financial benefits to related parties that could diminish or endanger those resources or that could adversely affect those interests be disclosed and approved by shareholders before they are given. Any person involved in the contravention of this legislation, including directors of the public company giving the financial benefit, may suffer a penalty.

Legislative amendments to the Corporations Law relating to continuous disclosure came into effect in September 1994. Under these amendments, a range of companies and other investment vehicles that hitherto have not had to comply with the continuous-disclosure requirements of the Australian Stock Exchange will be required to immediately disclose information that is not generally available and that, if it were available, would be expected to have a material effect on the price or value of the company's securities. Any person involved in a contravention of these provisions, including any directors or managers, may be sued for damages by any person who suffers loss because of the contravention.

These two reforms are best understood in the light of the managerialist theory of the corporation. At their core lie issues of management accountability. Their objective is to enhance this accountability by increasing the legal obligations upon corporate managers. The managerialist theory also emphasises the need for enhanced monitoring of managers by shareholders. This too is recognised in the reforms, both of which

contain increased disclosure-requirements to shareholders and, in the case of the related-party transaction reforms, require approval by shareholders of financial benefits to related parties.

Equivalent reforms in the US, in contrast, reflect the contractual theory of the corporation. Recent amendments to Delaware corporate law allow Delaware companies to amend their articles of association to eliminate monetary liability of directors to the company and its shareholders for breach of the duty of care. These amendments have been adopted by many other states (Bradley & Schipani, 1989). The reforms emphasise voluntary contracting by shareholders and, by permitting shareholders to contract out of what was previously a mandatory duty imposed upon company directors, acknowledge that there may be other means of aligning the interests of directors and shareholders than the imposition of mandatory legal rules.

However, it should be noted that other theories have been advanced to explain the introduction of certain changes in corporate law. One of these is public choice theory, which focuses on the political process conceived as a competition among groups for political influence (Farber & Frickey, 1991). One of the conclusions of public choice theory is that interest groups that are small, single-minded and well-organised tend to be more influential than interest groups with diverse agendas; as a result, the political process tends to produce laws that advance the interests of well-organised interest groups at the expense of weaker ones.

Some of the mandatory disclosure rules imposed upon companies seem consistent with public choice theory. It has been argued that the main beneficiaries of mandatory disclosure requirements in the US have been members of the professional trading community. Mandatory disclosure rules allegedly help these traders by making it cheaper to obtain, process, and verify information concerning companies. According to Gilson and Kraakman (1984:641), this explains 'the overwhelming support that the securities industry gave expansion of the disclosure system . . . as well as the generally high esteem in which the industry holds most [Securities and Exchange Commission] disclosure activities'. Phillips and Zecher (1981:118) also use public choice theory to explain the expansion of the Securities and Exchange Commission's disclosure requirements:

> These [disclosure requirements] are characterised by wealth transfers from investors and corporations for whom the cost is not great on a per capita basis to a relatively small group of processors [of the information], which includes securities lawyers, accountants, security analysts, and of course the Securities and Exchange Commission's employees. There is insufficient economic incentive by the members of the taxed groups to organise in opposition to this type of regulation.

The Costs of the Reforms

Whether the Australian reforms succeed in increasing managerial accountability to shareholders remains to be seen. However, some of the costs of the reforms can be

calculated. First, there are obvious compliance costs. The related-party transaction reforms require shareholders to vote on a range of financial benefits from public companies to their related parties. The continuous-disclosure reforms will also impose compliance costs. These costs may have adverse effects on the productivity of Australian companies and, to the extent that foreign companies competing in the same markets as Australian companies do not have to comply with these types of rules, they will affect their competitiveness too.

A second cost, which is related to the first point, turns on the argument that the recent reforms emphasise minimum conformity by company directors with the new obligations rather than the far more important objective of company performance. This argument is summarised in a recent report

> At some point over the last several years the debate about what boards of directors ought to do and be responsible for took a wrong turn. In almost every other area of economic life the debate has been about how various participants can improve the quality and volume of their productive contributions. For example, workplace reform, management development and financial deregulation are all about increasing competitiveness and productivity and achieving standards of best practice. In contrast, the debate about directors has become preoccupied with criminality, fraud, negligence and minimum standards. The worry about the rotten apple — and there have been a number — has deflected attention from the main game of wealth creation which is, in turn, the driver of new investment and job creation. . .
>
> What we are finding is that the board's list of responsibilities is expanding, and that most of the new activities fall into the conformance rather then performance category. As these activities are added to the board's duties, its agenda becomes increasingly cluttered and pressured. Moreover, many of these new responsibilities are sheeted home to directors personally, so that there is considerable individual incentive to overkill on compliance, even if the cost is less board attention on long-term performance. (Sydney Institute, 1993:1,18)

This quotation raises for discussion the critical issue of the circumstances under which the imposition of personal liability upon directors is appropriate. It may be that, in some instances, the costs of imposing personal liability upon directors outweigh the benefits. Interestingly, economic theory has traditionally had little to say about the legal duties imposed upon directors. According to Hart (1993), this may be because neoclassical theory, which until recently dominated the economic literature on the corporation, has little or nothing to say about directors' duties because it operates with a conflict-free conception of the corporation in which selfless managers act solely in the interests of shareholders. The development of economic theories that recognise that the interests of shareholders and directors may diverge allows analysis, from an economic perspective, of directors' duties as one possible way in which the costs that arise from this divergence may be reduced (McEwin, 1992).

From a law and economics perspective, it is appropriate to impose liability upon directors only where they can control the risks associated with liability and, where appropriate, can shift this risk to persons who are better bearers of the risk. Otherwise, directors will become risk-averse in their decision-making and fail to maximise shareholder wealth. With respect to the ability of directors to control the risks associated with their companies, it is important to note that, in the case of directors of public companies, the expectation is not that they will manage the day-to-day business of the company. Rather, the board of directors is expected to monitor management. This is recognised in the leading judgment of Justice Rogers where he stated:[2]

> The board of a large public corporation cannot manage the corporation's day to day business. That function must by business necessity be left to the corporation's executives. . . The directors rely on management to manage the corporation. . .
>
> It is of the essence of the responsibilities of directors that they take reasonable steps to place themselves in a position to guide and monitor the management of the company.

The main difficulty with imposing additional personal liability upon directors is that their inability to diversify or shift this risk makes them inefficient bearers of risk. Investors of both equity and debt in companies are able to diversify their holdings and thereby minimise the risk associated with investing in any one company. However, directors are much more risk-averse because their human capital is invested in only one company. The human capital even of non-executive directors is invested in only a small number of companies and therefore cannot be fully diversified.[3]

One way directors can diversify risk is by obtaining insurance. Recent reforms to the Corporations Law (s.241A) allow companies to pay the premiums for directors and officers' liability insurance. However, the international experience is that even where the law permits directors' and officers' insurance, it may often not be available (Daniels & Hutton, 1993). This point should be pondered by those who believe that imposing additional liabilities upon company directors is the necessary solution to problems in the area of corporate governance.

A final cost of some of the corporate law reforms is that, because they are mandatory rules, they deny shareholders the opportunity to enter into different types of contracts with corporate mangers. This is a particular problem for legal rules introduced by a national or federal government. On the other hand, regulation introduced by a state government may be superior in facilitating shareholder choice. These issues are discussed in the next section.

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2 *AWA* v *Daniels*, (1992) 7 ACSR 759 at 864 and 866.

3 A study of the largest 250 Australian companies revealed that 80 per cent of the directors of these companies held only one directorship while a further 12 per cent of the directors held only two directorships (Carroll, Stening & Stening, 1990).

National or State Corporate Regulation?

Australian corporate regulation is essentially a national system of regulation. In this respect, Australian corporate regulation differs significantly from that of some other countries where corporate law is the responsibility of state governments and the legislation can differ in substantial ways from state to state. If the goal is to facilitate shareholder choice, state governments may be better able to achieve it than the national government.

There are of course arguments that favour national regulation of companies. For example, the transaction costs associated with companies doing business can be reduced if they have to deal with uniform national law rather than a series of different state laws. In addition, regulation by the national or federal government may overcome the incentive of state governments to externalise costs. This will occur where a state government does not bear all of the costs of action that it undertakes.

Yet there are powerful arguments favouring state government regulation of companies (McEwin, 1990; Ramsay, 1990). The federal government may be more insensitive than state governments to the needs of shareholders and other participants in companies. Indeed, it is a fundamental rationale of federalism that governments with different jurisdictions can better satisfy the enormous variety of preferences in society (including the preferences of shareholders).

Another argument favouring state regulation is that a state government has less scope for enacting harmful legislation than the federal government. This is because the more local the jurisdiction of a government is, the more readily people and businesses can move in order to find a more hospitable jurisdiction: in other words, each government serves as a substitute for the others. Again, national regulation of companies makes it difficult to determine whether this regulation is optimal because there is no competition for the provision of corporate regulation. Companies and their shareholders do not have a choice and cannot indicate their preference for alternative regulation by incorporating in another jurisdiction. Finally, allowing regulation by state governments can increase innovation and experimentation as each government competes to attract business and employment by enacting corporate legislation that is attractive to companies and their shareholders.

Federal regulation can indeed stifle commercial innovations. In recent years limited partnerships have emerged as an alternative form of financing investment in particular projects. Partnerships are subject to state government regulation (each state has its own Partnership Act). However, the federal government intervened in the 1992/93 federal budget to provide that limited partnerships would be taxed in the same way as companies. Prior to this, limited partnerships enjoyed a significant tax advantage over other business structures such as companies in that they allowed the flow-through of partnership losses to individual partners that could be offset against a partner's other assessable income. The effect of this announcement by the federal government was a substantial decline in the registration of new limited partnerships (Ramsay, 1993).

Another example concerns partial takeovers. A partial takeover occurs where an attempt is made to gain control of a company by purchasing less than 100 per cent of the voting shares of that company. Partial takeovers used to constitute an important

part of the market for corporate control in Australia, at one time accounting for well over 20 per cent of all takeovers undertaken. However, in 1986, the federal government introduced amendments that effectively saw the demise of partial takeovers. The year after the amendment, partial takeovers constituted only 6 per cent of all takeovers and have never constituted more than 5 per cent since (Ramsay, 1992).

Conclusion

The pace of corporate law reform in Australia has quickened considerably. Much of the reform is best understood in the light of the managerialist theory of the corporation, which emphasises the importance of legal duties and obligations imposed on corporate managers.

Insufficient attention has been paid, however, to the costs of the some of the reforms. These include compliance costs and an emphasis on company directors' compliance with the new laws at the expense of their performance. Additional costs arise because the reforms are mandatory, thus denying shareholders the opportunity to enter into alternative contractual arrangements with company managers. Corporate governance would perhaps be more effectively reformed by changes that facilitate shareholder choice.

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Evaluating New Zealand's Companies Law

Michael J. Ross

The Companies Act 1993, which came into effect on 1 July 1994, provides for greater flexibility for corporate operations and for corporate restructuring in New Zealand. Two main areas of change are involved: equity capital and directors' powers and obligations. (The law relating to receiverships and liquidations is also amended; a new regime for takeovers was considered but not implemented.) Although the business community has generally accepted the changes, some points of contention have arisen, particularly in relation to directors' duties and obligations. The new rules have been condemned as cumbersome, a threat to managerial autonomy, and likely to restrain risk-taking. However, the critics have often misunderstood the current rules, or the new rules, or both.

The Background to Present Company Legislation

For 150 years, New Zealand company law was derived mainly from English law. In contrast, the Companies Act 1993 is based on a North American model. It was conceived in 1986, when the then Minister of Justice, the Rt. Hon. Geoffrey Palmer, requested the Law Commission to review existing companies legislation. In its initial discussion paper, the Commission took the view that English-based companies legislation was inadequate to deal with the flexibility demanded by current commercial practice: 'company law should concentrate on matters of company structure and should permit as much flexibility as is consistent with the integrity of the registration system and the prevention of abuse' (Law Commission, 1987:3). This stance is consistent with the views of Easterbrook and Fischel (1991), who argue that investors should be free to negotiate the type of business structure they desire, but that a standard statutory format that participants are able to adopt facilitates savings in transaction costs.

The discussion paper favoured the adoption of principles contained in the United States Model Business Corporation Act, a model that, in various forms, has been enacted in many North American jurisdictions. In its final form, the Companies Act 1993 drew heavily on Canadian legislation: the Ontario Business Corporations Act 1982, and the Canada Business Corporations Act 1985.

Michael Ross is Senior Lecturer in Commercial Law at the University of Auckland.

Companies presently operating under the Companies Act 1955 have three years within which to reregister as companies under the Companies Act 1993. Under the Companies Reregistration Act 1993, those companies that do not formally apply for reregistration during that time will be deemed reregistered at the stroke of midnight on 30 June 1997. Meanwhile, under the Companies Amendment Act 1993, many of the provisions in the Companies Act 1993 have been inserted into the 1955 Act, with effect from 1 July 1994. As a consequence, some but not all of the recent reforms apply to all corporates in New Zealand from the same date.[1] Two tiers of company law will therefore operate within New Zealand until 1997: the Companies Act 1955 (as amended) governs companies yet to be reregistered; and the Companies Act 1993 governs existing companies that have reregistered as well as new companies incorporated after 1 July 1994.

Reregistration involves a range of costs. Some 155,000 incorporated companies will require formal reregistration or will be automatically reregistered. In addition to filing fees on reregistration, there is the cost of professional advice on the form reregistration should take and the opportunity cost to management of determining the best constitutional structure and the best equity capital structure to carry into the new 1993 Act regime. But the cost of reregistration can be justified if the new regime reduces operating costs, as it will do if its potential is recognised and exploited.

Company Structure

The Companies Act 1993 provides for a streamlined structure for companies. As a bare minimum, each company must have at least one share, at least one shareholder, and at least one director (s.10). The previous requirements for a company constitution and a separate memorandum of association and articles of association are repealed (s.26). A company may operate off the 'standard' constitution embedded in the Companies Act 1993. Companies may depart from some, but not all, of the standard rules by filing their own separate registered constitution.

The legal possibility of a one-share-one-shareholder company does away with the historical need for a minimum of two shareholders: a requirement satisfied by the tiresome practice of needing one nominal shareholder holding a single share in trust for the true owner of the business. A one-shareholder company reduces administration costs in those areas where shareholder consent is required. This should prove particularly attractive to owner/operator businesses in which the business may become 'incorporated individual', and to wholly-owned subsidiaries where the holding company may be the sole shareholder.

[1] Amended into the Companies Act 1955 with effect for all 1955 Act companies from 1 July 1994 are: the codification of directors duties; enhanced minority shareholder rights; abbreviated procedures for amalgamating solvent companies and for compromises between insolvent companies and their creditors; and new liquidation procedures.

Even where a company has multiple shareholders, shareholder involvement may be minimised through use of a 'blank cheque' procedure. Shareholders may give consent, in advance, to directors operating their company other than in compliance with many of the strict statutory procedures (s.107). The consent must be in writing, and it must be unanimous; any one shareholder can withdraw consent (in relation to future actions) at any time simply by giving notice to the director(s). The requirement for unanimous shareholder consent renders this shortcut available only to closely-held companies where changes in shareholding are infrequent. Whenever there is a change in the identity of shareholders, 'unanimous consent' survives only if the new shareholders so agree. This procedure can reduce compliance costs when a company is repurchasing or redeeming shares, making a distribution to shareholders, providing financial assistance for the purchase of shares, and considering directors' remuneration. It minimises shareholder involvement in those companies where shareholders and directors are one and the same persons, but it does not minimise or reduce directors' general duties and obligations. In particular, the Act specifically requires that directors ensure that their company remains solvent while using these procedural shortcuts (s.108).

The obligation to appoint a company secretary disappears under the new regime. This gives directors some discretion over the level of compliance costs involved in meeting their statutory record-keeping and filing requirements.

Equity Capital

However, it is in the area of equity capital and distributions that the most radical change is wrought by the new Act.

Companies operating under the new regime must have shares of no par value (s.38). This does away with the accounting and legal problems that flow from shares with par value, in two ways. First, having no par value, shares can no longer be issued at a premium. The absence of a share premium account in a company's financial statements removes the historical problem of share premium being treated as part of the company's share capital and generally being unavailable for distribution to shareholders without prior court approval. Second, and by the same token, shares cannot be issued at a discount below par. Historically this has been a problem facing public-listed companies where their shares are quoted at a price below par value. The company's trading losses have eroded capital to such an extent that the shares have less value than the capital historically contributed. Under a par value regime, court approval is required to issue shares at a discount. But under the 1993 Act, directors are required simply to issue shares for a fair and reasonable consideration (s.47). In practice, this means that directors must ensure that the correct number of shares is being issued in return for the consideration being received: a calculation that directors must in any case implicitly make when issuing shares under a par-value regime.

Distributions to Shareholders

The capital maintenance doctrine is also abolished by the new regime. Directors may at any time apply company resources for shareholders' benefit as long as the company's ability to pay creditors is not harmed. The company must satisfy a statutory solvency test after making the distribution (s.4). The distinction between capital and income is done away with for company-law purposes. As long as there are sufficient resources left within the company to satisfy creditors, all other resources may be returned to shareholders. This is different from the traditional English practice, whereby issued or subscribed capital provided a buffer (often an illusory one) as creditor protection, and any 'reduction in capital' by way of a distribution to shareholders required prior court approval. The price of this new flexibility is that directors face potential liability to repay any distribution made to shareholders at a time when the company did not satisfy the solvency test (s.56). Even so, primary liability lies with the shareholder(s) who received the distribution: only if those shareholders are excused repayment by the court, or are insolvent and cannot repay, can the directors be held responsible for repayment.

Some lawyers have been critical of the 'paper war' arising under the new regime when directors decide to make a distribution. These criticisms are best evaluated by broadly comparing the provisions of the capital maintenance regime of the 1955 Act with the equivalent provisions of the 1993 Act. Under the 1955 Act dividends were payable only out of profits. Approval was required first by directors and then by shareholders. Court approval was needed for any distribution to shareholders of the portion of the company's resources held to be capital. Under the 1993 Act, in contrast, directors alone can decide to make a distribution. Before doing so, directors must ensure that the company can meet its debts. But this is not a substantial advance on the traditional obligation resting with directors to ensure that there were profits available for distribution and that creditors would not be harmed by payment of the dividend. Cases decided under the 1955 Act, such as *Hilton* v *Hilton International Ltd*,[2] make it clear that directors are always expected to consider corporate solvency before returning company resources to shareholders. The only difference under the 1993 Act is that directors must provide a certificate of corporate solvency before making a distribution. This requirement makes explicit what was an implicit obligation at common law.

From the New Zealand Court of Appeal:[3]

> The duties of the directors are owed to the company. On the facts of particular cases this may require the directors to consider inter alia the interests of creditors. For instance creditors are entitled to consideration . . . if the company is insolvent, or near-insolvent, or of doubtful solvency, or if a contemplated payment or other course of action would jeopardise its solvency.

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[2] [1989] 1 NZLR 442.

[3] *Nicholson* v *Permakraft (NZ) Ltd* [1985] 1 NZLR 242, 249 per Cooke J.

And from the House of Lords:[4]

> the company owes a duty to its creditors to keep its property inviolate for the repayment of its debts.

The obligation on directors to provide a solvency certificate whenever making a distribution to shareholders can hardly be considered an onerous obligation that negates the benefits otherwise available under the 1993 Act. Since 1980, New Zealand companies legislation has required company directors to maintain accounting records sufficient to ensure the financial position of the company may be determined at any time with reasonable accuracy (s.151 Companies Act 1955 and s.194 Companies Act 1993). There is a statutory obligation to maintain a management information system capable of providing timely information regarding solvency. It is surely a small step to confirm the use of this information with a signed certificate.

Codification of Directors' Duties in the Companies Acts 1955 and 1993

The major area that affects equally the operation of 1955 Act companies and 1993 Act companies is the codification of directors' duties. The Law Commission (1990:xxii) reported overwhelming support for the proposition that directors' duties should be extracted from the common law and made accessible in companies legislation. This would reduce costs to the business community in determining their legal obligations as directors.

Consequently, directors' duties have been codified, and the codification contained in the Companies Act 1993 has been inserted into the Companies Act 1955. Debate has been joined, not on the issue of codification, but whether the statutes as now worded reflect the common law or extend existing common-law obligations. The debate has involved a turf battle between the Law Commission and the Department of Justice over control of the process of company law reform; and business leaders with libertarian views have argued for a reduction in state intervention in business generally and corporate governance in particular. One author of the Law Commission's reports on the companies legislation has described the Companies Act 1993 as 'incoherent' (Hodder, 1994).

The rules relating to directors' duty of care and to risk-taking have attracted most criticism. A director's statutory duty of care as expressed in s.191 of the Companies Act 1955 and s.137 of the Companies Act 1993 require:

> A director of a company, when exercising powers or performing duties as a director, must exercise the care, diligence, and skill that a reasonable director would exercise in the same circumstances taking into account, but without limitation: —

[4] *Winkworth* v *Edward Baron Development Co Ltd* [1987] 1 All ER 114, 118 per Lord Templeman.

(a) the nature of the company; and
(b) the nature of the decision; and
(c) the position of the director and the nature of the responsibilities undertaken by him or her.

According to Roderick Deane (1994:3), Managing Director of Telecom New Zealand, this formulation is singularly unhelpful, and directors await case law to determine the definition of a 'reasonable director'. The statute requires a director to exercise a reasonable standard of care: the standard of care, diligence and skill expected of a director showing sound judgment in the given circumstances. A failure to meet this standard could leave directors liable to pay damages to their company. Given that the traditional common-law view as expressed in cases such as *re City Equitable Fire Insurance*[5] has been that directors (particularly non-executive directors) need display only such skill and expertise as they in fact possess, the new statutory obligation to exercise a reasonable standard of care appears to be a higher standard. However, the common law has moved on since cases from the turn of the century. The more recent view was best summarised by Justice Rogers in *AWA Ltd* v *Daniels*:[6]

> it is of the essence of the responsibility of directors that they take reasonable steps to place themselves in a position to guide and monitor the management of the company.

In the *AWA Ltd Case* the company's chief executive officer was held liable for part of the company's A$49m loss on foreign-exchange trading. He was aware that a company employee was involved in unsupervised speculative foreign-exchange dealing and that there was a lack of internal controls and a paucity of records relating to open foreign-exchange positions. Despite this knowledge, he failed to implement appropriate accounting procedures in the company's treasury section. By comparison, the company's non-executive directors were held not liable for any of the losses. They had expressed surprise at the level of profits on foreign-exchange dealing being reported to the board by the treasury section. They recognised foreign exchange dealing was a high-risk activity and sought assurances that appropriate internal controls were in place. The board was repeatedly assured by both the chief executive officer and the company auditor that everything was under control. It was not, but that was through no fault of the board, which had carried out its function of overseeing, guiding and monitoring management performance. The fault lay with management, particularly the chief executive officer. It was those who had failed to do their job properly who were ordered to pay damages.

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[5] [1925] Ch. 407.

[6] (1992) ACSR 759, 864.

The Privy Council recently affirmed the traditional views expressed in *re City Equitable Fire Insurance*, but then coloured this affirmation by stating that company directors must exercise reasonable diligence and skill in the performance of their duties as directors.[7]

The essence of this common-law obligation has been codified into the 1955 and 1993 Companies Act. At common law, directors must already exercise a measure of reasonable care and skill. At common law, there is a distinction between the respective duties and obligations of executive directors, non-executive directors and the board. The board collectively is responsible for policy, while company employees, including executive directors, are responsible for implementing policy. The board is not responsible for the defaults and failures of company employees, provided the board has in place an appropriate reporting system and a system of internal controls to monitor and review the performance of employees. These common-law obligations are now explicit in the statute. Those commentators who criticise the statute as imposing harsh new obligations, over and above those obligations existing at common law, appear not to appreciate the current common-law position. The common law does not discourage risk-taking. Neither does the statute. But it has to be a calculated risk, not an unsupervised gamble.

Another complaint is that s.189 of the Companies Act 1955 and s.135 of the Companies Act 1993 discourage risk-taking. These sections hold directors liable should their company carry on business in a manner 'likely to create a substantial risk of serious loss to the company's creditors'. The fear is that directors will become more risk-averse. The irony is that this phrase comes straight out of existing case law. In *Thompson* v *Innes*,[8] Justice Bisson said the reckless-trading provisions in statute law were designed to prevent directors 'continuing to carry on the business of the company [if this] would cause . . . serious loss to creditors'. Arguably, the new statutory provision is even more gentle on directors: they are at personal risk if continued trading would create a *substantial* risk of serious loss. Prudent directors have little to fear if the principles applied in *Thompson* v *Innes* are similarly applied in future cases. In *Thompson's Case*, the company was never profitable at any stage. Financial statements drawn up at the end of the first year's trading determined that the company had traded at a loss. Part way through the following year, the company's bankers intervened, requiring a budget and tight control of expenses in order to reduce the bank's exposure. The company's position did not improve, yet the company kept trading. In the last seven weeks of the company's existence, the directors purchased further goods on credit, removed stock for the directors' personal benefit, took cash drawings and repaid the guaranteed bank overdraft. The directors were ordered to repay NZ$25,000 for the resources extracted from the company over this last seven week period, a time when the company was hopelessly insolvent. They were not required to compensate the company for losses arising in the preceding months. The

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[7] *Kuwait Asia Bank EC* v *National Mutual Life* [1990] 3 NZLR 513, 533 per Lord Lowry.

[8] (1985) 2 NZCLC 99,463, 99,472.

courts have taken a pragmatic approach before imposing personal liability on management for company losses caused by reckless trading. Companies are given time to succeed or fail. Directors are held personally liable for debts incurred and resources extracted from the company when it is clear the company has no further chance of survival.

Conclusion

New Zealand's new companies legislation gives directors freedoms and flexibility not available under previous companies legislation. Directors are explicitly required to consider corporate solvency whenever carrying through transactions that might harm creditors. This is neither a new nor an onerous obligation. The Companies Act 1993 makes explicit those director's obligations that were implicit in earlier company law.

The question of corporate governance is addressed by a codification of directors' duties. The legislation imposes on directors a statutory duty of care. While there has been concern that this codification extends the duties imposed on directors, the sounder view is that the statute is simply declaratory of the existing law. The legislation captures recent common-law trends in corporate governance; codification of these rules makes the law more accessible.

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Insurance Pricing and Anti-Discrimination Legislation

Alan E. Woodfield

Many countries have legislation seeking to prevent discrimination. Outlawed practices typically include those based on highly visible characteristics of individuals such as sex, age or race, but sometimes include less visible characteristics, such as religion or sexual preference.

Should insurance companies be required in law to offer insurance under the same terms and conditions to people irrespective of their sex? This article tries to answer this question by reference to the outcomes of such legislation. It should be noted at the outset that although insurance firms charge women more than men for some types of insurance (such as annuity purchases and disability insurance), insurers also charge men more than women for other types of insurance (such as life and vehicle-collision insurance). These sex-based differences in insurance premiums reflect cost differences, arising from sex-related differences in risk.

The article concludes that unisex insurance pricing creates adverse selection in insurance markets and is inefficient. Unisex insurance pricing is an ineffective device for raising the welfare of those who pay high premiums because of their sex-based high risk. Not only may it fail to raise their welfare, but targeted tax-subsidy policies are more efficient. These conclusions are relevant also where categorisation is based on other sources of risk difference, such as age or race.

Sources of Discrimination

At face value, charging some people a higher price because of their sex appears to be discriminatory. Discrimination, however, can mean many different things. It may reflect prejudice, resulting in different people being charged different prices for what is the same commodity. Discrimination may also result from the exercise of monopoly power. However, what may appear to be price discrimination often turns out to involve price differences that are based on genuine differences in costs.

Discrimination based on prejudice is very difficult to sustain in competitive markets; and it is hard to argue that insurance markets are not highly competitive. They are characterised by the presence of many firms, relatively few barriers to entry (although they must attract sufficient numbers of customers to permit efficient risk-pooling), and relatively low profits. They appear to attract little attention from anti-monopoly commissions. Even if insurers wanted to act prejudicially towards

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Alan Woodfield is Senior Lecturer in Economics at the University of Canterbury.

one or other sex (and it is quite unclear why they would wish to do), their ability to do so would be removed by the presence of other firms who were not prejudiced, and who would undercut the discriminating firms.

A similar argument applies to monopolistic price discrimination. Suppose that risk did not differ by sex, and an insurer tried to make excess profits, say, by charging a higher premium per dollar of cover to women than to men. Even though men would be unable to resell their low-priced insurance contracts to women, competitors would undercut the premium for women and gain all their custom. With a sufficient level of competition, there would be one price of insurance in the market.

The essential reason why women pay higher insurance premiums than men for disability insurance and a higher price to purchase an annuity, whereas men pay a higher premium for life insurance, is that there is well-established actuarial and statistical evidence relating to sex-based differential risks. These differential risks may reflect biological factors or actions that are correlated with a person's sex. The implication, however, is that the present value of expected costs of providing a woman with an annuity of given value is greater than for a man, while the present value of expected costs of providing a man with a given amount of life cover is greater than for a woman, for the *same* reason, namely, that on average, women live longer than men. In these circumstances, if men and women are required to buy the same contract, it is arguable that discrimination has been *created*, not removed.

For example, the United States Supreme Court has argued that using separate mortality tables for men and women in pension compensation plans discriminates against women since they would receive lower annual benefits or pay more for equal benefits than otherwise similar men. But since women outlive men, on average, they receive benefits for a longer period. Since pension compensation is the expected present value of *lifetime* pension benefits, the use of sex-based mortality tables to set contribution rates *removes* discrimination by charging males and females the same amount for the same expected present value of future benefits. In this context, McCarthy and Turner (1993) estimate that the unisex policy required by the Supreme Court *created* sex discrimination equal to 23.4 per cent of pension compensation for males. These calculations, however, presume that insurers will offer men and women the same contract.

Since it is difficult to sustain discrimination in the sense that different groups pay different prices for the same commodity, legislators may need to be properly informed that insurance is not the 'same good' for different risk classes. Consider the recent revision of human-rights legislation in New Zealand. The New Zealand Human Rights Act 1993 amalgamated and revised the Race Relations Act 1971 and the Human Rights Commission Act 1977. Section 48 of the Act effectively maintained previous legislation with respect to insurance in that it provides an exception to s.44 of the Act by permitting insurers to sell annuities, life insurance, and accident insurance policies on different terms and conditions for each sex (and for persons with a disability) as long as the different treatment is based on relevant actuarial or statistical data, or on reputable medical or actuarial advice or opinion. Yet the Act's forerunner, the New Zealand Human Rights Bill 1992, proposed to abandon

this exception on 1 January 1995. The submission of the Life Offices Association of New Zealand (1993) to the parliamentary select committee dealing with the bill emphasised expected cost differences in supplying different classes of insurance to men and women. This view apparently prevailed.

Nevertheless, some legislators choose to proceed with anti-discrimination policies in spite of sex-based cost differences. One argument is that it is unfair that high-risk groups should face higher insurance premiums, particularly if the higher risk results from bad luck of the draw rather than their actions. Here, legislation is seen to be necessary to compensate for discrimination on the part of nature. Another argument is that although one group may be higher-risk on average, some members of this group may be lower-risk than average, and, if they are not identified, it is inappropriate for them to pay higher premiums. Both of these issues are addressed in following sections. A major conclusion is that legislators against discrimination may be disappointed, since their policies are by no means guaranteed to make high-risk groups better off.

How a Competitive Insurance Market Operates

To see why anti-discriminators should treat the market as a friend rather than an enemy, consider how a competitive insurance market operates. To keep the analysis simple, and to concentrate on essentials, suppose for the moment that all persons are identical, and have equal earnings in the absence of some form of 'disability'. Each person, however, can suffer a disability that would reduce income by a given amount. The risk of disability is the same for all. Each person is risk-averse, which induces them to buy insurance from risk-neutral insurance firms that pool these various risks with the objective of maximising expected profits. Those customers suffering a disability receive compensatory payments financed from the premiums received from all customers. Insureds voluntarily enter into an agreement to redistribute total premiums contingent upon some of them being disabled. Which persons will be disabled, however, cannot be identified at the time of signing the contract.

If there were no resource costs to operating an insurance company, zero expected profits would imply that total premiums would equal total expected net payouts. It would pay people to insure themselves fully, that is, to purchase just enough insurance so that they would be exactly compensated for the income loss suffered should they become disabled. Define the price of insurance as the premium per dollar of net (of premium) payout in the event of disability. The price of insurance will directly reflect the likelihood that a disability will be suffered. It is assumed that this likelihood is outside the control of a person buying insurance.

The market is efficient. People are doing the best they can, subject to the resource constraints of the situation. No one can be made better off without making someone else worse off. There is no discrimination. Everyone is paying the same premium for insurance which reflects their risk of disability.

Now change the situation slightly. Instead of people being identical in every respect, suppose that the only difference between them (as far as the insurance

market is concerned) is that *all* women have a higher risk of becoming disabled than do *all* men; that is, risks are *perfectly categorised.* In the absence of regulation, the competitive market outcome is as follows. Both women and men will choose to be fully insured, but men will face a lower premium than women, reflecting their lower risk. Zero expected profits will be made on contracts sold to both men and women, and there will be no cross-subsidisation. To some people, the unwillingness (rather, the inability) of insurers to make men pay higher premiums so as to subsidise the unlucky women is a fault of the market mechanism that anti-discrimination legislation can correct.

The market is still efficient in that both women and men are doing the best they can subject to the resource constraints faced by society. Women can be made better off only by a transfer of resources from men. But what happens when anti-discrimination legislation is enacted? Presumably, legislators expect that if insurance has to be offered under 'the same terms and conditions' to both women and men, insurers will offer everyone the same contract. Now insurers may believe correctly that they cannot now stop women buying the low-priced contract designed for the low-risk men. But this does not imply that insurers will offer women and men the same contract at a price reflecting average risk. Anti-discrimination legislation does not typically appear to require any given insurer either to offer insurance under identical terms to any *other* insurer, or to prevent any insurer from limiting the amount of insurance offered to anyone. Recognising this opens up wide possibilities[1] and has some surprising results.

A Segregated Insurance Market

First, suppose that everyone is offered the full-insurance contract that women would buy in an unregulated market. Now let some other insurers offer insurance to everyone at a lower price, specifically, that which reflects male risk. However, the insightful insurer knows that if women as well as men can buy a full-insurance contract at this price, losses will be made on sales of the contract to women. So to prevent women from buying insurance at a price reflecting male risk, insurers must offer a contract that men find attractive compared to that being bought by women, while at the same time not attracting the high-risk women (yet being available to women in order to satisfy the legislation).

The outcome in this case is a segregated insurance market. Women buy the same contract as in an unregulated market, and the legislation makes them no better off. Men buy insurance at the same price as in an unregulated market, but cannot buy the full insurance contract they would otherwise choose. Instead, their insurance purchases are rationed, and they remain underinsured. Men receive only partial income replacement should they suffer a disability, and are worse off than in an unregulated market. If men have dependants, they will presumably also be worse off in this situation. The result of the legislation is pure economic waste.

[1] These are examined in detail in Woodfield (1994a).

The irony of this situation is apparent. Legislators have apparently outlawed discrimination against women by requiring that insurers should charge women and men the same price for insurance. But this is not what happens. Some insurers are selling low-priced, partial insurance contracts to men, while others are selling high-priced, full-insurance contracts to women. Both contracts, however, are available to everybody. The legislation has merely disadvantaged the low-risk group, which is said to be *adversely selected.* No person benefits, and an efficient market has been rendered inefficient by the legislation. An insurance market segregated on these lines meets the letter of the law, if not its spirit.

A similar example is as follows. Suppose that incomes differ systematically by sex, and that insurers can costlessly observe income differences. Then it may be possible for well-paid men to be offered full insurance at low premiums reflecting male risk if no similarly-paid women are available to seek insurance on these terms. Insurers could then refuse cheap insurance to low-paid women on the grounds that they do not earn enough to qualify for the policy designed for high-paid workers (who just 'happen' to be males). The market segregates, but there are no welfare effects for anybody.[2] The fact that the legislation can be effectively bypassed in these examples says little for it.

Imperfect Categorisation

The situation is more complicated when risks are imperfectly categorised. For example, suppose that women are more likely, on average, to suffer a disability than are men, yet it is known that a small proportion of men are high-risk types and also that a small proportion of women are low-risk types. Suppose further that each insured person knows their appropriate risk class, but that insurers know only that men are typically lower-risk than women. An insurer observing that a customer is a woman cannot be sure whether she is a high-risk or low-risk type, only that it is more likely that she is high-risk than if she were a man. Sex is correlated with risk, but imperfectly so, and the market is characterised by asymmetric information regarding risks between buyers and sellers.

There are now four groups to consider: low-risk men, low-risk women, high-risk men, and high-risk women. If insurers were as well-informed as their customers regarding their appropriate risk class, two full-insurance contracts would be offered. All low-risk persons would buy the same low-premium full-insurance contract while all high-risk persons would buy the same high-premium full-insurance contract. But with asymmetric information, insurers cannot identify which women are high-risk and which are low-risk, or which men are high-risk and which are low-risk. They consequently set contracts so that their customers identify their risk class by their purchases.

If it is not possible for a firm to introduce any further profitable contracts, the insurance market will adversely select the low-risk group even in the absence of anti-

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[2] Further details of related examples may be found in Woodfield (1994b).

discrimination policy. The reason is that a full-insurance policy with a price reflecting the probability of a disability for the low-risk group would make losses to insurers, who are unable to ensure that only low-risk persons buy it. Excluding all women from the right to purchase this contract would exclude some low-risk women. Permitting all men to purchase the contract would include some high-risk men buying it, and losses would be made on sales to them. Instead, the market offers two contracts, only one of which would be offered under symmetric information. This is the full-insurance high-premium contract, and is purchased by all high-risk men and high-risk women. The second is a low-premium contract, and is purchased by all low-risk men and low-risk women. But this contract also involves rationing of insurance to low-risk types, in order to appear marginally unattractive to high-risk types. Compared to a full-information situation, low-risk men and low-risk women are worse off, while high-risk men and high-risk women are no better off. The market is inefficient relative to the full-information situation. Notably, the *same* contracts are offered as when categorisation is perfect and insurers are required to offer insurance under the same terms and conditions to men and women.

Anti-discrimination legislators may find this situation unfair to women on two counts. First, the majority of women will be buying insurance at a higher price than the majority of men because nature has unfairly selected women as the high-risk group. Second, the minority of women who are low-risk types appear to be penalised because insurers cannot identify them as such. In particular, high-risk men will not identify themselves as such since this might result in their losing the opportunity to be pooled with low-risk types. However, a similar argument also holds for high-risk women.

Suppose a firm is selling both of these contracts prior to the enactment of anti-discrimination legislation, and then finds itself having to offer insurance under the same terms and conditions to its customers, regardless of their sex. Recall that it is selling two insurance contracts that have different prices. However, *some* women and *some* men will be buying each type of contract. Further, no woman or man is prevented from buying either of the available contracts. The firm may well be able to defend successfully a suit brought against it under anti-discrimination legislation. If, however, an insurer must be observed to be selling insurance to men and women at a unisex price, the market will be segregated between a group of firms selling the full-insurance high-premium contract to high-risk men and high-risk women, and a group of firms offering the rationed, low-premium contract that will be bought by low-risk men and low-risk women. Everyone would buy the same contract as they chose prior to the legislation.

As with the case of perfectly categorised risks, anti-discrimination policy is ineffective in raising the welfare of high-risk types, most of whom, by assumption, are women. When risks are imperfectly categorised, however, the welfare of low-risk types, most of whom are men in this example, is unchanged rather than lowered. The welfare of low-risk women, however, does *not* increase. With perfect categorisation, anti-discrimination policy makes an efficient insurance market inefficient. With imperfect categorisation, anti-discrimination policy does nothing to improve

an informationally-constrained inefficient (although otherwise efficient) market. Anti-discrimination policy does not even redistribute in favour of the high-risk group.

Why does the market not offer a pooling insurance contract offered to everyone at the same price? First, as Riley (1979) noted, a pooling contract does not satisfy a requirement that contracts satisfy a *self-selection constraint*, requiring that the contracts chosen reveal information on whether a person is a high-risk type or a low-risk type. Second, as Rothschild and Stiglitz (1976) demonstrated, if a pooling contract is offered, it is always possible for an insurer to enter the market and offer a profitable contract that will attract low-risk types but not high-risk types.

If anti-discrimination policy is ineffective in obtaining benefits for high-risk groups when risk is correlated with easily observable factors such as sex, age, or race, why not tighten the legislation to prevent its intent from being bypassed? For example, why not outlaw those firms selling low-priced, rationed insurance to low-risk types? Would not a pooling contract reflecting average risk then be offered? To achieve this, it would also be necessary to outlaw *all* those alternative rationed contracts carrying a lower price of insurance that would attract low-risk types away from the pooling contract. This runs into a possible conflict with competition policy, which encourages non-predatory price cutting. Further, it denies the market its valuable ability to offer a variety of policies to cater for individual differences in attitudes towards risk (which have been assumed away here). If moral hazard is present, so that the probability of disability could be influenced by actions that are hidden from an insurer, forced pooling of different risk categories could lead to inefficient investment in self-insurance and self-protection since insureds no longer face the appropriate price for market insurance.

In any case, however, as shown by Crocker and Snow (1985, 1986), it is possible to do better for high-risk groups than simply forcing insurers to offer uniform contracts. This involves setting a lump-sum tax on a low-risk group, the proceeds of which are used to finance a lump-sum subsidy on a high-risk group. Crocker and Snow show that it is always possible for a low-risk group to overcompensate a high-risk group in order for them to get the benefits of categorisation of risk when categorisation is either costless or at least not too costly, which is surely true for categorisation by sex, age, or race. Two points, however, arise in this context. First, the implementation of a tax/subsidy scheme may be very costly, and would be even more so if there were differences in attitudes towards risk, since different tax and subsidy rates for different people would require computation. Second, the exercise may be largely unnecessary if it is accepted that disadvantage in some markets, such as being a high-risk woman, is offset by corresponding advantages in other markets. For example, while longevity appears to be a source of disadvantage for women in the annuities market, it is a source of advantage in the life-insurance market, and is a source of value in its own right, since, other things equal, people typically prefer a longer lifespan to a shorter one. It is not appropriate to focus attention on just one discrimination policy.

Concluding Remarks

Anti-discrimination policy that attempts to prevent insurers from categorising risks is generally ill-conceived. It may confuse the source of apparent discrimination, and may even introduce a form of discrimination if low-risk groups are required to subsidise high-risk groups. But the policy may also be effectively evaded by insurers, in which case persons alleged to be suffering discrimination are not made better off, while the rest of society is either worse off or no better off. Policies based on lump-sum taxes and transfers may be preferable, but only in the context of income-distribution policy in general.

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I would like to thank the referees for their helpful comments on an earlier draft, but take responsibility for what remains.

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Proof of Native Title: A Level Playing Field?

John R. Forbes

Despite intense professional and media discussion of the *Mabo* movement in Australia, remarkably little attention has been given to two eminently practical questions. What will the actual process of proof and adjudication be like? And what will be done to ensure that the fruits of successful native-title claims are honestly and fairly distributed to all members of the claimant group? This article seeks to attract attention to the first of these issues.

In *Mabo*, the High Court grafted a vaguely defined concept of 'native title' on to the common law of Australia. This was done, so we were told, to comply with the 'expectations of the international community' and the 'contemporary values of the Australian people'.[1] The decision has led to expectations of greatly increased benefits, enhanced powers for publicly funded Aboriginal bodies, and quasi-evangelical promises of 'reconciliation'.

The ambitions of some members of the burgeoning federal judiciary are apparently no longer satisfied by traditional judicial tasks. Mason CJ (1993:23) has argued, 'I think that in some circumstances, governments . . . prefer to leave the determination of controversial questions to the courts rather than [to] . . . the political process. *Mabo* is an interesting example.' A former Federal Court judge puts it more directly: 'The Court has constructed, from really nothing, a completely new doctrine' (Jackson, 1994:211). Perhaps *Mabo* was never intended to be self-sufficient, but to provide an impulse (or excuse) for federal legislation notwithstanding the 'land rights' schemes that already existed in the Northern Territory and in several States.

Act Not a Code: Vague Concepts Remain

The Native Title Act 1993 (Cth) (NTA) is virgin territory. By no means does it clarify the many broad and elastic concepts in *Mabo* itself. It adopts the judicial legislation (whatever it may eventually mean) and makes it 'a law of the Commonwealth' (ss.12 and 223). There is no definition of 'native title' or of those who may claim it. On the point of eligible claimants, the *Mabo* judgments wander to and fro among 'indigenous inhabitants', 'clan or group', 'native peoples', 'community',

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[1] *Mabo* v *Queensland* (No 2) (1992) 175 CLR 1 at 67 per Brennan J.

John Forbes is Reader in Law at the University of Queensland.

'family, band or tribe', 'society' and other similarly imprecise expressions. As to the *content* of native title, we are left with judicial advice that it may range from something like freehold to an occasional right of way. Its content is a matter of evidence in every case, and findings of fact in one case are not a precedent for any other. '[I]ts incidents and the persons entitled thereto are ascertained according to the laws and customs of the indigenous people who, by those laws and customs, have a connection with the land. It is immaterial that the laws and customs have undergone some change since the Crown acquired sovereignty provided the general nature of the connection between the indigenous people and the land remains.'[2] We are told that native customs may continue to evolve up to the time of a claim and may survive European influences such as the 'profound' effects of Christianity, the use of schools and other modern facilities and (in the case of the Murray Islanders) a change from gardening and fishing to a cash economy largely dependent on the public purse.[3]

Extensions to *Mabo*

In some respects native title is inferior to other land rights known to Australian law, but in other respects it is superior. On the side of inferiority, even if it resembles freehold or long-leasehold title it cannot be alienated by way of sale or mortgage (in some, perhaps many, cases it may fall far short of normal freehold or leasehold rights). But in other respects it is superior to freehold title. It cannot be subjected to mining or other developments authorised by government until a 'right to negotiate' has been exercised (ss.26-54). In the case of mining developments native-title holders *and mere claimants* have four months to negotiate with an intending explorer or developer. In return for their consent they may seek payments based on income or profits of the venture (ss.33, 35(a)). If four months elapse without agreement, either party may ask the Native Title Tribunal to arbitrate. The Tribunal is to 'take all reasonable steps' to decide within a further four months (s.36(1)(a)). Capitulation by would-be developers aside, the additional delays may vary from twelve to 24 months (*The Australian*, 8 February 1994, p.39; 28 February 1994, p.19). Commonwealth spokesmen are at pains to point out that the 'right to negotiate' is not a veto, but it remains to be seen whether this is a semantic distinction without a real difference. Aboriginal interests are still pressing for a veto *strictu sensu* (*The Australian*, 17 January 1994, p.2; 28 January 1994, p.4).

The limitations of 'Mabo title', as described by the judges, were significantly relieved by late amendments to the Native Title Bill. The legislation enables native-title holders to make an agreement with the Commonwealth or a State to exchange their title for 'a freehold estate in any land, or any other interests in relation to land, that the native title holders may choose to accept' (s.21(3)). The hitherto inalienable title would thus become available as security or as a marketable form of realty.

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[2] *Mabo* at 70 per Brennan J.

[3] *Id.* 192 per Toohey J.

There is nothing in the Act (although there may be something in government practice) to prevent a minor form of native title being quietly exchanged for a much more valuable freehold or a long-term Crown lease. Contrary to a clear statement by Justice Brennan in *Mabo* itself,[4] mining leases do not extinguish native title (ss.15(1), 231, 232, 238).

Special Judicial Arrangements

Disputed claims of native title or for compensation will be adjudicated in the Federal Court or in a State equivalent approved by the federal minister. Unopposed claims and objections to new developments on established (or alleged) native title land will be processed by a National Native Title Tribunal or other approved body (ss.26ff, 107ff, 251(1)). Mere claimants of title may lodge objections and impose the attendant delays if they are registered as such (ss.29(1)(b), 186).

For present purposes the Federal Court is constituted in a most unusual way. It is exempt from the rules of evidence (s.82(3)) — a provision that often applies to administrative tribunals but rarely, if ever, to 'real' courts. In these circumstances the rules of evidence cannot be 're-inserted' on appeals based on points of law. Further, the Court must 'take account of the cultural and customary concerns of Aboriginal peoples' (s.82(2)). Since it would obviously be bound to do so if normal evidence of those things were presented, this presumably means that the Court may take judicial notice (that is, give evidence to itself) on those wide and nebulous topics. Normally, judicial notice is a very limited source of evidence. There are two good reasons for that rule. The parties may not know exactly what the court is telling itself, and it could be very difficult to talk the self-informing judge out of the natural feeling that as well as being a fine judge he is also an unusually good witness!

These are not the only departures from normal court procedure. The Court is to be assisted by a professional 'super witness' and potential de facto adjudicator[5] described as an 'assessor'. These provisions are seen as a considerable advantage to claimants[6] and as a commensurate handicap to respondents. However, in the light of other problems mentioned below they may not make a great deal of difference in practice.

The composition of the National Native Title Tribunal is governed by s.110. The President, recently appointed, is a Federal Court judge. Australian politicians have a deep and abiding belief that the citizens will more readily defer to a tribunal or inquiry headed by someone entitled 'Justice'. Non-Presidential members of the Tribunal will include 'assessors' (as described above), some people with 'special

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[4] *Id.* 69 per Brennan J.

[5] Officially, of course, an assessor is 'not to exercise any judicial power of the Court': NTA, s.2(3).

[6] Of such arrangements it has been well said: 'The result is in practice, as we all know, that a (representative) is a partisan and an advocate rather than a judge . . . It is not easy to imagine a less satisfactory tribunal, viewed as judicial body'. *In re Skene's Award* (1904) 24 NZLR 591 at 597-8 per Denniston and Chapman JJ.

knowledge in relation to Aboriginal . . . societies', and others chosen by the federal executive. Special-purpose tribunals, even when they are not staffed by enthusiasts, rapidly become part of the 'club' or 'industry' concerned.

Nature of Evidence in Native Title Actions

There is little point in fine theoretical analysis that ignores the manner in which native title is likely to be proved, or that glosses over difficulties likely to arise for non-claimant parties.

Lay or 'traditional' evidence. Evidence for claimants will consist of 'lay' evidence and 'expert' evidence. The lay evidence will include assertions about customs, tribal practices, territorial boundaries and so on. The expert evidence (in this special field) will reiterate the lay evidence and reinforce it with purported scientific findings. Normally hearsay from lay witnesses is not permitted to re-emerge as the stuff of expert opinion. In June 1994 a Sydney barrister with experience in the Northern Territory told the present author:

> There are very few empirical facts when you're dealing with anthropologists. They repeat what they say someone else has told them. The hearsay of claimants is fed through an anthropologist and emerges as 'expert evidence'. The 'facts' of an anthropologist are commonly what a client or study-subject told them about perceived rights or wishes.

In the nature of things the lay evidence will often be self-serving hearsay, extremely difficult to cross-examine or assess, even if — in the club atmosphere which special tribunals develop — it were deemed 'correct' to attempt such an exercise. As a former Supreme Court judge has pointed out, alleged laws and customs 'are likely to be recalled in a manner favourable to the claimants which is, after all, simply human nature' (*Courier Mail*, 14 September 1993).

Elusiveness of hearsay on hearsay. Evidence and practice in the Northern Territory land rights tribunal, which has operated for some 16 years, gives a fair indication of what to expect in litigation under the new federal Act. A Queen's Counsel experienced in Northern Territory cases describes some remarkable forms of hearsay that are received in that jurisdiction, including 'group evidence' which lends itself to 'collaboration and concoction' (Hiley, 1989:195; see also Maddock, 1983:93).

If and when cross-examination is tolerated,[7] it will still be extremely difficult to test direct evidence (let alone hearsay) if the non-claimant parties have no access to alternative versions. It is uncertain whether the new adjudicators will take well-tried precautions in dealing with assertions that are easy to make and well nigh impossible

[7] In the Tribunal cross-examination requires leave: NTA s.156(5).

to check, or with the evidence of 'experts' whose scientific detachment is questionable. They *were* taken by the Supreme Court judge who conducted the 'grassroots' inquiry in *Mabo* (Moynihan J of Queensland) but the High Court paid remarkably little attention to his pointed comments on matters of credit. Moynihan J suspected that evidence of certain 'immemorial customs' owed a good deal to *The Drums of Mer*, an adventure tale by Ion Idriess published in 1941.[8] The judge was 'not impressed with the creditability of Eddie Mabo' who seemed 'quite capable of tailoring his story to whatever shape he perceived would advance his cause'.[9] The most careful perusal of the High Court judgments will not alert the reader to these comments (and others of more than passing interest) by the only judge who saw and heard the witnesses.

Expert evidence: partial and inaccessible? Land-rights litigation has given birth to a new expert witness industry consisting of anthropologists, historians and other 'social scientists'. The common-law courts have always had reservations about expert evidence, particularly when dealing with new and relatively inexact sciences prone to ideological influences. Graham Hiley QC reports that non-native parties have great difficulty in gaining anthropological assistance or advice; he notes the 'resentment' and 'alienation from his peers' facing any anthropologist who dares to cast doubt on a native title claim. After the Territory tribunal had been in operation for almost ten years, he could not recall a case in which a respondent to a claim had called such a witness, and there had been 'an understandable reluctance by anthropologists to be seen to be advising parties other than Aborigines' (Hiley, 1989:194-5; see also Hiley, 1985, 505-06).

Despite strong temptations to self-censorship there is evidence to support Hiley QC. In June 1994 a Sydney barrister who regularly appears in the Northern Territory land rights tribunal told the author:

> I was involved in an Aboriginal land claim and I rang round various universities to try and get an expert witness and no one would be in it. They were worried about their promotion. A couple of them said that they would *never ever* get a permit to go on to any Aboriginal land again to do work, and they would be effectively blackballed in their profession. And that's a real problem that respondents face in these applications.

Lawyers aside, some of the realism is provided by relevant social scientists, in the impressive form of admissions, some conscious, some unwitting. In March 1993 the President of the Australian Anthropological Society was reported as saying that 'most anthropologists are more comfortable working for Aborigines than in some situation where they could be construed as working against their interests' (*The Aus-*

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8 Findings of Moynihan J dated 16 November 1990: 'Determination Pursuant to a Reference of 27 February 1986 by the High Court of Australia . . .' Vol. I (mimeo 227 pp) at 60.

9 *Id.* 79, 70.

tralian, 5 March 1993, p.23). He was not the first of his profession to say so. At the Kakadu inquiry in 1991, an anthropologist employed by the Northern Land Council declared that the primary duty of experts like himself was 'to represent the people they work with'. He added that if he strayed into scientific detachment and disagreed with the Land Council's position he would be liable to lose his job (Brunton, 1992:51). In such circumstances there need not be positive falsehood; embarrassing information may simply be suppressed.

These admissions are quite consistent with the Revised Principles of Professional Responsibility of the American Anthropological Association:

> Anthropologists' first responsibility is to those whose lives and cultures they study. Should conflicts of interest arise, the interests of these people take precedence over other considerations. . . (*Australian Anthropological Society Newsletter,* June 1990, p.44)

No exception appears to be made for occasions when sworn evidence is required and when other people's interests may be at stake. Plainly these directives expose anthropologists to embarrassment if they are at all sceptical about native title. Scepticism would also expose them to prejudice in the public sector upon which they depend for employment: universities, government departments, Land Councils and kindred institutes where pressures to be 'correct' are strong.

Dr Peter Sutton, a specialist in Aboriginal affairs, acknowledges that 'the closed ranks of anthropologists [are] denying [miners] access to . . . scientific expertise' (Sutton, 1982:21). His colleague Professor Maddock (1989:167) is more specific:

> The suspicion that anthropologists who give evidence for Aboriginal claimants are hopelessly biased is strengthened by the difficulty objectors to land claims have in getting anthropological advice . . . In the Alligator River claim, the mining company Peko-EZ strongly contested parts of the claim, but the research on which they relied was carried out by a solicitor who apparently had no training in anthropology.

Maddock (1989:168) goes so far as to say that probable bias 'arises from the nature of anthropological research'. Dr Sutton (1982:22) elaborates:

> The problem with a sociological diagnosis, as opposed to a medical one, is that in our culture a medical diagnosis has very little to do with a physician's politics, while a sociological diagnosis can have quite a lot to do with an anthropologist's politics.

One looks in vain for statements disclaiming the views of the American Anthropological Society and its Australian disciples. There appears to be no published material challenging the comments of Maddock or Sutton or the simple statements of fact by lawyers who cannot secure witnesses.

It is easy to imagine the state of personal-injury litigation if the medical profession sent to Coventry any member who dared to give evidence for defendants. Out-of-court 'agreements' would be common but would they commonly be free and fair? It is interesting that the Native Title Tribunal (1994:4), at its first hearing, pointed out that, whatever the state of the evidence, native titles can be created by agreement. Fears of delays, costs or lack of access to expert evidence may induce many agreements — not to mention governments with a policy of 'running dead', as the Commonwealth did in *Mabo* itself.

Perhaps the best prospects of obtaining rebuttal evidence will be in cases where several groups compete for the same area. The Wik claim at Weipa faces competition. In these circumstances the experts may not be quite so sure where their 'first responsibility' lies and the lay witnesses will not be univocal. But even then there may be a compromise division of spoils rather than absolution for respondents or taxpayers. It will be interesting to see how often the existence and content of native title depends on the *ex parte* evidence of a claimant's anthropologist or historian. A mining industry spokesman predicts that 'under the tribunal system . . . [there] will develop a loose interpretation of the Mabo decision and certainly the federal legislation provides room for that . . . I think that if claims are made they will tend to be granted' (*The Australian*, 8 February 1994, p.43, quoting P. Ellery.) This prediction accords with Maddock's (1983:83) survey of Northern Territory cases in the 1980s: '[I]t has been usual for the Commissioner to recommend that most or all of the land claimed be granted'. On 13 May 1994 four claims for native title were pending in the National Native Title Tribunal, some in long-settled parts of New South Wales. In the event of success the air of romanticism would be intensified if roads and other services remained connected and 'traditional' hunting were pursued with rifles and four-wheel drive motor vehicles.

Extinguishment Issues

Perhaps the best chance of an even contest will occur when there is a question whether native title (if any) was extinguished before 1975. (The best advice now available suggests that compensation will not be payable in such cases.) The evidence on an 'extinguishment' issue will usually be much less woolly and it will be available to all parties on equal terms. According to the Chief Justice of the High Court the onus is on a native title claimant to prove, where required, that the title has *not* been extinguished by some lawful action of government in the past.[10]

Pseudo-Litigation?

Is it really too late for some conductor of this non-symphonic work to rattle the podium and cry '*da capo*'? If the collective wisdom requires an expansive and primarily economic 'reconciliation' in addition to annual expenditures now in excess of $1 billion is it necessary to wrap just one part of it in complex pseudo-litigation?

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[10] *Coe* v *The Commonwealth* (The Wiradjuri claim) (1993) 68 ALJR 110 at 119.

The federal minister's guess is that 'Mabo' title will benefit only 5 per cent of the vaguely defined class of beneficiaries (*The Australian*, 11 May 1994, p.9). Taxpayers will in any event contribute to the National Aboriginal and Torres Strait Islander Land Fund,[11] which, in conjunction with the Northern Territory Act and State legislation may well produce more 'native title' than the *Mabo* doctrine ever will. Taxpayers will also pay direct for any 'Mabo' titles extinguished since 1975 and for the legal services consumed by title claimants and objectors to new developments. So far relatively little has been heard about methods of ensuring that the fruits are equitably distributed by the new oligarchies: on 25 May 1994 the *Courier Mail* quoted a woman 'with 25 years experience in indigenous health care' complaining that 'the crumbs (are received) at grass root level' and that too much public money is 'gobbled up in administration' (p.6).

If access to evidence in native title cases is nearly so unequal as well-informed observers predict, would it not be simpler, cheaper and more candid to discard litigation and unequal 'agreements' for a simpler system of land funds and other benefits within the country's capacity to pay? The same constitutional power which has been used to 'pick up' and elaborate the *Mabo* decision could as well be used to replace that decision — and the litigious opportunities it provides — with a just and much more predictable scheme of assistance. Indeed, the Land Acquisition Fund which the Native Title Act has added to *Mabo*, in conjunction with longer-established benefits, could stand in place of the nebulous uncertainties of 'native title'. A frankly administrative scheme for *creating* titles may be better for all concerned — 'expert' witnesses, lawyers and tribunal staff aside — than an administrative/judicial maze in which pseudo-litigation legitimises part of the expenditure by 'finding' titles on elusive evidence which is available only to those whose material, political or emotional interests it serves.

[11] NTA ss.17(4), 23(5), 24(2), 25(2), 54 and Part 10.

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Myths about Dragons: The Case of Thailand

Peter G. Warr

Asia's successful newly industrialising economies (NIEs)[1] — Taiwan, (South) Korea, Singapore, Hong Kong, and now Malaysia, Indonesia and Thailand — have inspired the use of some silly zoological metaphors to describe them: 'dragons', 'tigers', 'flying geese', and so forth. They have been also been called Asia's 'miracle' economies (World Bank, 1993). The use of the language of mythology to describe this group of economies is in one sense apt. Much that has been said *about* them is indeed based on myth.

Proponents of the contending economic ideologies have attempted to 'explain' the performance of the successful Asian economies in terms of those countries' adherence to policies favoured by the writers concerned, while implicitly disowning the countries performing poorly. Bhagwati (1989:98) has commented: 'I have formulated the following law: Economic miracles are a public good; each economist sees in them a vindication of his pet theories'.

The effort to explain the 'miracle' economies, rather than the much longer list of economic failures, probably derives from recognition of a basic fact. There is an unlimited number of possible ways of performing poorly, but far fewer possible ways of performing well. Since the lessons of success are less country-specific than the lessons of failure, they may be more applicable to other countries. For this reason, explanations for the performance of successful economies are potentially important in a way that explanations for the failure of others are not.

This article discusses these issues in the context of Thailand. Much of what it says probably applies to other East Asian countries as well. It assesses the merits of three propositions regularly found in the economic literature on Thailand and some of its neighbours. They are repeated so often that they are in danger of becoming the conventional wisdom, but they are each wrong and potentially dangerous. In the Thai context, the proponents of these propositions include both Thai and non-Thai authors (who on these issues differ among themselves equally). But first, some background.

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[1] The term 'economies', rather than 'countries' is widely used in this context to avoid dispute as to whether some of these entities, including at least Taiwan, (South) Korea and Hong Kong, should be described as 'countries'.

Peter Warr is John Crawford Professor of Agricultural Economics at the Australian National University.

The Background

In 1950, following an entire century of economic stagnation, Thailand was one of the world's poorest countries.[2] Since then, its economy has achieved a startling combination of rapid growth, declining poverty and macroeconomic stability (Table 1). Between 1965 and 1990 the growth rate of Thailand's real GNP per head of population was well over 4 per cent (7 per cent in total), compared with an average growth rate of 2.5 per cent per head of population for low- and middle-income countries (World Bank, 1992). Even more remarkable was the stability of Thailand's growth. Almost uniquely among oil-importing countries, Thailand has not experienced a single year of negative growth of real output per head of population since 1958. Most recently, over the four years to 1990, the Thai economy was the fastest growing in the world.

Table 1

Basic indicators of Thailand and some other Asian economies

	Average annual growth of population 1980-90 (%)	*GDP per capita (US$) 1990*	*Average annual growth of real GNP per capita 1965-90 (%)*	*Average annual rate of inflation 1965-90 (%)*	*Income distribution: lowest 20% share of total (% year)*	*Gini coeff.*	*Poverty: population below poverty line 1980-89 (%) Total*	*Rural*
Thailand	1.8	1420	4.4	5	4.0 (1988)	0.47	30	34
China	1.4	370	5.8	2	n.a.	n.a.	n.a.	n.a.
Indonesia	1.8	570	4.5	25	8.8 (1987)	0.31	39	44
Philippines	2.4	730	1.3	13	5.5 (1985)	0.45	58	64
Malaysia	2.6	2320	4.0	4	4.6 (1987)	0.48	27	38
Korea, Republic	1.1	5400	7.1	13	n.a.	0.36	16	11
India	2.1	350	1.9	8	8.1 (1983)	0.42	48	51

Source: World Bank (1992).

[2] For excellent accounts of Thai economic history, see Ingram (1955) and Sompop (1989).

Although Thailand's income inequality apparently increased over the last two decades, the incidence of absolute poverty declined significantly. The rate of inflation has been low, averaging 5 per cent from 1965 to 1990 compared with a simple average rate of 32 per cent for all low- and middle-income developing countries, and the baht/ US dollar exchange rate has been highly stable. All this was achieved with only moderate growth of external debt and with stable international reserves.

Strikingly, Thailand achieved stable economic growth despite economic and political volatility. Like most developing countries, it has experienced internally and externally induced economic and political shocks; but while the economies of many developing countries, including some of Thailand's Southeast Asian neighbours, were badly destabilised by these and even lesser shocks, the Thai economy showed surprising resilience.

Thailand has joined that all too short list of successful economies whose performance economists are anxious to explain. Nevertheless, I contend that the standard analyses of Thailand's economic performance are wrong. Three examples follow.

Myth 1: Economic Growth Benefits Only the Rich

Visitors to Thailand see a wide disparity between the living standards of rich and poor Thais. Table 1 suggests that, judging from estimated Gini coefficients,[3] income distribution in Thailand is about as unequal as in its neighbours Malaysia and the Philippines, and a little more unequal than in Indonesia and Korea. Unfortunately, studies of income distribution and poverty in Thailand have necessarily been dominated by a single, deeply flawed and incomplete data set. The periodic Socio-Economic Surveys (SES) conducted by the National Statistical Office (NSO) have been the source for virtually all serious research on this subject.

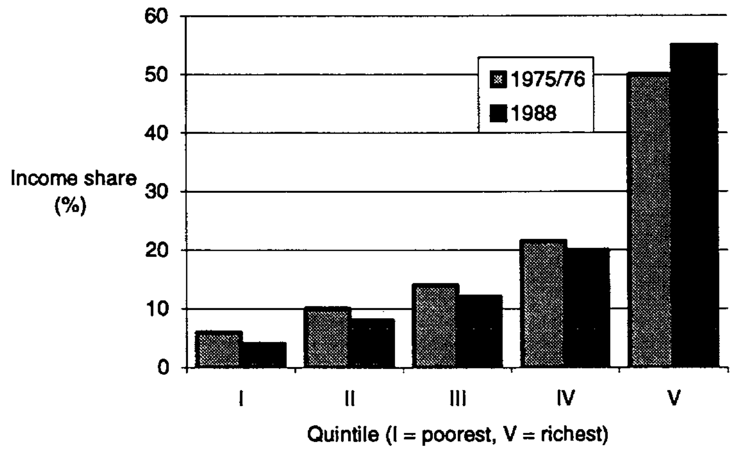
The difficulties of making comparisons across time when the sampling procedures and definitions used by the NSO have repeatedly changed and the difficulties of defining 'poverty threshold' levels of income — an inherently arbitrary matter — have dominated the academic literature. This has not stopped others from claiming that Thai growth has benefited only the wealthy urban elite, leaving the mass of the population mired in poverty, and possibly even worse off. Can this kind of claim be substantiated?

Between the mid-1970s and the late 1980s the NSO statistical definitions have been reasonably constant (but comparison with other periods is very difficult). During this period the distribution of income became more unequal (Figure 1). Thai scholars have debated whether or not inequality has increased at an accelerating rate (Medhi, 1993), but there is little doubt that inequality did increase.

[3] The Gini coefficient is a measure of the degree of inequality of the income distribution. The coefficient ranges in principle between zero and one. The higher the value, the more *unequal* the distribution.

Figure 1

Income shares by population quintile, 1975/76 and 1988



Sources: National Statistical Office (1988), Suganya & Somchai (1988).

Widening inequality, however undesirable, does not necessarily imply that the poor are worse off. Average incomes also increased over the same period. The share of total income received by the poorest quintile of the population fell from 6.1 to 4.5 per cent over the period 1975-76 to 1988, but total Thai income rose in real terms by 83 per cent. According to this calculation, the poorest quintile gained in absolute real income by 35 per cent, even though the richest quintile gained proportionately three times as much, by 103 per cent, again at constant prices.

An alternative way of addressing issues of absolute poverty is to measure the proportion of the population whose incomes fall below a designated poverty line. Studies along these lines necessarily suffer from the intrinsic arbitrariness of any such 'poverty' cut-off point, but the change in poverty incidence, so measured, may not be especially sensitive to the particular cut-off point that is selected. Table 2 shows data on this issue, drawn from the studies of Suganya and Somchai (1988) and Medhi, Pranee and Suphat (1991). The data confirm that absolute poverty in Thailand is principally a rural phenomenon, concentrated in the northeast region. What about changes in poverty incidence over time? While the limitations of the underlying SES data must be stressed, a clear picture does emerge. Over the decade to 1986 poverty incidence seems to have declined until the early 1980s, then to have worsened until the mid-1980s, and then to have declined again.

Table 2

Poverty incidence and economic growth, 1975/76-1988

	1976/76	1981	1986	1988
Poverty *(Baht per capita per year, current prices)*				
Urban	2961	5151	5834	6203
Rural	1981	3454	3823	4076
Poverty Incidence (%)				
By region:				
North	33.2	21.5	25.5	19.9
Northeast	44.9	35.9	48.2	34.6
Central	13.0	13.6	15.6	12.9
South	30.7	20.4	27.2	19.4
Bangkok and vicinities	7.8	3.9	3.5	3.5
Whole kingdom	30.0	23.0	29.5	21.2
Average growth rate of real GNP over preceding period (% per annum)	5.9	7.5	5.2	11.5

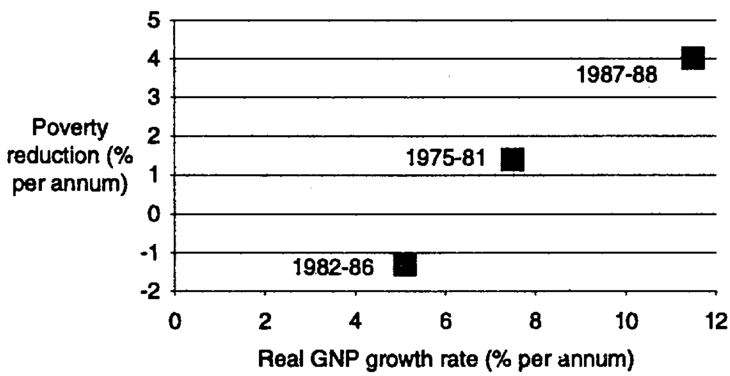
Notes: 1 baht = A$0.06. In both sources cited below, poverty incidence was calculated by applying the rural poverty lines to sanitary areas.

Sources: The poverty incidence data for 1975/76, 1981, and 1986 are from Suganya & Somchai (1988); those for 1988 are from Medhi, Pranee and Suphat (1991).

What could explain this pattern of apparently fluctuating poverty incidence? It is obvious that over the long term, sustained economic growth is a necessary condition for poverty alleviation; no amount of redistribution could turn a poor country into a rich one. But it is not obvious that growth favours poverty reduction in the short run. The final row of the table shows the average annual rate of GNP growth over the periods shown — that is, those for which survey results are available. In the case of the 1975/76 column the data show average real GNP growth from 1970 to 1975. These data are plotted in Figure 2.

Figure 2

Poverty reduction and economic growth, 1975-88



To the extent that the data can be trusted, and notwithstanding the smallness of the sample, the results are clear. The faster the growth, the greater the poverty reduction. Rapid growth from 1976 to 1981 coincided with declining poverty incidence. Reduced growth caused by the world recession in the early to mid 1980s coincided with worsening poverty incidence to 1986. Thailand's economic boom of the late 1980s coincided with markedly reduced poverty incidence. The data provide no support for the notion that rapid economic growth fails to benefit the poor in *absolute* terms. They suggest, on the contrary, that the rate of growth may be the single most important determinant of the rate at which poverty declines, even in the short run.

Myth 2: Industry Policy Promotes Export Growth

The role of industry policy has been a central issue in the interpretation of the economic performance of the NIEs, and this is now true of Thailand as well, because in the last two decades much of Thailand's growth has been led by manufactured exports. Discussions of Thailand's microeconomic policy have frequently characterised the period since the mid-1970s as one of 'export promotion', contrasted with the preceding two decades of 'import substitution'. Policy supposedly shifted away from discrimination against export industries and towards policies that favour them. The growth of non-traditional exports is then attributed to this supposed policy shift.

The evidence suggests that from around the mid-1970s Thailand's economic planners and their academic advisers shifted their focus away from import-substituting industrialisation policies. 'Export promotion' became the intellectual fashion among economists, in Thailand as elsewhere. This seems clear from the text accompanying the *Five Year Development Plans* produced by the govern-

ment's National Economic and Social Development Board. But while the views of the development planners may be important, they are not in themselves policy.

Myth 2 says that a shift in policy occurred that was significant enough to produce the subsequent dramatic surge in exports. The belief arises because the change in the ideology and rhetoric of the development planners coincided, *very roughly*, with significantly improved exports of manufactured goods from Thailand. Beginning with the Third Plan (1972-76), plan documents stressed 'export promotion' over 'import substitution', but this reflected intellectual fashion rather than policy commitment. Protection of inefficient manufacturing sectors actually increased during this period, as it did through the remainder of the 1970s.

'Export promotion' policies were indeed introduced in the 1970s, supposedly to promote manufactured exports. But did this shift in the government's industry policies contribute to export success or hinder it? Were the industries favoured by this system the ones which subsequently proved to be successful? An index of trade performance, based in part on earlier work of Balassa and others, and here called the net export performance ratio (NEPR) is used here to measure the degree to which an industry is competing successfully in international markets. The index measures the degree to which Thailand's net exports of a particular commodity, as a share of world exports of that commodity, exceed or fall short of Thailand's share of world exports in general.

We are especially interested in the correlation between this index and measures of industrial policy interventions. Five instruments of intervention can be quantified from available data: industry protection, the allocation of subsidised loans through the Industrial Finance Corporation of Thailand (IFCT), the promotion of industries through the Board of Investment (BOI), the allocation of tax exemptions by the Customs Department, and the allocation of tax rebates by the Fiscal Policy Office of the Ministry of Finance. The allocation of these five instruments of industry policy can be compared with the industries' export performance across the 16 major industry categories for which the relevant data are available. To allow for the fact that the industries concerned have different sizes, each industry's share of the total allocation of funds for the instrument shown (except rates of protection) has been divided by its share of total value added, summed across all 16 industries shown.

Table 3 shows the correlation coefficients between the measures of export performance and each of the above five measures of industry policy interventions over the intervals for which data are available. The results show that export performance is negatively related to all five measures. Moreover, the change over time in net export performance is negatively related to the change in all five instruments. Industries whose export performance *worsened* over time received increasing levels of support over time, not those whose performance improved.[4]

[4] See Warr (1994). The only exception to this pattern was the change in the structure of effective protection between 1984 and 1987, which showed a weak positive relationship to changes in export performance.

Table 3

Trade performance and industry policy, 1970-89: correlation coefficients across industries

Trade performance for period:	*Effective rate of protection*			*IFCT loan allocation*			*BOI projects*		*Tax drawbacks*	*Tax rebates*
	1974	**1984**	**1987**	**1960-69**	**80-85**	**86-90**	**1983-85**	**87-89**	**1986-89**	**1986-89**
1970-74	-0.06	-0.02	-0.08	-0.16	-0.03	-0.02	-0.24	-0.39	-0.16	-0.46
1975-79	-0.07	-0.11	-0.14	-0.18	-0.09	-0.08	-0.26	-0.47	-0.12	-0.39
1980-84	-0.06	-0.16	-0.15	-0.16	-0.11	-0.11	-0.23	-0.52	-0.11	-0.40
1985-89	-0.04	-0.14	-0.15	-0.17	-0.15	-0.25	-0.28	-0.52	-0.03	-0.35

Source: Warr & Bhanupong (1994).

In the case of import protection these results are hardly a surprise. Protection is explicitly an incentive to import-competing production and (implicitly) a disincentive to exporting. But the negative correlation with export performance is even higher in the case of the BOI instruments and, most surprising of all, the case of tax rebates as well. Far from being instruments of export promotion the IFCT loans, Customs Department tax drawbacks, FPO tax rebates, and most especially the BOI investment promotion schemes, turn out to be surprisingly similar to industry protection in their allocation across industries. At the industry level, poor performers, not successful exporters, are clearly promoted by these measures.

Presumably, industries that are well organised for lobbying purposes put proportionately more resources into the behaviour that secures bureaucratic support than less well organised industries. But the former are not necessarily performing well in economic terms: our results suggest the reverse. Thus policy measures intended to promote exports are captured by the system of rent-seeking and in fact support roughly the same poorly performing industries as are favoured by the system of protection.

Myth 3: Discretionary Fiscal Policy Stabilises Income Growth

Thailand has a truly impressive record of macroeconomic stability. It also has a set of professionally competent macroeconomic planners eager to practise stabilising fiscal policy. It is all too easy to suppose that the latter caused the former. It is widely recognised at a theoretical level that fiscal policy is more effective under a fixed exchange rate regime — such as Thailand's[5] — than under a flexible exchange rate, but that the opposite applies to monetary policy. Fiscal policy therefore seems a strong candidate as a potentially significant stabilising (or destabilising) force in the

[5] While Thailand's exchange-rate regime is now officially described as a managed float, it is highly stable with respect to the US dollar.

Thai context of a closely managed exchange rate, and has been described as an important source of macroeconomic stabilisation in the literature of Thailand's adjustment experience.

Table 4

Correlation between fiscal variables, income growth and inflation, 1970-90

	GDP growth (current period)	*GDP growth (previous period)*	*Inflation (current period)*	*Inflation (previous period)*
Change in total expenditure/GDP	0.32	0.56	0.009	0.03
Change in total revenue/GDP	0.69	0.68	-0.09	-0.20
Change in total deficit/GDP	-0.70	-0.54	0.13	0.29
Actual fiscal impulse	-0.35	-0.38	-0.32	0.27
Planned fiscal impulse	0.18	-0.09	-0.25	-0.38
Unplanned fiscal impulse	-0.39	-0.37	-0.24	0.37

Source: Bank of Thailand.

Table 4 examines the statistical relationships between the major fiscal aggregates and variations in aggregate income and the price level. The first three rows of the table show the correlation between real public expenditure, real public revenue and the real public-sector deficit on the one hand and the current and lagged values of GDP growth rates and rates of inflation on the other. The data cover the period 1970 to 1990. Clearly, the size of the budgetary deficit is negatively related to both GDP growth and the rate of inflation; and the behaviour of public expenditure is the principal source of both short-term relationships. The evidence confirms that Thai fiscal aggregates have behaved in a stabilising manner. But how was this stabilisation achieved? Myth 3 attributes it to the fiscal planners.

In the industrialised countries both *discretionary* adjustments in government fiscal policy and *autonomous* adjustments in fiscal outcomes are considered potentially important sources of stabilisation (Dornbusch & Fischer, 1992). The operation of the discretionary component depends on the way government policy responds to external shocks. Autonomous adjustments, the outcome of 'automatic stabilisers', operate through the structure of the tax and revenue systems themselves, and not through short-term discretionary changes in government policy.

Textbook descriptions of automatic stabilisers emphasise the role of personal income taxes on the revenue side and welfare payments on the expenditure side. In the OECD economies the dominant sources of revenue are personal income taxes. These revenues rise as real incomes and/or rates of inflation rise, but in a greater proportion than the increase in nominal income because of the progressive income-tax schedules. On the other hand, welfare and social security expenditures rise as incomes *fall* because income relief is most required in times of recession. Consequently, the public-sector deficit declines during periods of rapid growth, as tax revenues rise and welfare expenditures decline as proportions of GDP. The public deficit rises in periods of recession as income tax revenues decline and welfare payments rise. Because of these processes, the countercyclical behaviour of the government's fiscal deficit plays a stabilising role, reducing the impact of externally induced fluctuations of national income.

Automatic stabilisers are seldom mentioned in the context of developing countries. This is in one sense unsurprising. If personal income taxes and welfare payments were truly the important variables to look for, we should not expect automatic stabilisers to be significant at all for developing countries like Thailand. Personal income taxes are minor sources of revenue, accounting for less than one tenth of total revenues; and, like most developing countries, Thailand has no public-sector social-security system at all. This suggests that automatic stabilisers are unlikely to be important in developing countries and this presumption is consistent with Myth 3.

To some extent at least, tax revenues and expenditures will probably respond differently to short-term changes in economic activity, resulting in some degree of automatic stabilisation (or destabilisation). If the government forecasts of income growth and inflation are inaccurate, and they must inevitably involve some errors, then the actual levels of spending and taxation revenue will presumably be somewhat different from their planned levels. As a result, the planned level of deficit will be different from the actual level. Unexpected expansion (slowdown) of economic activity presumably causes underestimation (overestimation) of the future revenues on the part of fiscal planners.

It is possible to study the behaviour of fiscal intentions in relation to fiscal outcomes because the planned levels of revenue and expenditure are declared in the government's annual budget documents in advance of fiscal outcomes. The magnitude of the *planned deficit* reflects discretionary fiscal policy, which reacts to changing macroeconomic policy variables such as deviation from trend growth rate, the inflation rate, and the ratio of the current-account deficit to GDP. The inten-

tion here is not to study the way fiscal intentions are formed, but to compare fiscal intentions with fiscal outcomes and to relate both to income growth and inflation. We define the 'unplanned deficit' as the difference between the planned and actual deficit. The unplanned revenue, unplanned expenditure, and unplanned deficit can be thought of as a result of the responsiveness of automatic fiscal stabilisers.

Now consider the relationship between year-on-year variations in fiscal policy and year-on-year fluctuations in income. By 'expansionary fiscal policy' we mean that the ratio of the deficit to GDP is larger than in the previous year. 'Fiscal impulse' is defined as the change in the ratio of the deficit to GDP, and an expansionary fiscal policy will thus mean a positive fiscal impulse. The 'unplanned fiscal impulse' is defined as the difference between the actual and planned fiscal impulse.

The behaviour of these variables is correlated with the actual fiscal impulse. As described above, the behaviour of Thailand's actual fiscal impulse was stabilising in that it was stronger during periods when the real growth rate fell below its trend path, and was weaker during economic expansion. But a decomposition of the actual impulse into its planned and unplanned components reveals the source of the stabilisation. While planned fiscal impulse is positively (but weakly) associated with income growth, a striking negative correlation can be observed between unplanned fiscal impulse and growth deviation.

It is difficult to draw inferences from short sample periods, but the results suggest that any short-term stabilisation with respect to income was due *entirely* to the role of automatic stabilisers. Planned fiscal impulses were weakly destabilising with respect to current income. Clearly, to understand Thailand's fiscal stabilisation with respect to income it is more important to understand the operation of automatic stabilisers than the discretionary behaviour of the planners.[6] The key to this inverse relationship is that tax revenues are more responsive than expenditures to changes in aggregate income.

Short-run discretionary changes in fiscal policy do not seem to have been stabilising at all. But 'policy' clearly had a crucial effect in a deeper and longer-term sense. Most obviously, short-term discretionary behaviour was not significantly destabilising. It could have been otherwise, and the macroeconomic instability experienced by so many other developing countries may well reflect a significant difference in this respect. Equally important, the structural features of the Thai revenue and expenditure systems that produce the automatic stabilising outcomes we have demonstrated are themselves the products of past policies.

[6] This interpretation differs from Robinson et al. (1991:16). This important study mentions automatic stabilisers in passing, but emphasises what is described, without supporting evidence, as the stabilising role of *discretionary* fiscal policy.

The Sources of Macroeconomic Stability

What does explain Thailand's macroeconomic stability? With a Thai colleague, I have discussed elsewhere the long history of macroeconomic conservatism in Thailand (Warr & Bhanupong, 1994), but here I shall mention just one crucial source of sustained fiscal discipline in Thailand. It is the law. Legal limits on planned expenditures date back to laws introduced during the Sarit Government of the late 1950s and early 1960s. The 1959 Budgetary Law stipulated that the excess of planned spending over planned revenue should not exceed 20 per cent of the level of planned spending. In 1973, the limit on spending was relaxed somewhat by the amendment that the deficit must not exceed 20 per cent of planned expenditure plus 8 per cent of the principal repayments of the public debt. Since 1959, while actual spending has often approached these legal limits, the maximum levels of spending permitted by the law were almost never exceeded (Warr & Bhanupong, 1994).

This law contributed to stabilisation in two vital ways. First, because planned expenditure is constrained by the forecast level of revenue, through the operation of the Budgetary Law, the size of the actual budget deficit tends to be anticyclical, since during booms actual revenues exceed planned revenues, but actual expenditures do not exceed their planned levels. In boom years, the planned level of the deficit thus tends to exceed the level that is finally experienced, assuming that the boom was not fully anticipated by the planners. Similarly, during a slump, the planned level of deficit is less than the actual deficit. This mechanism produces a short-run stabilising feature from the revenue side of the budget. This effect has been much important than discretionary policy changes. Second, these budgetary laws contributed to long-run fiscal discipline by limiting the *overall magnitude* of planned fiscal deficits and so, in effect, constrained the capacity of fiscal policy to be destabilising, in both the short term and the long term.

What is most intriguing about these legal expenditure limits is that they have remained intact and effective for over 30 years. Subsequent governments could have repealed the laws concerned and could even have disregarded them; after all, several changes in the constitution have occurred over the three decades since 1960. But the Sarit laws were not abolished and were not disregarded. Even though the existence of these laws was at times politically inconvenient, it seems that once they were in place the political cost of removing or disregarding them was prohibitive. Their existence and wide acceptance, especially within the bureaucracy, generated a political inertia that helped constrain subsequent fiscal behaviour for at least three decades.

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This article is a revised and shortened version of a paper presented at the Retirement Conference for Ross Parish (Warr, 1994). A more detailed presentation of the empirical material reviewed in this article can be found in the longer version.

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REVIEW ARTICLE

The Fallacy of Political Innocence: Some Recent Reviews of Economic Reform

Michael Warby

Hugh V. Emy, ***Remaking Australia: The state, the market and Australia's future****, Allen & Unwin, Sydney, 1993*

Stephen King & Peter Lloyd (eds), ***Economic Rationalism: Dead end or way forward?****, Allen & Unwin, Sydney, 1993*

Peter Self, ***Government by the Market? The Politics of Public Choice****, Macmillan Australia, Melbourne, 1993*

In the immediate postwar period, there was broad intellectual and political agreement that government should grow faster than the economy or the population. The rate of increase was a matter for lively debate, but the direction was challenged only by a few despised dissenters. More recently, scepticism about the ability of government to deliver has greatly increased. The notion that government has become too large and ought to be reduced, though hardly a consensus position, certainly has far more currency than it used to. Government has still tended to grow, but at a reduced rate, and has actually shrunk (at least relative to the economy) in some areas and some years.

The decline of confidence in government has been accompanied by increasing use of market mechanisms. Deregulation and privatisation are worldwide trends. At the same time, economics has expanded in influence and reach. It has become an imperial discipline, reaching into areas covered by political science (public choice theory), criminology (economics of crime) and sociology (economics of sex and marriage). This has produced a range of responses. Some academics have picked up the offered analytical tools and techniques and run with them. Others have reacted with alarm and disdain at both the intellectual and the political trends.

The three books under review are all recent Australian contributions to this debate. *Economic Rationalism: Dead end or way forward?* is based on a conference

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Michael Warby is an officer of the Parliamentary Research Service, Canberra.

held at Melbourne University in February 1993. The book suffers the normal problems of conference collections: some lack of focus, and contributions of uneven quality. *Remaking Australia: The state, the market and Australia's future* is an attempt by a political scientist who has taken the trouble to become economically informed to offer an industry-policy direction for Australia. *Government by the Market? The Politics of Public Choice* is an intellectual assault on both the entire public-choice enterprise and the increased use of markets. It critically examines the theoretical basis and the empirical effects of pro-market public-sector reforms in English-speaking countries (UK, USA, Canada, Australia and New Zealand).

Different Intellectual Languages

The two critics of economic reform in King and Lloyd's collection are Michael Pusey, author of *Economic Rationalism in Canberra: A Nation-building State Changes its Mind* (1991) and Robert Manne, editor of *Quadrant* and co-editor of *Shutdown: The Failure of Economic Rationalism and How to Rescue Australia* (1992). Pusey[1] argues that economic rationalism is a narrow and destructive creed that stems from sectional social interests and threatens the social stability of host societies. Manne argues that the economists' claim to special knowledge is false. He has elsewhere characterised economic rationalism as a delusion of ideological zealots that filled the intellectual vacuum created by the collapse of the Keynesian consensus under the stress of stagflation. Pusey wants to rehabilitate state action and to revive the consensus that the state should continue to expand (or at least not shrink in relative size). Manne advocates a return to protection and regulation.

The defenders of economic reform in the collection include Richard Blandy, Geoffrey Brennan, John Freebairn, Allan Fels, and Ian Harper. Yet the reader is struck by the extent to which the critics and the defenders talk past each other. It is not at all clear they are talking the same intellectual language. Both Pusey and Manne exhibit a persistent tendency among the critics: a refusal to offer hostages to fortune by revealing their own assumptions (they cannot be so naive as to believe they do not have any) or providing serious evidence for their own policy prescriptions. They offer plenty of criticism of economics, economists and microeconomic reform, and, with much nostalgia for an idealised policy past, make assertions about the 'real' basis of the success or failure of other economies. But there is little attempt to grapple with the profound changes in the world economy or the complexities underpinning economic success. I am struck far more often by the simplistic and ahistorical nature of the comments of the critics than of the defenders of reform.

Most of the critics have not seriously tried to understand why what Andrew Norton (1993) calls the 'policy alliance' of economic rationalism has come about. To do so would involve having to acknowledge the serious failure of the past policy arrange-

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[1] I wrote a response to Pusey's paper that was subsequently published in *Quadrant* (Warby, 1993) and as Chapter 13 in James et al. (1993).

ments they find so congenial. Worse, it would undermine the ultimately simple-minded faith they have in political processes.

Experience matters. The patent failure of the command economies and economic success of the Asian Tigers is a far more potent catalyst for global change than any number of books or articles by economists (though economic theory was hardly absent from policy development in the Tigers; and to have powerful apparent confirmation of theoretical points is very useful). Debt burdens and fiscal pressure on budgets (as expectations from government continually run ahead of willingness to pay for them) have done far more to promote the worldwide trend to privatisation than have the writings of Milton Friedman. The persistence, even apparent increase, in poverty and 'need', despite burgeoning welfare expenditures, clearly acts to undermine willingness to endlessly pay for such expenditures, especially where such flows are identifiably geographical (e.g. from north to south Italy or from west to east Canada). The impact of the information technology coupled with human ingenuity in designing new financial instruments and institutions forced government after government, often reluctantly, into financial deregulation. Any commentator who does not grasp the importance of these *practical* factors simply does not understand what is going on. Pusey and Manne (and also Peter Self) give no impression of having that practical grasp. What I would call the 'fallacy of political innocence' — a selective refusal to look beyond immediate causes to underlying interventions — is evident in all three writers. But the effect of government on commercial and other social processes is so pervasive that to simply presume, as they do, that market outcomes have only market causes is utterly untenable.

The social realm is best conceived as a series of interactive concentric rings. The protective actions of the state provide a safe area for a wide range of social interactions. The health of these interactions then provides the basis for economic activity and representative government. From this flow the other functions of government. Each level interacts with the others. That the protective function is prior does not mean that all, or even most, state functions are to be treated as prior, though Self and Pusey talk as if they are. On the contrary, there is much evidence that democracy is itself derivative: that it works reliably and well only on the basis of a rich network of reciprocal relationships and associations (Putnam, 1994). It is far from clear that expansionary government, or the extended welfare state, is entirely healthy for civil society. An unfortunate feature of the debate about economic rationalism has been its tendency to a reductionist market/state dichotomy. The social realm is much larger than this; at least, it is in decent societies.

For the production, distribution or exchange of resources above subsistence level we have only four mechanisms: market exchange, command, custom and charity. Only the first two are seriously amenable to public policy, but they are very far from exhausting the social realm. Judgments about the balance between market and political mechanisms involve comparing their relative effectiveness in achieving particular ends. Such comparisons can be made intelligently only if we have a reasonable grasp of the *actual* features of both markets and politics. (That political processes may be democratic does not render them any less command mechanisms.) The fundamental

divide between supporters and critics of economic reform lies in their respective attitudes to the characteristics and virtues of political processes. The reformers share a certain scepticism about reliance on political and command processes, while the critics all assume that the practices and norms of power are superior to the practices and norms of commerce.

Naivety and Sophistication

In *Government by the Market?*, Peter Self argues that the empirical evidence does not support public choice analyses of political processes, that collective provision is systematically undervalued by public choice theory, and that 'New Right' critiques have currency because they appeal to selfishness. Much of his commentary implicitly assumes that public provision is public-spirited and effective, though he does acknowledge that competition can lead to better provision than monopoly. A distinct drawback of the book is the tendentious tone, which carries a constant implication of stupidity and/or fecklessness on the part of critics of government and welfarism. Self's use of economic statistics is often highly partial as well. Economic policies often have very mixed effects; Self places great stress on negative outcomes of policies he dislikes without giving very much weight to the other side of the story. He does score several direct hits, however. As a career public servant, I agree with Self that the universalisation of market mechanisms is neither workable nor sensible as a basis for public-sector reform. Problems of accountability and efficiency flowing from the sheer scale and complexity of political action are not solved by the proliferation of pseudo-markets (though these may have a useful transitional role). However, again as a career public servant, I am less convinced than Self is of the disinterestedness of public servants. Particularly in the spending departments, the problem is not so much a cynical selfishness as a tendency to find particular views of the world congenial: views that tend to be both narrow and self-serving. What is done is thought to be self-evidently in the public interest, but attempts to seriously monitor the effects are resisted (a disposition greatly aided by the difficulty of monitoring outcomes rather than processes).

Self's intellectual sophistication does not extend to any serious grasp of changes in the international economy or the modern welfare state's problems of sustainability. His judgments show a deep, naive faith in the rationality of government and political action. His wish to define 'public goods' as simply any good demanded or supplied through political processes (p.38) seems to indicate an antipathy to even theoretical limits on effective state action. For him, democracy is a talisman that wards off evil; his proposals for reform all involve strengthening democratic institutions. But 'democracy' is the bundling together in a rather haphazard way of a vast range of issues for occasional crude mass choice. Politicisation of choices does not necessarily spread or equalise social power. The failures of the command economies, the successes of the Asian Tigers, indeed the sweep of European history, suggest quite strongly that freedom of action is more important than democracy to social progress, however desirable it may be to have both.

Self is a prime example of the observation that intellectual revolutions are not made because people change their minds, but because one generation replaces an-

other. However informed and intelligent his criticisms of public choice can be — and there is certainly much to criticise in what is still a very intellectually underdeveloped area — in a deep sense he just doesn't 'get it', and there is no indication in *Government by the Market?* that he ever will. Some of the inconsistencies in his analysis are explicable in terms of tension between naive faith and intellectual sophistication. He writes at length about the failure to cut the government share of GDP and yet his commentary is full of talk of cutback of services. He raises concerns about the effect of government intrusion on the voluntary sector but displays no grasp of similar problems for households, commerce or social networks generally. He has the familiar problem of the interventionist: how to prevent centralised social functions from being run according to hostile values. Self concedes that there are problems in government provision but he often discusses issues in ways that give no serious weight to such problems. Democracy is clearly a supreme value, but politicians are partisan in ways that make them unreliable — so independent public services are vital. But if they are state-supplied, can they be 'independent'? And if they are independent, how democratic are they?

Self's inconsistencies are easily understood if he is taken to be, as so many critics on the Left are, a standard-bearer for the public-sector middle class. His common presumption of the public-spiritedness of public servants and the supporters of government action, and of the moral fecklessness of people in the private sector and their supporters, is of a piece with this. The conflation of 'government' and 'social' is a standard usage in such writing. Much of his commentary on the market has a very 1960s feel to it: for example, the talk of spreading 'commodification', as if that were not a process which has been going on for millennia and which the welfare state encourages rather than inhibits. Self concedes that the criticisms of actual markets all have their political corollaries, but his substantial commentary gives no real weight to this: the right sort of politics can not only deal with the problems of politics, it can deal with the market's problems as well. His idea of civic engagement is fundamentally a narrowly political one: other social processes do not produce the 'correct' outcomes. Self is aware of the tension between his use of democracy as an overriding value, his often dismissive attitude to actual politicians, and his clear desire for an independent bureaucracy; but this ends up only as another unresolved inconsistency in his outlook. He displays signs of a view of democracy as right intent by empowered permanent officials: the public-sector middle class's creed in a nutshell. He proposes even broader government direction of social processes, including government appointments to the boards of large corporations.

There are really only three fundamental ideas in economics: scarcity or the inevitability of rationing, gains from trade, and the diversity of preferences. All else is elaboration. It is simply not intellectually proper to criticise economists and economic advice without showing at least some willingness to grapple with these fundamental ideas. A truly staggering number of commentators, particularly academics, feel free to comment at length, and often in a highly patronising way, about economics, economists and economic policy and yet appear to have made no real attempt to grapple with the relevant concepts or underlying facts of the matter. At times Self appears to

have undertaken such intellectual engagement. At other times he appears to have understood very little. Sometimes he displays a clear understanding of rationing problems, yet he frequently writes as if shortages of public goods were merely the result of insufficient funding. It does not occur to him that rationing by queue might be the unavoidable alternative to rationing by price.

The Social Market

Hugh Emy, in contrast, grasps the importance of international pressures. In *Remaking Australia* he attempts to distinguish between structural changes in the world economy (which undermine reliance on commodity industries, requiring economic 'modernisation' for which he agrees free-market policies are the appropriate response) and the development of advanced interlinked manufacturing technology and transnational trading networks ('globalisation'), for which he thinks strategic planning and co-operative intervention are required. He does not, however, address the simple reality that the spread of manufacturing technology to low-wage countries committed to market policies is what most threatens the incomes of lower-skilled Western workers.

Emy argues strongly for the continuing need for economic restructuring, for dismantling the institutions and culture of protectionism in order to participate in the higher growth path of high-value manufacture. While still a critic of economic rationalism, which he sees as hostile to his firm belief that state and market should be partners rather than opponents, he nevertheless calls it 'rather more than half right' (p.35). Indeed, he is clearly deeply concerned about the unravelling of popular support for economic reform. He wants restructuring to be done more effectively and to be more concerned with fairness and equality, particularly employment opportunities. Unfortunately, he continually invokes Germany, Sweden and Japan as models: appearing to be far more aware of their past successes than of their current deep structural problems.

Emy raises interesting issues about the importance of industry linkages in modern economies, the difficulties involved in 'sequencing' policy changes and the role of skills. With increasing emphasis on human capital and knowledge as determinants of growth, the plausibility of creating comparative advantages clearly grows. Emy is very much an advocate of the middle way between interventionist protectionism and pure free markets: the 'social market' rather than the protected market or the free market. His problem is that such an approach needs a very good sense of the actual faults and virtues of political processes: something we still lack. (The public-choice theorists will have to work harder. In particular, they will have to take power rather more seriously and embrace a richer psychology.)

Concluding Comments

The critics of economic rationalism all believe in politics as the unfolding of the public interest. Formalising the assumptions of the public-interest model of politics is not hard. They are: there is a public interest; it is discoverable through the political proc-

ess; and it can be reliably implemented by officials, either through altruism or because the incentive structure reliably leads to dutiful behaviour.

One looks in vain to Pusey or Emy (or Manne in his other writings) to provide serious demonstration of the circumstances in which such assumptions are warranted, though Emy is clearly far more aware than the others of the need to do so, and Self does discuss the issue. Even Emy talks as if the market's being a 'social construct' and needing moral guidance establishes his case (pp.31-3). But the state is even more of a social construct and even more in need of moral guidance. Neither point in any way establishes either the right or the capacity of the state to fulfil the many aims that Emy, and still more the other critics, wish on it.

Emy aside, all the critics pay lip service to the desirability of markets: they just object to anything more than lip service. For example, Pusey's analysis elsewhere of the two realms that make up 'civil society' — the realms of 'states, bureaucracies and the law' and of 'economies, markets and money' (Pusey, 1993) — looks more generous to markets than it is. His commentary (leaving aside the misrepresentations of economics, the bastardisation of recent history, and the inadequate characterisation of civil society) acknowledges no limits on the realm of government in interfering in the realm of the economy. The latter realm is permitted to exist, but has no authoritative claims beyond that. Even any power it has to set prices (particularly wages) is strictly on a 'grace and favour' basis. Similarly, Self's criticism of the use of the term 'redistribution' on the ground that it presumes some moral basis for the pre-existing distribution, and his belief that government has the right to decree whatever distribution it deems appropriate, show the unlimited nature of his faith in (democratic) government. A greater incitement to the politics of aggrandisement and self-interest is hard to imagine. That there is no serious social legitimacy beyond (or against) democratic politics is clearly the central tenet of Self's personal faith, and also of Pusey's and (perhaps) Manne's.

Much of the debate has focused on attitudes to markets. But this is only half of the matter. It is only by looking at attitudes to politics and political processes that we can fully understand what is dividing market reformers from their intellectual critics.

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Agenda, Volume 1, Number 2, 1994, pages 237-244

NOTES AND TOPICS

Volunteers for Nature Protection: Examples from Bavaria

Jeff Bennett

Nature conservation in Australia has normally been a responsibility of the public sector. Almost all of the areas of protected natural ecosystems in Australia are owned and managed by public-sector agencies such as the State National Park and Wildlife Services and Forestry Commissions. Traditionally, such government involvement has been thought necessary because many of the benefits provided by protected natural areas have public-good characteristics that make private-sector provision unprofitable. Yet initiatives in the German State of Bavaria suggest that private-sector clubs and associations can successfully secure conservation benefits for the community in a cost-effective manner.

Public Sector Involvement

It should be said at once that the public sector is heavily involved in nature conservation in Bavaria. The State government closely controls the allocation of land for all purposes, and federal and European Union laws significantly affect land-use decisions.

Nature protection is promoted by two land classifications: *Naturschutzgebiet* (Nature Protection Area) and *Nationalpark* (National Park). A *Naturschutzgebiet* (NSG) maintains a specific ecosystem in its current state because of its natural beauty or because it provides a habitat for plants and animals. Once designated as an NSG, an area, no matter who owns it, is subject to a decree that sets out the land-use practices that are compatible with its status and hence permitted. A decree may limit the scale and intensity of agriculture (for instance, by limiting fertilizer application) or even regulate routine land-management practices (for instance, by stipulating the period within which mowing of pastures for silage is permitted).

The *Nationalpark* (NP) classification protects areas of environmental significance but also makes them available for research and recreation. Bavaria's two NPs — *Nationalpark Berchtesgaden* and *Nationalpark Bayerischer Wald* — are State-owned, but the law permits privately owned areas to be designated NPs. Some land within NP *Berchtesgaden* is under perpetual lease to farmers who continue to graze the land, although under tightly controlled conditions.

As of September 1993, the total area of NSGs in Bavaria was 138,565ha, making up 1.96 per cent of the total land area. The two NPs accounted for 34,000ha (0.48 per cent).

Although some of the opportunity cost of the restricted land-use practices allowed by the NSG decrees is deemed by the government to be the 'social responsibility' of the land-owner, generous compensation payments are made to those affected. In addition, the government is obliged to pay some of the costs of landscape management in the NSGs, especially in cases where the private owner ceases to farm an area.

The government is also involved in buying land for nature protection purposes. Purchases are made not only from the budget of the environment ministry but also from the *Naturschutzfond* (Nature Protection Fund, or NSF). This is a capital fund of approximately DM25m (A$21.3m), established in the mid-1980s and managed by the government. The yearly income from the fund, together with any funds contributed by private sources, is used to buy land for nature protection. In 1992, the NSF contributed DM665,000 for land acquisition; a figure in excess of DM2m was projected for 1993. In 1992, the ministry paid DM3.1m directly from its budget for land purchases.

The State government disburses funds from the NSF in close collaboration with *Landkreise* (local councils) and with the private sector. The *Landkreise* submit proposals for purchasing land for conservation to the Bavarian government. Upon approval, the State contributes 50 per cent of the price on average. Areas deemed to be of special significance may attract up to 66 per cent funding by the State.

Private Sector Involvement

Private initiatives for nature protection in Bavaria are wide ranging and involve varying degrees of cooperation with the government.

Most closely associated with the government are those private activities that complement the work being undertaken in the NPs. Although this is only at an early stage of development, park managers have sought to use voluntary labour for specific tasks in their parks. 'Voluntary' work has sometimes been paid for by private corporation sponsorship. The German section of the Federation of Nature and National Parks of Europe (FNNPE), a private non-profit organisation, aims to coordinate the management activities of the NPs and to facilitate private sponsorship of NP projects (the enabling legislation for the NPs prohibits direct sponsoring). Hence the FNNPE acts as a clearing house for commercial sponsoring. For example, the computer systems at NP *Berchtesgaden* have been provided by IBM and this is given recognition in the park's visitor centre.

The *Deutscher Alpenverein* (German Alpine Club, or the DAV) also works closely with the government, but in a very different way. It is a large organisation with over half a million members throughout Germany and an annual fee revenue base of DM14m. Its activities include the teaching of climbing skills, alpine rescue services and lobbying the government on environmental issues. Especially important is the DAV's involvement in management of the alpine regions. This involve-

ment takes two forms: the construction and maintenance of paths and signs in alpine areas (which are owned largely by the government), and the operation of a network of alpine huts (which are owned by the DAV). DAV members undertake these tasks on a voluntary basis, except for the provision of hospitality services at the huts. The DAV allows a 'hut-server' to sell food and beverages at the hut in return for the collection of the accommodation fee and the general maintenance of the buildings. The operation of the huts is strictly monitored by the government, especially for their environmental impacts. Some huts have been closed because they failed to meet government waste-water quality requirements or because the DAV lacked the funds to improve the facilities of all their huts within a short time period.

Other nature protection associations in Bavaria have a more direct interest in the provision of land specifically for nature protection. The most important of these are the *Bund Naturschutz in Bayern* (Bavarian Nature Protection Association, or the BN) and the *Landesbund für Vogelschutz in Bayern E.V. — Verband für Arten- und Biotopschutz* (Bavarian Bird Protection Society, or the LBV). The BN has 105,000 members in Bavaria. Its annual membership fee revenue base is DM4.5m, but it has total funds available of DM10m (including donations, bequests and fines directed by local courts to the BN). The LBV has about 35,000 members and 12,000 'sponsors' who often contribute more than the membership fee but do not wish to be members. Its membership fee revenue is DM1.6m; other sources of funds bring the total funds available for spending to DM3.5m.

Both the BN and the LBV buy land for nature protection purposes. As with the local councils, the government provides funding for, on average, half the purchase price. The BN currently owns approximately 1,100ha and leases a further 700ha, allocating in the order of DM600,000 to DM800,000 annually to the task. The LBV owns about 800ha and a further 800ha of leases. It currently devotes approximately DM650,000 annually to land acquisition.

The two associations manage their land differently. The LBV encourages its members and the public to visit its reserves (except where the ecology is fragile) by providing guided tours and/or information boards. The BN does not encourage visitors. Both organisations rely on members to provide voluntary labour for management tasks, although some of the non-labour costs of management are subsidised by the government. The LBV in some cases leases back land to farmers who contract to manage it in a manner that is compatible with the LBV's goals. Where the government has partly funded the land acquisition, the organisation agrees to devote the land to nature protection and to allow it to revert to government ownership should the association cease to exist.

The DAV owns land that is used for conservation purposes. In fact, it is the largest private land-owner in Austria, through its holding of 30,000ha adjacent to NP *Hohe Tauern* in the Austrian Alps.

Making Voluntary Associations Work

The success of private involvement in nature protection depends very largely on the ability of voluntary associations to attract and keep members. How do they do it?

Possibly the most important factor is the groups' common organisational structure. A relatively small central coordinating headquarters is combined with a host of sub-groups that provide the focus of most activity. The DAV, for example, is made up of 320 sections, each responsible for a specific region of the Alps. The BN is organised into groups, each centred on a particular *Landkreis*. These groups may have anything from 1,500 to 12,000 members, but they are in turn broken down into smaller groups based at the suburb, town or village level, where membership may range from five to 300. The LBV is similarly divided into 350 groups with between ten and 3,500 members.

So despite their overall size, the Bavarian associations operate through small groups, which, by mobilising peer pressure, motivate their members for action and discourage free-riding behaviour. As well, personal pride in achieving goals is encouraged by assigning responsibilities for particular tasks to specific groups. This practical focus of group activities has proved to be a very attractive feature of membership.

The Bavarian associations encourage membership also by providing non-collective goods. The DAV, for example, grants its members access to the club's network of alpine huts at special rates, and provides them with alpine transportation, rescue services and mountaineering tuition. All the clubs are increasingly involved in merchandising: tee-shirts and stickers help create the images that encourage membership.

Nevertheless, the associations are very largely an adjunct to government action. And they are relatively small. For instance, the BN in Bavaria has been able to recruit about 2 per cent of the population, whereas ADAC, the German motoring association, commands a membership of about 25 per cent.

Australian Applications

The Bavarian experience suggests that private-sector organisations are capable of a wide variety of nature-protection activities that can complement the actions of the public sector.

Australian evidence that privatisation of national parks is not only feasible but cost-effective exists in the form of Earth Sanctuaries Limited. This private company operates two nature reserves in South Australia (Warrawong in the Adelaide Hills and Yookamurra between the Barossa Valley and the Murray) and one in western New South Wales (Scotia, north of Wentworth). According to its prospectus, Earth Sanctuaries aims to ensure the survival of Australia's native flora and fauna within a commercial environment. Using eco-tourism as its source of income, the company has been able to raise equity funding to maintain an active expansion program that involves the purchase of land, while earning operating profits in its established reserves. This success has been achieved without government subsidies.

The management of Australia's national parks could be selectively privatised. The government could put the implementation of the plan of management out to tender and monitor the performance of the successful bidder. Competition between bidders would ensure that the goals of the plan of management would be realised in the most cost-effective manner.

Clubs and associations could be encouraged to purchase areas for nature protection purposes. Governments could direct funds allocated to conservation organisations away from untied grants and towards the subsidisation of land purchases. They could invite selected associations to put forward proposals for areas of land to be protected, vet the proposals, and allocate funds to supplement money raised by the associations for the purchases. Ownership of the areas so purchased would be vested in the associations but specific covenants could be included on the titles to limit land use to nature protection. This mechanism would inject some market discipline into the process of adding to the stock of nature protection areas.

A system of nature protection that takes advantage of the strengths of both the private and the public sectors would ensure that the limited resources available for nature protection are used to best advantage.

Jeff Bennett is Associate Professor of Economics at the University of New South Wales.

Are Tobacco Taxes Too High?

Robert Albon

Governments have intervened in various ways in the production, sale and consumption of tobacco products. Perhaps some of these interventions are in the public interest as usually interpreted, but some may reflect political correctness, pressure from special interests and a preoccupation with costs. Recently some rather draconian proposals have emerged, including blanket bans in pubs, restaurants and clubs, and even the suggestion that smoking, which is already subject to the highest tax rate of any commodity (about 190 per cent), be taxed at an infinite rate (that is, banned).

A balanced debate on smoking would exhibit the following three characteristics:

- Recognition that there are benefits to smokers, measured by what smokers are prepared to pay to smoke. To assume otherwise is inconsistent with the principles of a free society. Many observations on smoking are based solely on

costs, apparently stemming from the influential study of the costs of drug use by Collins and Lapsley (1989).

- Application of the conventional efficiency criterion, based on the summation of all benefits and costs in dollar terms, irrespective of the identity of the individuals to whom the benefits or costs are attached. If this is a positive sum, the industry is desirable and any policy change which increases this sum increases its desirability.

- Application of notions of fairness, including avoidance of regressivity and discrimination.

The main public policy issues emerge easily, revolving especially around the implications of divergences of social and private costs: the costs to non-smokers from the smoke created by others; the costs to the community of treating smoking-related diseases; and whether there is a rationale for the extraordinarily high levels of taxation imposed by the Commonwealth and the States.

Second-Hand Smoke: Smells and Health Risks

The unpleasantness and health risks associated with second-hand smoke and smells have given rise to various legislative endeavours (usually in the form of bans on smoking in many work-places, airports, aircraft, and so on) and social adjustments of various kinds.

Three points may be made about these changes. First, the costs have always fallen on smokers. Whether this is fair or not is a matter of individual judgment, but the direction of the cost burden is clear.

Second, from an efficiency viewpoint, it is not clear that the use of bans is warranted in all circumstances. The approach developed by Ronald Coase (the Coase Theorem) might yield an efficient solution with a positive amount of smoking in some circumstances. If property rights were allocated either to non-smokers (the right to clean air) or to smokers (the right to smoke), these rights would be tradable. For example, if non-smokers had the right to clean air, smokers could smoke only in a particular place if they compensated non-smokers by an amount determined by them. The smokers may be prepared to pay more, up to some level of smoking, than non-smokers need in compensation. In other circumstances the cost of even one unit of smoking could exceed the benefit, and zero smoking would be efficient. It may be possible for an efficient solution to arise even where property rights have not been allocated. The essence of Coase's approach is that the 'right' amount of smoking arises in a market context, but only where transaction costs between the parties are sufficiently low. There are probably circumstances (for example, lifts) where bargaining costs are too high, and a ban may be appropriate.

Third, in spite of the efforts of a number of special interests, the political process has so far been unwilling or unable to extend complete bans to bars, clubs and

restaurants in any jurisdiction. Perhaps this reflects a realisation that bans in specific areas have gone far enough, and that it is time for voluntary actions to take over.

Health Costs

Now consider the second possible divergence of social and private costs. The Collins and Lapsley study concentrated on the costs of smoking and other drug usage and gave the impression that smokers do not pay their way with respect to health costs. However, as has been convincingly shown in a study by ACIL (1994), Collins and Lapsley overestimate the costs that can be attributable to smoking, do not differentiate between social and private costs, and in other ways misrepresent the true situation.

According to ACIL, the health costs of smokers imposed on the community through the socialised health system in 1992/93 were less than A$400m. These are health costs of smokers that are not borne by the smokers themselves. This may seem to be a large amount in absolute terms, but not when compared with the revenue received by Commonwealth and State governments from tobacco taxes: $2,963m in 1992/93. That is, smokers are taxed more than $2,500m in excess of the level necessary to meet their public-health costs.

The Right Tax Rate

Governments have to get their net revenue from somewhere, and tobacco products are, along with other commodity taxes, income taxation, and so on, a source of that net revenue. But we can apply equity and efficiency criteria when enquiring whether governments try to get too much net revenue from tobacco products.

Is the high rate of tax fair? First, the tobacco tax rate stands out as being by far the highest for any commodity group. The combined Commonwealth and State tax rate for tobacco products is over 190 per cent (a carton of 200 Marlboro cigarettes costs $12 in the Canberra downtown duty-free store and around $35 in Canberra supermarkets). The next highest — on spirits — is only about 120 per cent. If the contribution to health costs is removed, the rate of taxation on tobacco products is still higher than the rate on any other of the range of highly-taxed products, even without taking out their excess health costs.

Second, although some might regard it as fair to charge excess health costs to smokers, the idea would be more appealing if *all* groups (drinkers, drug users, hang-gliders, gluttons, and so on) paid their excess health costs through a special tax or user charges. Clearly this is not the situation at present.

Third, tobacco taxes are highly regressive. This arises from the combination of inelastic demand (own-price elasticity-of-demand estimates range from -0.2 to -0.57: ACIL, 1994:24-5) and a concentration of smokers in low income groups (ACIL, 1994:47). Low-income smoking households sacrifice products other than tobacco when prices are raised by taxation. The high-tax regime on tobacco could be removing the sausage-meat from many a poor child's dinner table.

Are the high taxes efficient? As with virtually any tax, there is an excess burden or deadweight loss from taxing tobacco products. As a tax rate applied to a particular base is increased, the total deadweight loss from the tax increases. Further, the deadweight loss increases at an increasing rate.

To achieve efficiency in raising a given total revenue from a variety of taxes, it is necessary to equalise the marginal excess burden from each. Where marginal excess burdens differ, an efficiency gain would result from reducing those with relatively high marginal excess burdens, and increasing those with relatively low ones.

On the basis of this efficiency criterion, there is *prima facie* evidence that tax rates on tobacco products, as the highest on any commodity group, are too high. To determine whether this rate could be in excess of the efficient level it would be necessary formally to examine the relationship between marginal excess burdens and tax rates for major taxes, but this would represent a large econometric task.

The rate may be in danger of becoming too high in a sense more relevant to governments: revenue. Taxation revenue rises at a decreasing rate as the tax rate is increased, eventually peaking and then falling. This relationship — the 'Laffer curve' — could indicate that governments are close to going too far with tobacco taxes and that an increase in rates could decrease revenue.

Conclusion

In recent years the debate on smoking has moved outside the usual bounds of public policy discourse. Political correctness has become an important factor; consumer sovereignty, fairness and economic efficiency have been down-played or ignored. Robert Tollison and Richard Wagner (1988) have warned of the slippery slope: a slide into other incursions on individual freedoms.

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Robert Albon is Senior Lecturer in Economics in the Faculty of Economics and Commerce at the Australian National University.

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REVIEWS

Defunct Macroeconomists

*Alfred J. Malabre, Jr, **Lost Prophets: An Insider's History of the Modern Economists**, Harvard Business School Press, Boston, 1993*

Reviewed by ***John Foster***

Alfred Malabre, Jr is an eminent journalist who is well known for his insightful commentaries on US economic policy in his capacity as economics editor of *The Wall Street Journal*. In *Lost Prophets*, he examines the reasons why several schools of macroeconomic thought gained and lost influence in the formulation of American economic policy after World War II. However, this is no dry account of the history of modern economic thought. Rather, it is a compendium of personal recollections and opinions, which focuses upon those economists who were most closely involved in policy formulation. Malabre displays an excellent memory for people, places, dates and economic statistics, which are spread liberally throughout the text. Written in lively journalistic style, the book constitutes an entertaining read for economists and non-economists alike.

Malabre interlaces his commentaries with his own evaluations of postwar American policies. Early on he provides a scathing critique of the Bretton Woods agreement in 1946, which gave the Western world a system of fixed exchange rates. So it does not take long to discover that the author has an aversion to government intervention, at least of the Keynesian variety. Yet he correctly points out that Keynes's brand of economics had little influence on economic policy in the immediate post-war years.

Unfortunately, he does not stress the residual power of American institutionalist thinking in this period, following its high point in the era of the New Deal. This is a serious omission that raises questions about the author's depth of understanding of this subject. In this regard, Malabre seems to work backwards and forwards from the monetarist vs Keynesian characterisations of macroeconomics, popular in the late 1960s and 1970s. He appears to have little understanding of the quite different characterisations, whether before, during and immediately after World War II, or in the 1990s. For example, to understand fully Milton Friedman's economics it is essential to appreciate the influence of Wesley Mitchell, the famous American Institutionalist, both directly and indirectly through the teaching of Arthur Burns. As well, the 'Chicago Tradition' of that period was a branch of American institutionalism, far removed from the monetarism of the 1960s. Malabre focuses, correctly, upon Kenneth Galbraith as an influential Keynesian, but, once again, his presentation is flawed because he overlooks the fact that Galbraith was an institutionalist, applying Veblenian insights.

Malabre provides a fascinating history of the economic advisory process of the 1960s, when Keynesianism came into its own. But the presentation is marred by simplistic statements about budget deficits and by an overwillingness to attribute the economic policy mistakes of that time to economic advice rather than to over-riding political considerations. He commits the common mistake of equating President Johnson's Great Society programs with Roosevelt's New Deal, despite the entirely different circumstances surrounding the introduction of each. Nor does he make clear the fundamental problem with economics at the time, namely, a shift from pragmatic, real-world institutional economics to an abstract theoretical macroeconomics. The rise to prominence of Paul Samuelson, which Malabre traces, was indicative of this unfortunate transition: he proved himself to be an abstract economic theorist *par excellence* and, simultaneously, a warm-hearted but naive 'Keynesian' in matters of economic policy. It was a simple matter, in later years, for politicians, and journalists such as Malabre, to lay the blame for the politically induced economic ills of the 1960s and early 1970s at the door of such economists. In contrast, the earlier generation of American institutionalist economists, such as Allyn Young, Lachlin Currie and John Commons, to name a few of those centrally involved in policy formulation, understood the meaning of 'political economy' and made lasting contributions to the economic well-being of the United States that few politicians, or journalists, are able to denigrate.

Malabre provides an entertaining history of the successive failures of economists to forecast the future. A central figure is, of course, Milton Friedman, who defined economic science in terms of its ability to forecast accurately. He rightly concludes that economists, seduced by the false scientism of applied econometrics, built upon illusory economic theories, proceeded to make fools of themselves in the grand manner. Malabre documents the predictive failures of Friedmanite monetarism in a manner that is both entertaining and amusing. The banalities of supply-side economics, promoted in the era of Reaganomics, are also exposed. Malabre shows how an abstract and simplistic theory, which appealed to political conservatives, was promoted without any attempt to provide evidence in its support. But, once again, there is little appreciation that it was *political* forces that brought this kind of economics to the fore. Malabre does admit that supply-side economics was never very popular among American economists, but he does not explain why a minority viewpoint rose to such prominence.

In Chapter 7, Malabre 'looks ahead' and it is here that the book disappoints. Economic journalists are typically fixated by the economics they were taught, or picked up, in a formative period of their lives: hence Keynes's famous remark concerning 'defunct economists'. They are usually out of their depth in dealing with current developments in economic analysis. Space does not permit me to sort out Malabre's misinterpretations and misjudgments. Perhaps it is enough to point out that in Fig 7-1 (p.223), which provides a guide to a selection of schools of economic thought, he fails to distinguish the powerful New Keynesian school from earlier Keynesianism. He also ignores the important new school of evolutionary economists

who employ nonlinear dynamic methods and revitalise many of the ideas of the old American institutionalist school.

Economics is entering a period of crisis and struggle whereby theoretical habits of thought, implanted by decades of subservience to ideological priorities, have to be exorcised from the discipline before any progress can occur. This is hard to discern from the vantage point of an editorial chair in Wall Street. Indeed, Alfred Marshall or Maynard Keynes could have told us that sitting amidst the chaotic swirl of the financial markets, observing the day-to-day machinations of the policy process, is the worst possible position for understanding the great issues of economic science. Because of this, we should, perhaps, forgive Malabre's misjudgments in his analysis of the development of modern American economic thought, his overstatement of the influence of individual economists and his tendency to ignore the fact that it is politicians, not economists, who have been responsible for policy mistakes.

However, I do not wish to end on a negative note. *Lost Prophets* remains a fascinating account of the involvement of many well-known economists in the process of formulating American economic policy. Malabre's account contains all the elements of good journalism: combining the seductive skills of the gossip columnist with the moral outrage of the investigative journalist, along with the clever presentation of descriptive statistics, which is the hallmark of a good economics correspondent. In sum, the book is a very entertaining read but one that is not to be taken too seriously.

John Foster is Professor of Economics at the University of Queensland.

The New Moralism

*James Q. Wilson, **The Moral Sense**, The Free Press, New York, 1993*

*Reviewed by **Knud Haakonssen***

Morality is a flavour of the month that has become theme of the decade. Anyone who wants to figure in public life must invoke the caring attitude. Every profession and pseudo-profession must have its code of ethics. And the greatest change to professional moral philosophy during the last generation has been towards a concern with the practice of being good, with the application of moral ideals to matters of life and death rather than with the meaning and status of goodness. In these developments the conception of morals has also changed. Instead of seeing morals as a matter of prescriptive rules for behaviour, fashionable moral thought is dealing with the *virtues*, with the qualities of character that make a person good. In tune with this, new liberal opinion is rejecting the ideals of the Enlightenment on the alleged grounds that it is impersonal and asocial, as epitomised in the political economy of Adam Smith and the legalistic ethics of Immanuel Kant. Instead, inspiration

is being sought in a cuddly Aristotelianism that embraces us with the virtues of 'the good life' that can be fostered only in the womb of community and without which community is impossible.

This mode of thinking — or feeling — is sufficiently woolly to be attractive to a wide ideological spectrum. It supplies the rhetoric, if not the ethos, of the Clinton White House; it is invoked by celebrators of the inherent virtue of femininity and by the family-values lobby; it is central to many aspects of multiculturalism and policies towards minority groups; and it seems to play an increasing role in UN and other development-aid programs.

In most of these arenas the new moralism is in sharp conflict with a pervasive cultural and moral relativism. In fact, the virtue push is largely inspired by the fight against relativism and has accordingly been received with open arms by Catholicism. The central concern is that the Enlightenment ideal of the moral person as an autonomous individual defending personal rights and imposing moral rules upon himself has led to pure subjectivism and relativism, if not outright value nihilism. So the search is on for the virtues of an inherently good life. Are there such universal virtues?

In *The Moral Sense*, James Wilson, Professor of Management and Public Policy at the University of California at Los Angeles, answers this question in the affirmative, but he approaches it in a way that makes his answer more interesting than the question might lead one to expect. With inspiration not only from Aristotle but also from such 18th-century thinkers as Francis Hutcheson, David Hume and Adam Smith, he argues that there is overwhelming scientific evidence that humanity has a specific moral nature, or that human nature *per se* includes moral features that can usefully be characterised as moral senses (the text is more cautious than the title). Wilson draws on all the modern sciences of human nature — biology (including development genetics), evolutionary theory, individual and social psychology, sociology, anthropology, political science — providing an impressive synthesis of a huge literature.

The moral nature of humanity is a composite of several factors that Wilson divides into sympathy, fairness, self-control and duty. Sympathy is 'the human capacity for being affected by the feelings and experiences of others' (p.30) and, while necessary for the moral life, it is, as Wilson shows, a capacity as readily employed for moral ill. Fairness is analysed in terms of equity, reciprocity and impartiality, and is traced to 'the parent-child relationship, wherein a concern for fair shares, fair play, and fair judgments arises out of the desire to bond with others' (p.70). Wilson provides a particularly clever analysis of the emergence of self-control — in effect a combination of the ancient virtues of prudence and temperance — and shows that, in isolation, it is as morally ambivalent as sympathy. The sense of duty, or conscience, is likely to have roots in an innate desire to please parents, but, as an autonomous force independent of considerations of reward and punishment, it is socially learnt. Wilson is here very close to Adam Smith in *The Theory of Moral Sentiments*.

In the second half of the book, Wilson seeks out the 'sources' of the moral senses under four headings: the social animal, families, gender and the universal aspiration. In a grand tour of evolutionary, social and anthropological theory, Wilson identifies

the extent to which all 'humans are disposed to be social before they learn what sociability is all about' (p.125); he shows how this disposition is in constant tension with the self-interested 'desire for survival and sustenance' (p.123); he makes sense of the complex relationship between genetics and social life in the family, linking basic personality to the former and its moral expression to the latter; and he cautiously summarises what can be said about gender-determination of the moral senses. But while natural sociability, family life and gender play their roles in the moral life of the species everywhere and at all times, 'the universal aspiration' is unique to the modern world and especially to the West (meaning northwestern Europe and North America) for only 'there has been erected a cultural commitment to individualism and universalism — that is, to the belief that all men ought to be free and each man is entitled to (roughly) equal respect' (p.197). This aspiration was generated in the Enlightenment through the idea that human life 'could be understood by the use of our natural faculties and without relying on ancient custom or revealed religion' (pp.196-7). Wilson offers an imaginative explanation of why this phenomenon has emerged only in the West: that 'the growth of universalism and individualism was the product, in part, of the rise of consensual marriages and the existence of private property' (p.214). While stressing both the speculative and the incomplete character of his theory, Wilson's basic point is that the nobility of the universal aspiration has been 'purchased at a price, and sometimes a very high one: a lessened sense of honour and duty, and a diminished capacity for self-control' (p.218).

This leads to the concluding challenge: how to achieve a coherent view of morals that both honours the empirical arguments for universal moral senses and rescues as much universalism and individualism as possible without paying the price indicated. The rich scientific material enables Wilson to dismiss the more notable rejections of a natural morality, such as Marx's reduction of morals to ideology, Freud's idea of morality as a socially induced thwarting of our natural antisociability and aggressiveness , B. F. Skinner's explanation of morality as a conditioned response and Richard Rorty's Gucci-philosophy of the moral self as fashion. But such ideas can thrive only because they are nourished by a much more pervasive 'ambiguous legacy of the Enlightenment' (p.244), namely a perversion of the fine ideals of individual freedom, autonomy and equality into pure subjectivism and relativism. Wilson is perfectly clear that the sciences of human nature are of little help in establishing a balance here. From the theory of universal human nature we can deduce only 'a handful of rules or solutions to any but the most elemental (albeit vitally important) human problems. The reason is that one universal truth — man's sociability . . . — coexists with other universal truths — man's ambition, avarice, and vanity' (p.218). A resolution 'requires moral reasoning to take up the incomplete task of natural development' (p.237). Yet it is not reasoning but intuition in which Wilson places his faith. Ultimately the 'balance among the moral senses is, to me, more an aesthetic than a philosophical matter. It is aesthetic in two senses: it is a balance that is struck without deliberation or reasoned justifications, and in the character thereby formed there is no clear distinction between form and content' (p.243; Oakeshott is duly acknowledged).

The problem with this is that we each have our intuitions. If we want them to match sufficiently to resolve conflicts, not among our own moral senses but between our moral senses and those of others, then we shall have to resort not only to reasoning but to argument. This is indicative of the basic weakness of Wilson's impressive book. He has no appreciation of that part of the Enlightenment legacy that sees morality as, in part, a public, inter-subjective process of discussion in which ideals of cogent argumentation hold sway. While the theory of humanity's moral nature suffices to reject the notion that anything goes and that 'autonomous individuals can freely choose, or will, their moral life' (p.250), it still leaves a wide open field of possibilities. The field is undoubtedly narrowed down by, among other factors, habitual 'aesthetic' intuitions of the balanced character. But central to the Enlightenment's 'dangerous' lessons is the habit of questioning habits, and it is in response to this that we have developed an intricate, sometimes institutionalised, culture of public moral and political discussion. Conventional moral philosophy in effect addresses such discussion by trying to supply criteria and ideals for moral decision-making. Wilson has little appreciation of this aspect of morality, but he is quite right in rejecting as naive the belief that traditional theories, such as utilitarianism, Kantianism, and rights-theories, exhaust the moral sphere. The contribution of this fine book is to give a sharp portrait of the moral nature which in the Enlightenment learnt the lesson that what it can do with itself is a matter of debate. This debate cannot be reduced to either sociobiology or aesthetic intuition.

Knud Haakonssen is Senior Fellow in the Research School of Social Sciences at the Australian National University.

Tradition and Innovation

Michael J. Lacey and Knud Haakonssen (eds), ***A Culture of Rights: The Bill of Rights in Philosophy, Politics, and Law — 1791 and 1991****, Woodrow Wilson International Center for Scholars and Cambridge University Press, Cambridge, 1991*

Reviewed by ***Charles Richardson***

Constitutional protection of human rights, which seemed to have gone out of fashion a few years ago, is now clearly back on the agenda in Australia and New Zealand (Moens & Trone, 1994; Mapp, 1994). The controversy over Australia's international obligations in relation to Tasmania's anti-homosexual laws is only the latest ingredient in a continuing debate over whether certain issues of individual rights should be put beyond the reach of legislative majorities. Recent decisions of the High Court, most notably in the 1992 political advertising case,[1] have suggested an

[1] *Australian Capital Television* v *Commonwealth*, (1992) 177 CLR 106, 108 ALR 577.

increasing trend of judicial activism in this area. It is therefore a good time to be looking more closely at the most durable model for such protection, the Bill of Rights of the United States. The Bill of Rights was adopted in 1791 as the first ten amendments to the US Constitution. Although other protections of individual rights have been added since, especially in the 'reconstruction' period following the Civil War, these ten amendments are of fundamental importance.

A Culture of Rights originated in a series of workshops conducted by the Woodrow Wilson Center in Washington to commemorate the bicentennial of the Bill of Rights (the whole Constitution is usefully printed as an appendix). Rather than giving a complete history or analysis of the Bill of Rights, the contributions focus on two historical periods: the Revolutionary era when the Bill of Rights was adopted, and the present day.

The book's title gives an important clue to its message: respect for individual rights has become a part of American culture, and understanding the way that rights are protected under the Constitution involves looking at much more than just legal theory. This echoes a point made by many conservatives in opposing the introduction of a Bill of Rights in Australia: purely 'formal' guarantees of rights, they say, are useless without a tradition which supports them. By taking the historical perspective, however, this book reminds us that traditions do not just appear out of nowhere. The Bill of Rights was not a product of 'conservatism'; it was created in a time of political and ideological ferment to meet an entirely new set of circumstances.

After a short introduction by the editors, the first four essays look at different aspects of this Revolutionary era. Knud Haakonssen locates the American philosophical debates of the period within the European 'natural law' tradition; James Hutson surveys the political process by which talk of rights developed in the American colonies and in the formation of the Constitution; Jack Rakove analyses the thinking of those who adopted the Bill of Rights, and particularly its author, James Madison; and Charles Griswold discusses the philosophy of rights held by Thomas Jefferson, as revealed in his views on slavery.

Taken together, these essays suggest that the history of the Bill of Rights is much more than merely historical interest. Professor Rakove in particular shows how today's arguments about constitutional interpretation have their roots in the debates of the 18th century, and that bad legal theory frequently rests on bad history. Writers like Robert Bork, whose interpretation depends on the 'original intent' of the Constitution's authors, come in for some criticism; as Rakove says, their 'pressing need to find determinate meanings at a fixed historical moment . . . cannot capture everything that was dynamic and creative — and thus uncertain and problematic — in Revolutionary constitutionalism' (pp.100-01).

The last three essays deal with the Bill of Rights in contemporary America. William Galston gives an excellent survey of recent work in the philosophy of rights, approached from a practical standpoint, asking what 20th-century philosophy has to offer in understanding rights. William Fisher writes on the fragmented nature of modern American legal theory, beginning with the Legal Realists of the 1920s and continuing to such recent developments as Critical Legal Studies. In the final essay, Alan

Ryan compares attitudes to rights in the United States and the United Kingdom, exposing cultural differences that strike some familiar chords with Australians, who lie somewhere midway between the British and American constitutional traditions.

Some of the individual essays show the pitfalls of interdisciplinary studies, as different writers grapple with issues from outside their own fields. James Hutson, for example, gives a fine historical analysis of 18th-century politics, but seems at sea when trying to distinguish the different philosophical positions that the participants held. Professor Griswold is clearly more at home with the abstract philosophical side of Jefferson's thought than with the practical political constraints under which he operated. On the other hand, Rakove, Galston and Ryan all represent the interdisciplinary approach at its best. Taken as a whole, the book is a successful effort, showing that history, law, and political and moral philosophy are all important in understanding the constitutional status of rights.

It may be dangerous, however, to try to draw too many lessons from history. One thing that emerges from the historical accounts is the remarkable extent to which the framers of the Constitution and the Bill of Rights agreed on which rights needed protection, despite the varied and uncertain nature of their philosophical foundations. What was novel and interesting about their situation, and therefore most hotly debated, was the problem of finding a way of protecting those rights in a new political environment. Clearly, political progress can sometimes be made despite deep philosophical disagreement. But it is not clear that even the basic practical consensus on what rights are worth protecting is present today in Australia and other Western countries. Indeed, readers of this book will be immediately struck by the decline since the 18th century in the quality of philosophical thought applied to public policy. Today's philosophers rarely venture outside of their ivory towers, and today's politicians are ill-equipped to understand them when they do. Modern-day Jeffersons and Madisons, sadly, are in short supply.

The reader will also be struck by many differences between the Australian and American experiences. A Bill of Rights for Australia, whatever form it may take, would have to do more than copy some available model; it would have to be anchored in Australian traditions in order to win acceptance. The error made by the conservatives is to assume that tradition alone will do the work for us. A culture, whether it involves respect for rights or something quite different, seems to lie somewhere between natural organism and human artefact. To get the culture that we want, we have to be prepared to take deliberate steps, although we should be aware that the result may turn out to be not quite what we expected.

The 'culture' of rights, from its enigmatic beginnings in the 18th century, is now a worldwide phenomenon. America's lessons, such as they are, are our lessons as well. It is only natural that, in times of constitutional contention such as the present, people will continue to look to the American experience of judicial review, in the hope of discovering how best to protect and preserve that culture for themselves. This book would be a good place to start.

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Charles Richardson is a moral and political philosopher currently working as an adviser to the Victorian government.

Fatal Legacy

Myron Magnet, ***The Dream and the Nightmare: the Sixties' Legacy to the Underclass****, William Morrow, New York, 1993*

Reviewed by ***Roger Sandall***

Ten years after Charles Murray's *Losing Ground*, a lot more ground has been lost. And eight years after Lawrence Mead's *Beyond Entitlement* much of that ground has been occupied by people whose defiance of civic obligation goes well beyond anything Mead foresaw. Whole districts of American cities are now living without law. According to Myron Magnet, after a stray bullet had killed an innocent nine-year-old girl in Brooklyn a neighbour lamented: 'Our lives have been reduced to the lowest levels of human existence' (p.172). It is this barbarising of American urban life, and the steady destruction of civic culture that has followed each well-intended subversion of public order (much of it undertaken at the behest of the Supreme Court), which is the 'nightmare' Magnet's book describes.

How could the American Dream end like this? The 1964 Civil Rights Act was inspired by a noble vision of racial equality. Yet the quota-driven affirmative action programs that followed it have sharply increased ill-feeling on both sides. In the words of the black writer Shelby Steele, instead of making all men one, quotas 'make blacks something of a separate species for whom normal standards and values do not apply'. When tens of thousands of psychiatric patients were released into the streets this was hailed as a liberation equal to the fall of the Bastille. It was not foreseen that when public shelters were provided for these and other 'homeless' they would turn into 'huge, ravenously expensive, permanent bureaucracies with specious "entitlements" that continually expand the clientele and sink clients into permanent dependency' (p.113).

And then there's the Teenage Mother Syndrome now being addressed by President Clinton himself. Aid to Families with Dependent Children was meant to

assist the underclass. Who could have imagined that it would create 'a machine for perpetuating that very underclass, by encouraging the least competent women — with the least initiative, the worst values, the most blighted family structures — to become the mothers of the next generation and pass along their legacy of failure?' (p.135). The result? Delinquent teenage baby-breeding without end.

So who's to blame? Like Charles Murray, Magnet is associated with the Manhattan Institute for Policy Research. Unlike Murray, he sees the wasteland of US welfare policy as a symptom of a far-reaching 'cultural revolution' — of a radically regressive change of values — rather than as a calamitous collection of disincentives. 'Economic opportunity is meaningful only if individuals are culturally equipped to seize it' (p.27). And it is those who have wilfully deprived the underclass of that equipment — the main elements being belief in themselves, hope for the future, and a strong conviction of 'the worth of the respectable working life, however humble' — who are the villains of the piece. These range from left intellectuals like Michael Harrington and William Ryan who redefined even the working poor as 'victims', to investment bankers and prominent Democrats like Felix Rohatyn who told Magnet that a man and his wife doing menial work in support of their three kids were 'people living dead-end lives' (p.33). Will this help them? In Magnet's eyes Rohatyn's statement is a classic expression of the political irresponsibility of the Haves. Its message to the hard-working Have-Nots of the working class is that those who have got married and stayed married, got jobs and kept them, and manage to support their children while working at low-paid jobs, are idiots: while its message to the welfare class is that the dole is the only way to go. Smart guys become wards of the state.

Of course, no immediate harm is likely to come to Mr Rohatyn for expressing such views. Wealth pleasantly insulates him from the consequences of his own philosophy. But the harm done to the morale and well-being of low-paid workers, by equating them with people too stupid to claim relief, is incalculable. Nor was Dr Thomas Szasz personally hurt when he announced that mental illness was a myth, and that schizophrenics should henceforth be 'liberated' into the streets (known sentimentally as 'the community' in welfare circles). But the mentally ill, not to mention society itself, have paid dearly. No skin is visibly missing from the noses of the Supreme Court judges whose rulings effectively abolished the vagrancy and loitering ordinances, and who in cases like *Miranda* and *In re Gault* have created a situation where thousands of wild juveniles across the nation regularly, and literally, get away with murder. In each instance it is not the well-intentioned Haves who have suffered. But the neighbourhoods where the Have-Nots live have become uninhabitable.

There are well-known polemical advantages in dividing society into two mutually exclusive categories: Haves and Have-Nots. But was it the 'mainstream culture' of the Haves who live in the penthouses and the better suburbs who 'remade' American life from the 1960s on? Or was this precipitated by a smaller but immeasurably more influential collection of academic intellectuals from Galbraith on — persons who are habitually idealistic and impractical, and whose ideas are some-

times downright crazy? Magnet tends to equivocate, mainly in order to expose the pernicious role of the affluent in ruining the lives of the poor. But Charles Murray's narrower reference to an intelligentsia that originates ideas, writes about them, and confers respectability on 'elite wisdom', is a more consistent and perhaps more useful way of talking about the changes that have taken place.

Can the uninhibited spread of sex and violence throughout American culture be realistically explained without at least some reference to commercial forces? Are the twin ideals of More Sex and Less Work wholly attributable to 1960s radicalism? Certainly, under the rubric of 'liberation', the counter-culture vigorously promoted these ideals. But a lofty distaste for work and a weakness for sexual indulgence have been aristocratic traits throughout history. Indeed, has there ever been a secure, materialistic, pleasure-loving elite that did not display them?

Magnet would no doubt dismiss this as an idle aside. And perhaps he should, for it hardly affects his argument. Which is, in brief, that it was one thing for Margaret Mead and Co. to advocate, for an educated academic readership, looser standards of sexual conduct and more liberal drug laws, but it is quite another to deal with the final consequences of this 'liberation' for the black underclass: doped-out teenage crack addicts copulating in broad daylight in vacant lots. And if this doesn't worry you, how about the selling of the brain-damaged offspring, by their own mothers, as sexual toys?

Magnet's book is essential reading for anyone involved in the making of social policy. It would be ridiculous to claim that the situation in Australasia is of comparable seriousness. But the ingredients are here, especially the popularity of victimology in welfare circles, with its assumption of systemic poverty that only more governmental largesse will cure. For this reason *The Dream and the Nightmare* holds important lessons for us too.

Until his recent retirement, Roger Sandall was Senior Lecturer in Anthropology at the University of Sydney.

Markets and Community

*David Willetts, **Modern Conservatism**, Penguin, Harmondsworth, 1992*

*Reviewed by **Michael James***

When David Willetts wrote this book he was Director of Studies at the Centre for Policy Studies, a British think-tank set up over two decades ago by a group of free-market Conservatives. In 1992 he entered Westminster as a Tory MP. He is now a major contributor to the debate about 'community' that has sprung up in Britain in response to disillusionment with the Thatcherism of the 1980s.

'Modern conservatism', as Willetts defines it, emerged as a reaction to the economic *dirigisme* of Britain's post-war Labour government. It was distinguished by its commitment to freedom, prosperity, and a version of the welfare state. One of Willetts's main purposes is to show that the Thatcher period was not an aberration inspired by a dogma hostile to traditional conservatism, but was rather an authentic manifestation of modern conservatism and, moreover, of Britain's conservative tradition generally. Willetts does a good job of showing that conservative thinkers from Burke to Oakeshott have espoused free-market economics, and that this commitment does not conflict with their equally strong commitment to community. But his attempt at a conservative justification of the welfare state is far less successful.

Willetts is especially good in his treatment of two central problems in conservative thought. The first is the claim that conservatism is led by its scepticism and emphasis on tradition into relativism — supporting everything that exists just because it's there. Willetts argues that although conservatism avoids abstract and absolute principles, it does embody criteria for evaluating institutions. The most important criterion is the British tradition of equality before the law; this justifies opposition to trade unions' 'customary' immunities. Willetts cites the further tests of durability (which itself is evidence of usefulness) and the extent to which practices rely on state coercion (the more they do, the greater the presumption against them).

Nevertheless, these criteria can conflict with one another. Britain's first-past-the-post electoral system, for example, is certainly durable, but it renders individual votes unequal. Willetts himself devotes several pages to arguing in favour of the electoral status quo; for him, durability should have precedence over fairness on this issue. (Only when the Tories are out of office, it seems, do they notice that Britain is governed by a system of 'elective dictatorship'.)

The second problem relates to the conservative commitment to community. Willetts easily shows how misplaced is the claim that capitalism destroys community: 'It is capitalism which creates the space for communities' (p.25). The problem this topic raises is this: 'Does the conservative believe in the *community* embodied in the nation-state or rather in an intricate, overlapping *network of communities* in which the nation-state has a special but not commanding role?' (p.71; author's em-

phasis). Willetts rejects Burke's conception of the communitarian state in favour of Oakeshott's notion of the state as a civil association that protects people's freedom to form and maintain communities. In response to talk of the 'atomisation' of modern society, Willetts draws attention to the Americans' astonishing capacity, despite their mobility, to form communities of the like-minded.

In contrast to Willetts's treatment of these themes, his chapter on the welfare state is muddled. Contradicting his earlier argument against the community-state, he writes: 'The welfare state is an expression of solidarity with our fellow citizens . . . it expresses our sense of community' (p.141). He later approaches reality when he admits that the welfare state 'can alienate us from others' (p.148). But his main argument for the welfare state is that it is a form of mutual insurance that assists the market, and not an instrument for redistributing incomes in the name of 'social justice'. He backs up this distinctive 'conservative' justification of the welfare state by citing F. A. Hayek's claim in *The Constitution of Liberty* (1960) that governments could legitimately have a role in providing social insurance and education. Actually, Hayek went on to warn that if social-insurance arrangements were monopolised by the state they would stifle innovation and evolve into an instrument for socialising income distribution. Hayek therefore recommended 'the gradual transformation of the sickness and unemployment allowance systems into systems of true insurance under which the individuals pay for benefits offered by competing institutions' (p.304). As for age pensions, he warned that financing these from the incomes of the current working generation would probably create an ever-growing tax burden from which voters would try to escape by inflation or outright default. A careful reading of Hayek suggests that he actually recommended a state-guaranteed minimum income with the maximum possible private-sector involvement in competitive service delivery.

Willetts favours the growth of voluntary charities and recognises their role in enhancing community. But he nowhere acknowledges that that role is largely crowded out by state welfare and in particular by the heavy tax burden it imposes. He actually opposes the means tests that would in principle lighten that burden, on the grounds that they create disincentives in the form of poverty traps. But high taxation itself creates disincentives. So although Willetts is aware that the welfare state can erode values, he seems to shy away from the tough policy decisions needed to avoid that outcome.

The sad truth is that the Thatcherites failed to reform Britain's welfare state and so bequeathed their successors a monster growing out of control.

Willetts's book raises two questions in my mind about the identity of conservatism. The first is its relationship with classical liberalism. Willetts contrasts the conservative principle of community with the liberal principle of abstract individualism, citing John Rawls's contractarianism as an example of the latter. But mainstream liberalism stems from 18th-century thinkers like Hume and Smith who rejected social-contract theory and abstract individualism generally. Towards the end of his book, Willetts admits that the conservative insight that community and the free market are mutually dependent brings it 'close to the most sophisticated liberal-

ism' of thinkers like Hayek, whose essay 'Individualism: True and False' is, he says, 'a classic Conservative text' (p.182). Willetts thus displays a sounder grasp of social thought than those Australian conservatives who insist that a vast gulf separates conservatism from liberalism.

The second question is whether Willetts's conception of modern conservatism is historically sound or whether it represents an idealisation of Thatcherism. There have always been interventionist conservatives as well as free-market ones; Willetts himself traces the see-saw between Tory 'wets' and 'drys' over the last 50 years. But this leaves one suspecting that each group has an equally legitimate claim on the party's traditions. Margaret Thatcher is no doubt an authentic British Tory; but Michael Heseltine, Britain's Minister for Trade and Industry who once said he was ready to intervene three times daily before meals, is surely no less of one.

Michael James is Editor of ***Agenda****.*

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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)*

The Queensland IndyCar Grand Prix: Assessing Costs and Benefits

Terry Black

In the past decade, public policy in Australia has increasingly become involved with major sporting and cultural events, such as the 1982 Commonwealth Games, the Australian Formula One, Expo 88, the IndyCar Grand Prix and the Sydney 2000 Olympic Games. These events have typically been evaluated by unsound methods involving, in particular, gross benefits. Instead, such events should be evaluated by cost-benefit analysis.

When the Queensland government decided to fund Indy (which has been held annually since 1991), the Treasurer, Keith De Lacy, did not envisage the need for taxpayers to subsidise the event. Speaking on ABC Television's *7.30 Report* on 16 March 1994, he said that the government's financial analysis in 1991 indicated that the race would break even in the first year and would make money after that. Clearly, the government expected Indy to behave according to the commercial principles of private firms: to maximise the flow of income received by shareholders, with the public-sector analogue being taxpayers.

After incurring losses amounting to A$60m from the running of the four races since 1991, the government shifted ground, and argued that the benefits to the tourism industry justified the use of taxes to subsidise Indy. It commissioned Ernst and Young Consulting to produce an economic impact report, which claims that 'As compared to the economic benefits of $23.0m from hosting the 1994 Australian FAI IndyCar Grand Prix, net financial costs of running the event may be in the vicinity of $10.5 million . . . .' (1994:1).

Ernst and Young use a method that estimates the first-round effects of the additional spending directly generated by the event, and utilises Keynesian multipliers that recognise that recipients of the additional spending will save a fraction of it and spend the balance. Recipients of the second-round spending will in turn save part of it and spend the balance. In this way the initial spending is multiplied several times as it works it way through the economy. This methodology produces estimates of additional direct and indirect spending generated by Indy.

One may object to the consultants' execution of the methodology on several grounds. Corporate ticket holders were excluded from the survey; the estimated length of stay by overseas visitors of 15 nights is approximately double that recorded for Indy or for any other event in 1993; and the multipliers chosen have the effect of increasing the value of additional spending. But the fundamental objection is that the methodology is inappropriate for evaluating Indy. It fails to recognise the costs incurred in generating the benefits of the additional spending; that is, it does not evaluate the opportunity costs of using public funds in alternative ways. Ernst and Young acknowledge in their report that 'it is not a cost-benefit study as it does not investigate either the financial viability of the project or the wider social costs and benefits of the project' (1994:3).

By aspiring to take into account the economic effects of a project, cost-benefit analysis seeks to ascertain whether a project maximises social welfare. Welfare economics recognises two dimensions of social welfare: economic efficiency and distributional justice. Standard cost-benefit analysis facilitates the assessment only of economic efficiency. It recommends that a project should be undertaken only if the winners could fully compensate the losers without themselves becoming net losers. This approach implies the simple addition of gains and losses, and if total benefits exceed total costs, social welfare is enhanced.

The Ernst and Young report bases its estimates of benefits on a random sample of Indy visitors' spending on accommodation, food and drink, retail items, and entertainment. But this figure corresponds to the *sales* of the various businesses, not their *profit*. Since the report does not identify the *costs* of providing services to visitors, it does not indicate whether Indy was profitable. That requires recognition, not just of the costs of providing tourist services, but of the costs incurred by the government in operating the race.

If it is (generously) assumed that tourism spending generates a profit of 10 per cent of sales, the \$23m of additional spending net of the cost of providing the services results in a benefit worth approximately \$2.3m. This is much less than the \$10.5m loss funded by taxpayers. By declining the opportunity to fund the 1994 Indy, private business firms certainly behaved as if they thought it would not be profitable, despite the government offer of a subsidy of \$5m. It could of course be argued that each firm privately thought that Indy would generate a net benefit, but rationally tried to obtain a free ride from the event. But for free riding to pay, Indy had to take place. Yet during 1993, when it appeared that the 1994 race would not proceed, private businesses failed to offer to sponsor the race up to the amount of their net benefit — which suggests that they really did not expect to derive any benefit from it.

Would it be beneficial on balance for taxpayers to fund the losses of, say, the first three races, if Indy were likely to be profitable in the future? For Indy to be a worthwhile investment for taxpayers, taxes on future profits by businesses from Indy races not only have to cover the $60m spent by the government to date, but must also provide a better return on the investment than taxpayers could have provided for themselves. The Ernst and Young report claims that the 1994 race generated $1.5m-2m in State government revenues. If we make the heroic assumption that 1995-98 races do not add further losses to the taxpayers' $60m investment, it will take some 30-odd years to pay it back before taxpayers start to receive a return on their investment. For taxpayers to earn a market return of, say, 7 per cent on the $60m investment over the next four races, each race has to generate $18m annually in State revenues: over ten times the amount generated by the 1994 race.

By recently extending Indy for a further four years, the Queensland government appears they have rejected the 'dollar is dollar' weighting and adopted differential weighting in favour of business firms and race attendees and at the expense of taxpayers.

Taxpayers in general incurred the opportunity cost of forgone hospitals, teachers, police and other services of $10.5m in 1994. Either the government could have spent the money on such services or taxes could have been reduced to enable taxpayers to spend the money as they wished. Most probably, the majority of taxpayers would prefer more government services to Indy.

The government views its continued support of Indy as a politically rational decision. Whether voters agree is not so clear.

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Terry Black is Senior Lecturer in Finance at Queensland University of Technology.

Swy and the Market

Shaun Patrick Kenaelly

Two-up or swy has a strong claim to being the Australian national game. In earlier forms (like pitch-and-toss and Head-in-Em), it was played (doubtless) by both prisoners and guards aboard the First Fleet. Over the years it has acquired marked national characteristics. The appeal is classless, the rules are fair, it generates intense excitement and it is highly illegal in most States. It was also a game the Anzacs played and it is played still, with the authority of tradition, each year on Anzac Day, wherever returned soldiers gather. In very recent years a temporary legality has been conferred upon it for the one day, 25 April. It was not always so. The police might have turned a blind eye. Sometimes they pounced. Western Australian gaming-squad detectives raided a two-up game in the Ocean Beach hotel at Cottesloe in 1985, arresting 25 old diggers. The oldest was 78. The fine was $75, with costs. Two-up also has historical associations with race meetings. Two men were charged with operating a game at the Mornington races in December 1962. They had set up in the car-park and attracted a crowd of some 200. Police raided the exclusive Victorian Club on Melbourne Cup eve, 1992. A two-up game had started, apparently quite spontaneously, following the drawing of the traditional Calcutta. Two-up has enjoyed a lawful existence within the Wrest Point Casino since 1974. That despite, it continues to flourish in warehouses, in backlanes — as press reports of proceedings in the magistrates court reveal.

Serious researchers are more than grateful to such reportage. It provides a substantial foundation for the study of what is otherwise a rather fugitive history. Fortunately, there is also an ancillary literary history. C. J. Dennis makes reference to the Melbourne schools in *The Sentimental Bloke* (1915). He also has *kip*. In Sydney, the legendary *Thommo's* School floated around Darlinghurst from the 1920s on. The Kalgoorlie School has, presumably, existed since the initial gold rushes of the 1890s. The same would be true of the Broken Hill School, which proved so persistent that the last known police raid was in 1947. The Echuca School, raided in December 1978, had existed continuously 'for up to 100 years'. On that occasion, one participant swam the Murray in order to avoid prosecution. The authorities agree that the Anzacs were responsible for *swy*, deriving from *zwei*, the German for *two*. The OED has a useful citation from 1921: 'Just done me last dollar up at the swi school.' Philologically speaking, the topic is of some interest.

An *entrepreneur* may establish a two-up school virtually anywhere there is a piece of even ground. He is the *boxer*, i.e. *keeps the ring*. The game is played on the result of the fall of two pennies tossed in the air: in other words, heads or tails. King George V pennies are generally used, on account of some particular quality found in their minting. Any player who fancies his luck is the *spinner*. He tosses

the coins from a flat wooden board, the *kip*. A *bender* will reach down to replace them between spins. A *cockatoo* or *nit-picker* keeps watch at the door: invitation to the school is usually by personal introduction. The spinner bets that two heads will fall. Someone will cover his bet and side-bets made around the circle. A heads-tails result means he has *oned them* and may spin again. If he wins, he may continue as long as he chooses. This explains why the Bloke should say that he has lost his *former joy* in *'eadin' browns,* after he has met Doreen. Two tails means he has lost and another spinner *come in.* White crosses are often painted on the reverse, as an aid to identification. This must account for the superstition that it is exceedingly unlucky for anyone to *cross the ring* between spins — as a pair of tails will invariably follow suit.

A casual acquaintance with the extensive philosophical literature on probability will suffice to show that the odds of success at two-up are pretty much even. It is an exceedingly fair game of chance. The record for an unbroken sequence of heads, 23 in a row, through a number of spinners, is held from Kalgoorlie. But 23 is also a superstitious number and readers of Frege or Carnap may care to discount the claim. Besides, Westralians tend to exaggerate, wildly. Nor can the odds entirely explain the game. To conforming suburbanites belong the *pokie* machines in club and pub, with mindless lever-pulling, the mirror of factory work, and the prospect of three happy lemons with a pealing of bells. Two-up belongs to lanes, warehouses, disused factories and carries the risk of running foul of the law. It surfaces unafraid at fixed calendrical points and at times of social dislocation, such as war. Which was the sense of *Come in Spinner* (1951), the novel by Dymphna Cusack and Florence James. Two-up, as played between floors in the jammed lift of a luxury hotel, is the controlling metaphor for Sydney in wartime. Swy belongs to the city. More precisely, to markets. 'What you lose one night you win back another', as Mrs Cavendish explains to Guinea. For the Sydney of the novel is also a world of rationing, shortages, price-controls and black markets using American hard currency. In other words, a time of economic dislocation. Swy enjoys a season of open enthusiasm because it offers a mirror of the workings of the market economy.

In Melbourne, the school operated by Lionel 'Nappy' Ollington flourished around the north-west corner of the city throughout the 1960s and 1970s. His duels with the head of the gaming squad, Chief Inspector Fred Sylvester ('The Cat'), are legendary among students of the game. On one occasion The Cat broke up play by swinging through a window, on a rope. A perfectly commodious and suitable venue, the Banana Stores (a disused three-storey warehouse in Franklin Street, opposite the Queen Victoria Market), was used on and off, but I was told that it spooked players, as it possessed a ghost, which tapped on the roof. Given the ways Sylvester and his men had of dropping in unexpectedly, this gave people the jitters. The school moved frequently and was known by its current address: the Franklin Street School was the same as the West Melbourne, or North Melbourne, or Queensberry Street. A pattern may be plotted from this. The school moved into premises that circled the Queen Victoria Market; floating, but always keeping very close. The market was the abiding source of regular patronage. In September,

1965, a school was raided *within* the Camberwell Market itself. Excellent: this would follow the pattern. Note also that the Bloke pushed a barrow in the old Eastern Hill Market and that Ginger Mick hawked rabbits. The market is something more than a venue for the sale of staples, wholesale and retail. A way of life attends it, rich and rare like the fruit and veg. Alongside the stallholders are the truckies, rat-catchers and sweepers; the people who sell coffee, soup and hot-dogs from parked vans: all quite legitimate. But they are accompanied by the illicit traders and service industries: SP bookmaking, sly grogging, prostitution, manila games, two-up schools.

It is, surely, *because* the market deals so directly with basic commodities that it encourages an excitement and desire to run risks that is channelled so effectively into swy. It is a world of natural tides and seasons, of often rapid price fluctuations and the centrality of cash transactions. Swy follows the pulse. Likewise, the Broken Hill and Kalgoorlie schools illustrate a game that goes with the metal. The origins of the Echuca School probably lie in the extensive traffic that formerly passed up and down the river. Financial markets obey much the same rhythms as the rise and fall of the pennies; with bullish and bearish moods, booms, busts and bubbles. They are both predictable and risky — and incredibly sensitive. The Stock Exchange is easily spooked.

Like most marketplaces, swy enjoys a form of regulation, albeit crude, by policemen armed with sledgehammers. And the operator takes his percentage of the winnings. Much is made of the elements of security and trust present in market transactions, rightly so. Yet there is also risk. More, there are intangibles, not easily translated into textbook language. The point at which venture becomes gambling is not easy to establish. Michael Oakeshott made the distinction between cookery books and cooking; the rules of cricket and playing the game. Swy, then, belongs to the imagination of every-day market life, mirroring a neighbouring world of busy exchange and drawing inspiration from it. There is no reason to suppose that it will cease to be played in its old haunts, so long as there are men willing to stake their luck and give the coins a spin.

S. P. Kenaelly is a private scholar.