Agenda, Volume 2, Number 1, 1995

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New Zealand's Fiscal Responsibility Act

Graham Scott

The Fiscal Responsibility Act passed by the New Zealand parliament in June 1994 makes the government and the Treasury responsible for reporting to parliament specified information about fiscal strategy, the current economic and fiscal situation and the outlook over the medium and long terms. It specifies principles of fiscal policy that the government is to consider, but not necessarily to implement, when developing its budgets. The Act's supporters aim to tilt the balance of fiscal decision-making away from the short-term economic and political considerations that have been influential in the past and towards strategic and long-term fiscal objectives.

Outline of the Act

The Act provides for regular and explicit fiscal reporting; for parliamentary review of fiscal reports; for a set of benchmarks against which fiscal policies can be assessed; and for more open budgetary processes.

In operation, the Act endeavours to establish ownership of a broad fiscal strategy within the government with the oversight of parliament. It does this by requiring the government to develop an annual Budget Policy Statement and to present it to the parliament three months before the deadline for the budget. In this report the government presents its intentions for the main fiscal variables for both the coming budget and for the longer term and by reference to the principles of fiscal policy specified in the Act. It thereby sets the parameters of the forthcoming budget debate. This is intended to promote more informed trade-offs of strategic fiscal objectives by separating debate about them, at least temporarily, from the crush of detailed fiscal compromises and decisions in the final run-up to the budget. This is backed by requirements for full disclosure of information and for a Fiscal Strategy Report at the time of the budget, which compares the actual economic and fiscal information and decisions with the intentions laid out in the earlier statement and also with projections of the longer-term implications of current policies up to ten years ahead. The parliament is subsequently given regular economic and fiscal updates, and there is provision for special reporting in the period before an election. The Budget Policy Statement, the Fiscal Strategy Report, and the economic and fiscal update tabled at the time of the budget are to be referred for scrutiny to parliament's Finance and Expenditure Committee.

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Each economic and fiscal update is accompanied by statements of responsibility signed by the Minister of Finance and the Secretary to the Treasury attesting respectively that all policy decisions or circumstances with material economic and fiscal implications known to the government have been communicated to the Treasury and have been included.

Development and Passage of the Act

The Act's sponsor was Ruth Richardson, then Minister of Finance, who introduced it to the parliament in September 1993. Following the National government's near defeat in an election in November 1993, Richardson returned to the backbench and from there became chairperson of the Finance and Expenditure Committee that oversaw the development of the Bill.

She promoted the legislation in response to New Zealand's history of difficulties with fiscal policy, processes, information and outcomes. There was also some concern that the arrival of coalition governments after the introduction of mixed member proportional (MMP) representation might further complicate fiscal decision-making. Richardson believed that the build-up of government debt since the early 1980s raised a moral issue in that the political system was being used to pass a tax burden on to future generations who were underrepresented by today's politicians (the first balance sheet for the New Zealand government drawn up under its reformed Public Finance Act showed a negative net worth of NZ$14 billion). As Minister of Finance, she had experienced the difficulties of trying to keep a cabinet focused on strategic fiscal objectives rather than becoming lost in short-term decision-making portfolio by portfolio. Her advisers in the Treasury had acquired first-hand experience of this problem; as well, they had studied equivalent practice and reactions to it in other countries, notably the UK, Australia and the US, which suggested the importance of stable and open budgetary processes with a medium-term framework.

Politically, the Bill's development was stimulated by concern about the fiscal information available to the public during an election campaign. In 1990, as in 1984, an incoming government claimed, correctly, that the fiscal situation was much worse than it had been led to believe. The insolvency of the Bank of New Zealand (BNZ), which was known to the government but not to the opposition, prompted the Ombudsman to assert that the fiscal situation in the run-up to the 1990 election should have been more transparent than it was. In reality, it would be impossible in any circumstances to disclose that a government financial institution was on the edge of bankruptcy without simultaneously announcing the solution to the problem. But any such solution would require the agreement of the opposition: which would be all but impossible to negotiate between political opponents in the middle of an election campaign that the opposition was likely to win. The BNZ issue did, however, focus attention on the wider issue of the desirability of full fiscal and financial information being available on the eve of an election.

Several questions arose in the debate before the Finance and Expenditure Committee and in the parliament. Can parliament bind or seriously influence fu-

ture governments on such matters as running fiscal surpluses? Should debt be expressed in nominal amounts or as a ratio to gross domestic product (GDP)? Are the principles of fiscal policy in the Act sufficiently clearly expressed to exert any real influence? Is a government less likely to depart from the Act's fiscal policy principles because it has to give public reasons for doing so? How would the effects of fiscal policies on social equity, growth and employment be taken into account?

The provisions of the Bill that promoted full information, more informed debate and more stable and open budget processes attracted bipartisan support (the Labour Party members of the Finance and Expenditure Committee included some ex-ministers who had experienced New Zealand's fiscal stresses at first hand). The majority of the committee preferred to embody principles of responsible fiscal management in guidelines rather than mandatory targets on the grounds that such guidelines

- 'state explicitly what the characteristics of responsible fiscal management are;
- encourage a medium to long term perspective in the conduct of policy;
- can provide a mechanism to allow for shor term cyclical fluctuations; and
- recognise that governments may have to depart from the guidelines or their objectives but require any departure to be justified and thus transparent.' (Finance and Expenditure Committee, 1994)

The Labour opposition did not, however, support the inclusion of principles for 'responsible' fiscal management. But the Minister of Finance, Bill Birch, accepted the majority recommendation and proposed five principles expressed in the Act as follows:

- reducing total Crown debt to prudent levels by achieving operating surpluses every year until a prudent level of debt has been attained;
- maintaining total Crown debt at a prudent level by ensuring that on-average operating expenses of the Crown do not exceed operating revenue;
- achieving and maintaining levels of Crown net worth that provide a buffer against adverse future events;
- prudent management of the fiscal risks facing the Crown; and
- the pursuit of policies consistent with a reasonable degree of predictability about the level and stability of tax rates for future years.

Any departure from the above five principles must be both transparent and temporary.

The Public Finance Act was amended in order to support the intentions of the Fiscal Responsibility Act by extending the coverage of its basic concepts, such as the Generally Accepted Accounting Principles and output-based appropriations and financial management across the whole of government. The result is that the financial implications of government decisions are highly visible: for example, an appropriation is required when the government disposes of an asset below its recorded book value.

The Act raises several basic questions. Has New Zealand's fiscal policy been poor, and is it likely to be in the future? Have institutional biases towards poor fiscal policy arisen from budget processes, the government's financial management regimes or the structures of parliament and the incentives on its members? Can the Fiscal Responsibility Act correct any such institutional weaknesses?

New Zealand's Fiscal Record

While the fiscal situation is satisfactory today, it has displayed difficulties, that were sometimes serious, for most of the last 20 years, and all of the last ten. The government's fiscal advisers in the Treasury repeatedly emphasised this, as is evident from the series of briefing papers presented to incoming governments after each election (Treasury, 1984, 1987, 1990, 1993). In 1984, the IMF described the fiscal deficit, which was rising to about 9 per cent of GDP, as 'a major imbalance in the economy that had become more serious [and] threatened to have a severe destabilising effect on the economy' (cited in Douglas & Callan, 1987).

This situation had developed over many years. Spending on goods and services and transfer payments, which had increased from 22 to 25 per cent of GDP between 1950 and 1974, rose to 38 per cent in the late 1980s. Real taxation per head more than doubled from the 1970s to the 1990s. The fiscal balance moved heavily into deficit at the end of the 1970s and remained there until recently. Real gross public debt per head in 1993 dollars rose over the same period from NZ$7,500 to nearly $14,000 by 1990. Net public debt rose from 40 per cent of GDP in 1984 to a peak of 51 per cent in 1992. This debt was not backed by productive assets owned by government; and its financial statements estimate that the net worth of government, which had turned negative probably in the early 1980s, was minus $7.7 billion in 1993. (These calculations ignore possible long-term increases in tax revenues and reduced social costs resulting from education and social policies.)

The ratio of debt service to government revenue reached about one fifth in the late 1980s. New Zealand's credit rating slipped over the decade from the early 1980s from AAA to AA; a single A rating was narrowly avoided in 1991 only because the incoming government after the 1990 election took decisive action to contain a deficit that was forecast to expand to 5 or 6 per cent of GDP.

Policy Design, Implementation and Coordination

New Zealand's fiscal policy has sometimes been poorly coordinated with other instruments of economic strategy: monetary policy in particular, but also regulatory policy and public-sector management. Fiscal policy has periodically been directed at objectives that were better approached by other policy instruments, and has not been sufficiently focused on medium-term macroeconomic objectives.

Macroeconomics. Structural fiscal problems were treated as if they were cyclical problems, and growth promoted through discretionary fiscal and monetary policy. Typically, the economy was stimulated in the run-up to an election, but not reined in afterwards to the same extent. As a result, it began successive fiscal cycles from a progressively worse position. Like other countries, New Zealand learned late that discretionary policy is ineffective in the presence of more fundamental structural problems and when a short-term stimulus is not sufficiently credible to evoke a strong response from the private sector. More generally, manipulating short-term fiscal policy to stabilise aggregate demand rather than directing it to longer-term objectives often turned out to be destabilising because of the way it was implemented and the coincidence of stimulatory action with the electoral cycle. Such policies were therefore sometimes pro-cyclical rather than counter-cyclical (see Deane & Smith, 1979.)

It is very difficult to disentangle by econometrics the impact of fiscal policy on other macroeconomic variables, particularly interest rates. But the government and its advisers became convinced that the fiscal situation was putting upward pressure on interest rates and exchange rates, so delaying the return to economic growth. These pressures were attributed not only to the deficits themselves but also to the lack of credibility in the financial market-place of the policies designed to eliminate them. If credible, a promise to cut the deficit can buy time to do so with less cost and disruption. If a promise is not credible, then short-term action is needed to establish credibility and to contain the country-risk premium that is built into interest rates. The Reserve Bank of New Zealand Act 1989, which set up an independent central bank with an explicit inflation target, had dramatically increased the credibility of monetary policy. But, in Ruth Richardson's words, 'monetary policy needed a mate' in the form of credible fiscal policy. This had been lost in 1990 due to cyclical, structural and political factors. But the fiscal corrections initiated in 1990 and emerging in the 1991 budget restored credibility: the decline in the credit rating was arrested, and interest rates and the exchange rate declined together, contributing to the economic recovery that began at that time.

Structural issues. New Zealand's fiscal policies suffered from structural weaknesses on both the taxation and expenditure sides. Tax reform, to replace a narrow tax base and variable rates with a broad base and low rates, was instituted to provide a more buoyant tax base with lower efficiency losses while continuing to meet some equity objectives. Key features of the approach included the goods and services tax, fringe benefits tax, imputation, elimination of tax expenditures, an international in-

come-tax avoidance regime, timing rules and support for people on low incomes delivered through the tax system. On the expenditure side, the underlying frameworks of government intervention were reformed in order to correct fiscal imbalances while pursuing other policy objectives. These reforms were conceived in the mid-1980s, a time of serious fiscal problems that could not be fixed by traditional marginal adjustments to expenditure and revenue. Governments since have sought to improve the process of fiscal decision-making and the management of government organisations. The role of the state has also been reduced or redefined in many areas to reduce and redirect fiscal loadings. Specific programs to achieve this have concerned state enterprises, privatisation, structural reforms of government institutions and a results-based management system in core government administration.

Fiscal reporting and information. Information about fiscal policy and government finances was for a long time of poor quality, late or non-existent. As early as 1978, the Auditor-General was deeply critical of the government's financial management information systems, but was largely ignored. New Zealand learnt to its cost the dangers of cash-based accounting systems that did not reveal the extent of deterioration in the government's net worth or the huge contingent liabilities that came to charge on a large number of government sponsored energy-based investments that crashed in the mid-1980s.

Intergenerational transfers of wealth and taxes. In common with many other countries, New Zealand had come to realise through the 1970s and 1980s that some of its fiscal difficulties had a long-term dimension. Leading politicians on both sides of parliament were acutely aware of the difficulty of pruning an unaffordable government superannuation scheme that had been introduced hastily in 1975 and promised every citizen 80 per cent of the average post-tax weekly wage from the age of 60. The aging of the population was turning this program into a fiscal time-bomb with a very long fuse and bringing about an inequitable redistribution of income towards the elderly. It was one element in a pattern of distribution causing growing concern that the welfare state had arguably cared for the older generations throughout their lives but was now leaving younger generations with less support (Thomson, 1991).

The Current Fiscal Situation

In late 1991 the economy began to recover from recession and the fiscal deficit subsequently began to improve as a result of cyclical influences and the effects of policy changes and compression of administrative budgets. By the latter part of 1994 the fiscal situation had turned around. The ratio of government expenditure to GDP, which had peaked in 1991/92 at 44 per cent, had fallen to 35 per cent. The government was running the first fiscal surplus for 17 years. The net worth in the government balance sheet was still negative at about NZ$6 billion, but expected to turn positive within three years. The growing credibility in fiscal policy was among

the influences that had resulted in the country-risk premium in interest rates falling from roughly 4 per cent to 2 per cent at the trough (though it had risen a little due to political uncertainty and other factors). The OECD had, some years earlier described New Zealand's tax system as 'the least distortionary of its member countries'.

Will the Act Address Past or Prospective Institutional Weaknesses?

Although the fiscal situation and prospects have very greatly improved since the economic recovery began in late 1991, New Zealand has clearly suffered very considerable fiscal difficulties over a long period and, despite the present favourable trends, still has some distance to go. The record also suggests that many lessons must be learned if history is not to repeat itself.

The problems in fiscal policy noted above arose from several interacting causes:

- a lack of clear objectives;
- a short-term focus and lack of appreciation of the medium-term consequences of decisions;
- poor policy instrument assignment and coordination;
- poor information for decision-making and performance reporting;
- inertia and incrementalism in fiscal-policy decision-making; and
- lack of appreciation of the need to measure, anticipate and manage risks.

The recent improvement in New Zealand's fiscal situation was accomplished without the Fiscal Responsibility Act. But the Act codifies and extends some of the measures and policies that underlie that improvement. It is a logical addition to the reforms over recent years to fiscal policy and public-sector management in New Zealand, which themselves enhance the prospects of achieving the Act's objectives. The key questions about the Fiscal Responsibility Act are whether the institutions of fiscal policy have biases against desirable outcomes that help explain past problems, and, if so, whether the Act usefully addresses them.

The Act provides for better information and analysis, a stable reporting cycle, a greater focus in reporting on strategy, less secrecy about budget planning, more scrutiny by parliament and benchmarks for assessing fiscal policy. Important as these are, embodying them in law might not by itself make much difference, particularly if the government of the day is not committed to the goals of the Act. Such a government might, for example, comply in a perfunctory way with the requirements for budget reporting (though it would still be harder to avoid scrutiny than in the past; and the accounting standards, being beyond the control of the government, cannot be evaded). But in the context of the stream of fiscal reforms in recent

years, and on the assumption that a future government, particularly its finance minister, is not determined to evade it, the Act can make a significant contribution.

A wide perspective of fiscal policy takes account of the complexities of real-world decision-making, the information and incentives on the many parties involved, inadequacies in political representation of the wider public interest, externalities, public goods and the strengths and weaknesses of various institutional arrangements in biasing the whole system towards good or bad fiscal outcomes. These issues are largely missing from conventional models of fiscal policy, which often imply that fiscal settings are made by omnipotent beings motivated solely by the public interest and operating with high-quality, if not perfect, information and with little or no uncertainty about either the future or the effects of policy interventions.

Some of the ideas from the institutional economics literature concerning fiscal policy emerged in the submissions on the Fiscal Responsibility Act. The New Zealand Business Roundtable (1994) noted some of the theoretical reasons why democratic processes might have biases towards outcomes that are not in accord with the voters' interests or may be inefficient in serving them. Voting procedures can fail to reveal underlying preferences. Politicians are likely to concede to expenditure demands from groups of voters when their benefits are highly concentrated but their costs widely spread. This also occurs where the self-interest of politicians and bureaucrats in the expenditure programs themselves impinge on the decision processes. Pressure for excessive deficits can also arise where those who will bear the costs (in particular, future generations of taxpayers) are under-represented in the political process. Information on major choices is poor; in particular, voters do not know the deadweight losses imposed by taxation.

The philosophy behind the Act is to provide a counterweight to such biases by providing for at least an informed debate over medium-term fiscal strategy objectives and, preferably, ownership of objectives that are in some measure of harmony with specified guidelines. This need not mean the subordination of careful detailed decision-making about fiscal programs and their management to general macroeconomic imperatives (experience shows that such attempts fail anyway). It does, however, favour prior political agreements and understandings about broad fiscal goals and the need to embody them in tight managerial processes that coordinate the extensive machinery of fiscal decision-making in a way that effectively imposes strategic priorities on the whole system. The objective should be to integrate macro and micro approaches to get both well-designed and effective programs as well as macroeconomic policy that contributes to wider development goals. In terms of conventional principles of public finance theory, the objective of fiscal decision-making is to equate the contribution to welfare of the last dollar of public expenditure with the cost to welfare of the last dollar of taxation raised. The challenge for practitioners is to design institutions that enhance knowledge of the costs and benefits of fiscal interventions and so help us make decisions that move us closer to the ideal balance. The Act should contribute to such an improvement.

New Zealand's budget system was beset by untidy and changing processes through stresses in the 1980s that harmed fiscal outcomes. In contrast, Australian federal budgetary systems at the time were characterised by tightness and stability. New Zealand adopted some Australian innovations, such as the use of baseline forecasts from the previous year to initiate the preparation of the current budget. New Zealand's budgetary processes have improved steadily and are today good by OECD standards. Some of the management and reporting innovations are on the frontier of international developments. Yet institutional biases towards poor fiscal policy have contributed significantly to difficult fiscal outcomes. Many of these problems have been addressed; the Fiscal Responsibility Act has the potential to make a contribution to further improvements in some areas.

The long-term forecasts and scenarios that the Act calls for are intended to expose the out-year effects of current decisions. The Act properly requires publication of the key macroeconomic variables that heavily influence any fiscal forecast and are vital for the proper appraisal of forecasts. Whatever their degree of accuracy, these out-year forecasts have sometimes been critical to assessing the need for fiscal correction; and governments' occasional past reluctance to publish them suggests their significance. The developments proposed in the Act and included for the first time in last year's budget are an important advance.

Long-term Projections

It may take some time for people to learn to evaluate the information content in long-term projections. Though not forecasts, some commentators will inevitably treat them as such and try to embarrass the government when events stray far from them. The projections are a way of expressing the implications of certain decisions whose effects are long lasting and/or involve policies that take a very long time to change or involve long-term contractual commitments between government and citizens.

Attention to the long-term implications of the current fiscal stance also raises the issue of long-term sustainability. While there is ample scope for a government or a succession of governments to make adjustments to fiscal policy over a five- or ten-year period, some large areas of expenditure involve entitlements that cannot be changed without serious disruption when problems arise. People are entitled to make plans in the expectation of stability of those aspects of fiscal policy that have a major impact on their standard of living and life-cycle. Similarly, businesses that have made or are considering making long-term investments in New Zealand will be discouraged by unpredictable and rapid changes in those of their key costs that are determined by the government.

Those elements of fiscal policy that involve the government in long-term commitments should be planned in a long-term framework that requires attention to long-term fiscal scenarios. This applies to the linkage between fiscal policy and demographic change in the population structure. Lack of long-term planning in these areas could precipitate arbitrary intergenerational transfers of income and wealth: a particularly serious issue in current thinking about long-term fiscal policy.

Emphasis on long-term projections and other elements of transparency (including, in particular, the government's unique financial statements) will help to indicate the extent to which the tax burden is being shifted into the future.

Improved Information

The Act links the information systems for budgeting with those of reporting the government's finances. This simple idea is used everywhere, from tennis clubs to the largest corporations. Governments, however, tend to focus on their plans at the expense of outcomes. The sections modifying the Public Finance Act in order to apply accrual accounting to payments to third parties on behalf of the government is a long-planned step in the evolution of the government's financial management.

The clauses that require full disclosure of the government's information about the fiscal outlook are critically important to the whole scheme and should remove a major source of public dissatisfaction about nasty surprises that were, or should have been, known to the government.

The clauses requiring pre-election fiscal information will at times raise tensions in the relationships between the government and its advisers. But New Zealand's experience suggests that these are manageable and should be a source of increased stability and realism in the development of fiscal promises by parties seeking power.

The reliance on the Generally Accepted Accounting Principles is almost unique internationally and highly desirable. It does, however, require New Zealand's public-sector accounting standards to be continuously researched, developed and upgraded by the active participation of public-sector accountants in the Accountants' Society, and endorsed by the Accounting Standards Review Board established in the Financial Reporting Act. The Finance and Expenditure Committee of parliament should satisfy itself periodically that these standards are being developed satisfactorily and are addressing topical issues. Although the requirements for accounting standards are generally the same for both public and private sectors, the public sector raises some unique accounting issues that must be dealt with on their own terms rather than through the careless adoption of conventions from the private sector or other countries.

The Act makes important advances in establishing the financial responsibilities of departmental chief executives and linking their financial plans tightly to their appropriations. Any slippage between these two could eventually impair the usefulness of the estimates to parliament as a management document.

Targets and Guidelines

American experience suggests that fixed targets are not politically durable and are evaded. This and other international experience influenced the Finance and Expenditure Committee's deliberations. Labour parliamentarians opposed inserting principles in the Act on the grounds that future governments could not be bound and that forecasting errors could, in conjunction with the let-out provisions, be so

large as to render the degree of consistency between budget and principles very uncertain.

The point about uncertainty is valid. But the question remains as to whether the statement of fiscal principles can have political durability and remain influential in fiscal debate. The Act leaves the government with a wide range of discretion in being able to persuade the parliament of the day that its decisions are in the country's long-term interests. There will always be debate about whether fiscal policy is too tight, too loose, or just right. This could not have been resolved by the setting of mandatory targets, which is neither technically desirable nor politically feasible. It would create incentives to window-dress fiscal policy by concealing information and moving policies off-budget.

It should prove beneficial to require fiscal policy to be assessed in relation to criteria that, although general, have been approved by a majority of the parliament. This will strengthen the Minister of Finance and others negotiating a budget in the face of pressure from sectional fiscal interests that ignore the larger picture. It is inevitable and desirable that debate will continue about what the principles mean in changing circumstances. Over time, norms and technical details will become established. Parliament will still be free to ignore the criteria but, where adverse trends are clear in the figures, will do so in the face of information suggesting that the fiscal policy is not sustainable. Many members of parliament would not do this lightly.

The criteria established by the Act are well chosen. The credit rating was excluded from the Act; but it will inevitably be a point of focus in the debate about managing risks in the government's balance sheet. Any well-designed medium-term fiscal strategy will give consideration to debt ratios and the debt-servicing capacity of the economy, the vulnerability of the economy to adverse shocks if the government's plans for economic growth are not realised for either domestic or international reasons, and the implications of today's decisions for future tax rates. Any government with substantial debts that was not giving consideration to these could be suspected of being sanguine about inflating the debt and interest away or rescheduling it.

It is impossible to place the criteria for sound fiscal policy beyond argument; and the Act does not try to do so. In the debate over the Act, the economist Bryan Philpott (1994) argued against the use of the Generally Accepted Accounting Principles in reporting the government's position. His concerns relate to the distinction between consumption and transfers, capital as opposed to current expenditures, and externalities arising from government expenditure on, for example, infrastructure and education. He argued that social rates of return must feature in government accounts or, more particularly, in policy-making. He and others were concerned that the Act would inhibit the government from implementing countercyclical fiscal policy to regulate aggregate demand. But although these considerations should be accounted for in setting medium-term strategy and any particular annual budget, the reality is that a government that does not take the initiative in ensuring that its financial position is sustainable is more likely to have the adjustment imposed on it from the outside with far greater costs to its citizens. The prin-

ciples in the Act require information to be provided bearing on the sustainability of the financial position.

In addition to the principles, other issues will have to be accounted for, such as the separation of cyclical and structural elements of a deficit, the risks surrounding fiscal and economic forecasts, and the risks within the balance sheet arising from volatility in exchange rates, interest rates, cash flows and equity values in state-owned enterprises.

Given that no single measure of fiscal stance is completely reliable, the question arises as to the weights that parliament will attribute to the different criteria. Financial markets will apply the criteria in judging the budget after they see it. But politicians have constituents to worry about other than those from whom the government borrows, and they might be more likely to take advice from an organisation of their own creation. The government's analytical resources for passing such judgments lie in the Treasury, for whom this is a natural part of any suite of budget advice. Parliament will want to question Treasury on that advice, and can then form its own judgment of the analysis. This could lead to tensions between the department and the Minister of Finance if their judgments differ, though experience in recent years suggests this is manageable. It is very important, however, that Treasury's political neutrality is preserved, even though it is required to give straight advice based on its professional judgments. (The Council of Trade Unions raised concerns in the Finance and Expenditure Committee over the possible politicisation of the Treasury.)

If parliament sought a view independent of the public service, some other organisation could be created for that purpose. But any such body would have to become deeply involved with the Treasury's forecasting and analyses in order to be able to make a well-founded judgment.

The Fiscal Responsibility Act vs the Reserve Bank of New Zealand Act

Ruth Richardson was influenced by the importance of credibility in policy settings following the implementation of the Reserve Bank of New Zealand Act 1989, which she had strongly supported from the opposition benches when it was promoted by the Labour government. This Act made the central bank independent by means of a contract that specifies the government's inflation target and delegates to the Governor of the bank the responsibility for managing short-term interest rates to achieve this. The result has been a dramatic decline in inflation rates and much enhanced credibility for monetary policy. Richardson asked the Treasury for advice on how to impart similar credibility to the conduct of fiscal policy while recognising the fundamental differences between monetary and fiscal policies.

Although the experience of institutional reform to create a credible monetary policy formed part of the background to the debate over the Act, there is no substantial parallel whatsoever between New Zealand's monetary and fiscal policy reforms. It is reasonable to believe that the comparative advantage of monetary policy instruments lies in controlling the price level and that, although it has secondary influences on other policy objectives, these are better met by other policies that have comparative advantages in those areas. As well, it is reasonable to believe that

the effects of monetary policy are felt with unpredictable time lags that are often so long that the policy is best conceived as having a medium-term horizon and requiring complex judgments to be made in the art of central banking. New Zealand's record of complete political control of day-to-day monetary policy was associated with high and unstable rates of inflation and very large costs to the taxpayers from underwriting exchange rates. Against this background it was thought wise to create a central bank that was insulated substantially from short-term political pressure and free to exercise its discretion about short-term interest rates while targeting a medium-term inflation rate that is set by the government. Fiscal decision-making, in contrast, goes to the very heart of a government's development strategy and political priorities, and cannot be delegated in the same way. Only the implementation of detailed fiscal decisions can be delegated.

The Prospects for Coalition Governments

In his study of the economic effects of MMP, Alan Bollard (1993) concludes that fiscal policy alone is likely to experience difficulties as a result of the new electoral system. The Minister of Finance will more than ever need institutional arrangements that enable fiscal strategy and policy to be developed and adhered to throughout the many months of decision-making that are involved in putting together a budget. It is quite impossible for a Minister of Finance to do this alone. New Zealand's most unsatisfactory budgets in recent years have all been associated with a lack of support for the Minister of Finance. New Zealand's experience, like that of Australia and the UK, demonstrates the importance of tight cabinet procedures in enforcing agreements about priorities and maintaining lines of strategy. The Act should be of some assistance to a Minister of Finance who wishes to structure a debate about medium-term fiscal strategic goals. But it remains to be seen how coalitions will go about forming fiscal policy.

Conclusion

Within the context of the wide-ranging reforms over ten years in fiscal policies, public-sector management, improved information and parliament itself, the Fiscal Responsibility Act should make a useful contribution to improving policy-making and offer some comfort for those who are concerned that one of the effects of MMP might be a return to deficits and increasing debt. The Act's information requirements entrench and enhance improvements since the late 1980s and should improve the chances of framing fiscal-policy debate over a longer-term horizon and with a concern for integrating sustainable fiscal policy within wider development strategies.

The Act's principles for responsible fiscal policy are likely to influence the debate; but uncertainty surrounding the forecasts and projections will complicate judgments over whether they are being observed, and the provisions for explaining departures mean they will not be binding. Yet this arrangement seems superior to

excluding mention of fiscal principles from the Act or going for mandatory targets. Time will tell.

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Ensuring Responsibility in Australian Budgets

Robert Albon

By 'fiscal responsibility' I mean the commitment on the part of government to reducing heavy debt burdens on future generations, or, where existing debt is low, to avoiding such burdens. I assume throughout that it is desirable to reduce debt.

Proposals for making governments more responsible are receiving a measure of public attention in both Australia and New Zealand. Whereas in New Zealand such proposals have progressed to legislative actions on budget presentation and commitment to debt reduction, in Australia they have made little legislative headway. However, the governments of both New South Wales (NSW) and Victoria have proposed balanced budget constraints, and the Commonwealth initiated a 'deficit reduction plan' in its 1993/94 budget. (Prime Minister Paul Keating has since dismissed those seeking a more rapid elimination of the Commonwealth deficit as 'deficit Daleks'.)

None of these three governments acknowledges that the form of budget presentation — in particular, the actual meaning of the bottom-line 'deficit' — is important to the debate. But discussion about proposals to approach or achieve budget balance naturally reflects, whether explicitly or implicitly, the current Australian concept of 'deficit' or 'surplus'. This is the so-called Government Finance Statistics (GFS) convention, adopted by all nine Australian governments at the 1991 Premiers' Conference. The adequacy of this convention as an indicator of change in a government's net economic position, and the reliability of the accounts in conveying the complete fiscal picture, are major concerns of this article.

It doubtless appears responsible to commit to a 'balanced budget'. But the degree of responsibility depends on the details of the commitment, the accounting standard against which the commitment is assessed, and the context in which it is made. If a 'balanced budget' means a zero GFS deficit, it could be consistent with substantial increases in superannuation debt, and some of the revenue contributing to the balance could flow from a conversion of tangible assets into monetary ones. More important, even if there were no underlying debt creation or asset conversion, a balanced budget could mask massive debt accumulated in the past.

I have argued elsewhere (Albon, 1994) for a format of budget presentation that both reveals the government's overall net economic position and indicates where

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the deficit or surplus represents a change in the government's net economic position.[1] This concept, which is necessary for assessing the prevailing degree of fiscal responsibility, is only obliquely related to the welfare of present and future citizens. Thus, an improvement in the government's net economic position does not necessarily mean that social welfare has in some sense been enhanced. Further, as the economic literature on 'generational accounting' makes clear, the existence of a deficit or a surplus bears little relation to the impact of the budget on future citizens.[2]

As noted, the New Zealand government has actually committed itself to fiscal responsibility through legislation (the Fiscal Responsibility Act 1994). This was preceded by the adoption of a new framework of presentation — 'full accrual' — introduced following passage of the Public Finance Act 1989. These processes faithfully reflect both the totality of, and change in, the government's net economic position. They provide a model for Australia to follow.

Australian Practice

The traditional practice of Australian Commonwealth and State governments was to present their annual budgets on the 'Consolidated Fund' basis: summing up dollar outlays of all kinds and total revenues of all kinds, and expressing the difference between these as a deficit or surplus. The different treasuries adopted their own variations of this practice, resulting in a poorly defined non-uniform approach. But, as noted, in 1991 the new GFS convention of government budget accounting was adopted. Some jurisdictions, such as Victoria, were already using the GFS, while others agreed to phase it in.

The budget has both a narrow dimension ('general government'), which focuses on departments, and a broader dimension ('whole-of-government'), which includes the activities of public trading enterprises. Since the GFS, like the Consolidated Fund, has both these narrow and broad dimensions, at least four different official measures of the 'deficit' apply during the phase-in. Further, some authorities define 'whole-of-government' very broadly, while others are less inclusive.

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[1] Some commentators argue that the deficit should reflect the public sector borrowing requirement (PSBR). Others regard the PSBR as of dubious value to macroeconomic management. Irrespective of the rights and wrongs of this debate, the PSBR has only a national or aggregate relevance, and is of little value in connection with the accounts of a subnational government. Details of the aggregate PSBR are published in the Australian Bureau of Statistics, Catalogue Number 5501.0, and the National Fiscal Outlook (1994).

[2] Public discussions in the United States about 'generational accounting' centre on the impact of budgetary decisions on the welfare of current and future citizens; see Auerbach, Gokhale and Kotlikoff (1994) and Haveman (1994). Adoption of a broad accrual based system is an important step towards accommodating generational concerns.

Reflecting Changes in the Net Economic Position

If the government reveals the complete GFS deficit on a whole-of-government basis, how well does this reflect changes in its net economic position?

The essence of the GFS approach is that outlays that are transfers into special accounts are not counted as expenditures. Such items are usually called 'provisions'. For example, in some jurisdictions some outlays from the Consolidated Fund go into a superannuation fund or a debt retirement fund. Under the new format, these are treated as transfers rather than net outlays.

With respect to sums going into accounts to provide for debt retirement, the move to GFS marks another small improvement. Treating these as transfers rather than net outlays is correct, since, on the other side of the ledger, the government's current borrowing or 'debt creation' (which adds to government's liabilities) is already taken into account. The GFS deficit or surplus is an accurate representation of the change in the government's general debt position. Suppose the government actually spends $1 billion more than it raises in revenue, but at the same time puts $500m into a debt retirement fund. If it has no reserves to draw on, the government would have to borrow $1.5 billion to finance its 'deficit', but its net economic position would have declined by only $1 billion, the deficit on GFS.

Thus, the GFS treatment of debt picks up the borrowing liabilities of government. But this symmetry breaks down with respect to superannuation. A payment into the fund is not an outlay, as explained in the following statement on superannuation in the 1993/94 ACT Budget Papers (No. 2, p.245):

> Some recurrent expenditure from the Consolidated Fund is excluded. For example, payments to the Superannuation Provisions Trust Account are treated as recurrent expenditure from Consolidated Fund but, in the Economic Transactions framework, these are treated as inter-account transfers which do not impact on final consumption expenditure as they do not add to outlays but rather represent additions to financial assets.

But although it is reasonable to treat payments into the superannuation fund as transfers rather than outlays, this ignores the accumulation of superannuation liabilities. In any normal year the entitlements accruing to members of the scheme are likely to increase, representing a rise in the government's liabilities. These liabilities — or debt accumulation — detract from the government's economic position. Both sides of the ledger should be reflected in the 'deficit' or 'surplus'.

An asymmetric approach is also observed in the treatment of asset sales. As explained in the Commonwealth's presentation set out in Statement No. 7 of Budget Paper No. 1 of 1994/95:

> Consistent with UN [1968] treatment adopted by the ABS [1989], receipts from sales of physical assets are recorded as offsets within outlays to assist in the measurement of the net stock of capital assets in the economy. Un-

der the IMF [1986] treatment such receipts would be classified as capital revenue.

However, while the receipts from asset sales are regarded as a positive item in the budget, the fall in the stock of asset holdings does not register as a negative one. Further, any run-down of asset values through inadequate maintenance does not enter the budget.

The American economist, Robert Eisner (1989:75) reflects the consensus in criticising what he describes as 'the nonsense of counting sale of real or financial assets as "receipts" (or as offsets to expenditures)... Such sales are ... essentially portfolio changes, having no first-order effect on the net debt or net worth of government...' That is, Eisner insists that account must also be taken of the negative impact of the government's loss through the diminution of its stock of assets. The failure of the current system is clear when an asset worth $100m and sold for $10m shows up as a net improvement of $10m rather than a deterioration in the government's net economic position of $90m.

Governments can also show an illusory gain through inadequate maintenance of their assets. While this saving is a 'positive' item in the budget, the loss through the running down of the quality and value of assets should (but does not) enter on the other side of the ledger. Further, if asset values are written down (or up) for whatever reason, this should show up as a change in the government's position.

It must be concluded that the GFS standard used by Australian governments does not provide an accurate indication of the change in a government's net economic position. In particular, a surplus can be consistent with a fall in the government's net economic position, while a deficit can be consistent with an improvement.

Reflecting the Total Net Economic Position

Under Australian practice, the total picture of the government's economic position is not particularly transparent, although it has improved since the 1991 agreement. In particular, it has been difficult to discover the extent of a government's total debt, especially that with respect to superannuation.

In accordance with the Uniform Budget Presentation Standards agreed in 1991, governments are now required to present a comprehensive debt account. Other problems aside, the GFS deficit or surplus is an accurate indicator of the change in a government's net economic position with respect to debt related matters. It is desirable to have the aggregate position and the flow of borrowing and repayments set out clearly in one place. The obligations on governments to provide a mass of information about their debt position in a consolidated format makes it easier to evaluate the totality of the government's net economic position with respect to debt. Victoria's practice (see Chapter 6 of Budget Paper No. 2) is a good example.

The position with respect to superannuation is less revealing. Not only can governments effectively hide the accumulation of superannuation debt in their standard budget presentation; it has been extremely difficult to determine the total debt.

But the position is improving rapidly, and governments are now introducing explicit superannuation accounts in their budget papers (for example, NSW Budget Paper No. 2, 9.3). These accounts should eventually reflect the total superannuation position on a fully funded basis. Payments of employer contributions into the fund would, as under GFS, remain a transfer in the ordinary budget. In the superannuation account itself, this transfer plus employee contributions and income from interest and dividends on fund investments would all appear on the positive side of the ledger. On the other side would appear the actuarially determined increase in liabilities accrued during the period plus payments out of the fund to superannuants. The difference between these positive and negative accruals represents the net change in the government's superannuation position during the period. As most Australian governments have large unfunded superannuation liabilities (Queensland appears to be an exception), over a transition period (that is, until the fund became fully funded) payments to superannuants out of consolidated revenue funds would remain an outlay, showing up in the general budget.

Finally, there is the problem of assets. The asset position can be clarified only by the creation of a comprehensive asset account, which would ideally contain all assets and reflect the influence of appreciations and depreciations on particular asset values, as well as disposals and acquisitions. However, valuation problems would be substantial, as there is no generally agreed approach and valuation is particularly difficult for assets that are not traded (Blejer & Cheasty, 1991). Practical approaches differ; New Zealand has adopted a pragmatic approach (including the use of historic cost for some assets), NSW uses a current cost basis, and Western Australia's new Government Property Office is compiling a register of government assets. The formation of an asset account would have the added advantage of providing a basis for improved asset management.

An Accrual Approach

These considerations make a case for accrual accounting on a whole-of-government basis, as adopted in New Zealand and as experimented with through the production of alternative accounts in NSW.

New Zealand's Public Finance Act 1989 required that accrual accounting be adopted for all public accounts by 1991 (see anon., 1994). Because both the public and private sectors must use it, accrual accounting is also known in New Zealand simply as 'generally accepted accounting practice', or GAAP. The government assesses and reports changes with respect to all of its assets and liabilities, allowing it to determine its true net worth. Changes in the net worth over a year are an indication of the change in the government's net economic position, and represent the analogue of the traditional notion of 'deficit' or 'surplus'.

Under accrual accounting, each of the nine Australian governments would be required to emphasise or 'headline' the change in its net economic position, taken across the whole of government. Its appropriate bottom line would be the sum of three items: its GFS deficit or surplus, the net change in its superannuation position from the superannuation account, and the net change in the value of the asset ac-

count. This would be *the* deficit or surplus, giving a ready guide to the change in the government's position. Analysts could go to the specific accounts for more information. A single indicator would achieve not only consistency across States, but also consistency within States over time.

The NSW Balanced Budget Proposal

The commitment to a balanced budget in NSW surfaced in the 1994/95 Budget Papers, which announced an intention to 'phase-in a sustainable balanced budget . . . as early as possible within the next term of the Government' (No. 2, 1-5). This commitment was later strengthened with a proposal to ask the electorate whether it was prepared to alter the constitution to require the NSW government to balance its overall budget, perhaps over a business cycle. The proposal has received a considerable amount of public attention (see McGuinness, 1994; Robinson, 1994; Walker, 1994a).

If balance were to be defined according to the standard used for budget presentation, the commitment could appear to be met when in reality it was not, and *vice versa*. In keeping with the Uniform Budget Presentation Standards agreement between all Australian governments, NSW adopted the GFS standard in 1991, because it provides 'information on the economic impact of the budget and facilitates intergovernmental comparisons of budget policy' (cited in Mackintosh, 1993). However, as it does not provide a very good account of the change in the government's net economic position (for reasons already set out), a GFS balance could mask either a surplus or a deficit.

In 1993/94, NSW almost achieved budget balance on a total State basis (the deficit was only $138m).[3] Whether this reflected an actual balance depends on movements in a number of other, more obscure accounts. There appears to have been a small improvement in the superannuation account, with unfunded liabilities falling by about $400m. Receipts from asset sales (amounting to $430m) are not included as 'negative outlays' in NSW, and therefore do not necessitate any adjustment. In the absence of other liabilities that may have accumulated with respect to certain off-budget arrangements, the NSW government appears to have enjoyed a small net economic improvement of around $260m in 1993/94.

If it is serious about the successful introduction of a meaningful balanced budget constraint, NSW would use its alternative accounts to assess its performance in meeting the commitment. NSW is sometimes cited as an example of a jurisdiction that practises accrual accounting: for example, in his 1992 Annual Research Lecture in Government Accounting, Ian Mackintosh (1993) referred to the 'NSW practice of accrual accounting'. This is a reference to the inauguration in 1988 of the publication of a separate set of accrual accounts. However, these are presented

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[3] The Treasurer and the 1994/95 Budget Papers actually headlined the 'general government' deficit, which was greater than that of the total government.

in a non-accrual format in the government's annual budget. Robert Walker (1994b) has asked, 'If accrual is better, why not flaunt it?'.

The Victorian Balanced Budget Proposal

The Victorian proposal, which first appeared in the Treasurer's 1994/95 budget speech, is much weaker than that of NSW, in two respects. First, it involves a legislative change rather than a constitutional one, making it much easier for a future government to discontinue the practice. Second, it refers only to the current account, not the total budget, when most governments have found it easy to run current account surpluses even during the recession.

The Victorian government has used the GFS basis for budget presentation since 1989/90. It budgeted for a GFS deficit of $3.663 billion in 1993/94. The effects of expenditure cuts on the deficit were expected to be delayed because of plans to make large one-off redundancy payments to former employees as part of the rationalisation program ($1.3 billion in 1993/94) and the payment of sums owing to various superannuation funds withheld by the previous government ($1.4 billion in 1993/94). However, a variety of factors worked in favour of the 1993/94 GFS deficit outcome of only $572m (Budget Paper No. 2, 2-3). The position appears better than this if some crude adjustments to an accrual basis are made.

The Victorian government moved to cut back its superannuation liabilities by redundancies and adjustments to entitlements. These measures, together with the payment (counted as an outlay) of $1.4 billion into the superannuation fund, meant that between 1992/93 and 1993/94 the unfunded superannuation liability fell from $18.7 billion to $14.9 billion. This represents a net gain to the government of about $2.4 billion; the deficit for 1993/94 should be adjusted downwards by this amount. On the other hand, the treatment of asset sales as 'negative expenditures' leads to an overstatement of the improvement in the Victorian budgetary situation, as there is no downward adjustment in the asset account. Direct asset sales in 1993/94 resulted in receipt of only $384m, including the proceeds of the Casino licence. However, the government also repatriated capital of $1.2 billion from the Transport Accident Commission.

The sum of these items indicates that 1993/94 was a year of substantial net economic improvement for the Victorian government. After making these adjustments the government's net economic position appeared to improve by about $250m, rather than declining by $572m as suggested by the official deficit. It is somewhat ironic that the Victorian government over-achieved an even stronger balanced budget target in 1993/94 than the one it is contemplating setting itself in future years.

Yet although the adjusted accounts are now showing a net improvement, the aggregate position remains parlous. There are massive unfunded superannuation liabilities of nearly $15 billion, and net debt with respect to past borrowings stands at over $32 billion. The improvement in 1993/94 was relatively small. A great deal of net improvement over many years will be necessary to repair the aggregate position.

The Victorian government envisages a commitment to balance only its current budget. This would allow the accumulation of debt to continue. But fiscal responsibility in Victoria demands persistent debt reduction rather than budget balance (however defined). Indeed, the Victorian Treasurer has displayed a concern with debt reduction. The true position may become easier to decipher in future years with 'the eventual development of "whole-of-government" financial reporting . . . of the assets and liabilities of the State' (Budget Paper No 2, 1994/95, p. 7-7).

The Commonwealth's Deficit Reduction Program

The Commonwealth's commitment is to a deficit reduction program that is even weaker. As described on page 1.3 of the 1994-95 Budget Paper No. 1:

> The Government made a commitment prior to the 1993-94 Budget to reduce its budget deficit to around 1 per cent of GDP by 1996-97. . . This year's Budget consolidates . . . [the 1993-94] progress indicating that the budget should be approaching balance by 1997-98.

This commitment does not impose any constitutional or legal discipline on the government; it does not envisage eliminating the deficit (or balancing the budget) even on the current account and as measured; and it does not require the government to retain any low deficit that might be achieved. It does not involve any serious reduction in the structural deficit, but merely allows economic recovery to trim it.

The statement of the Commonwealth accounts is conceptually an inaccurate indicator of changes in the government's net economic position. The published deficit is large, and adjustments with respect to superannuation and asset sales appear to make the position worse. The Commonwealth quite possibly does not fully fund its superannuation scheme on a year-to-year basis. In recent years a substantial program of asset sales has been implemented, the one-sided budget treatment of which has helped disguise the true deterioration in the Commonwealth government's net economic position. If the proceeds of asset sales are subtracted, the deficit is increased by the same amount.

What is also clear is that the size of Commonwealth government debt is large. Vincent FitzGerald (1994) has drawn attention to the superannuation debt and argued that the aggregate debt situation has been understated at Commonwealth and State levels. A promise to reduce the rate of accumulation of debt — and not even this is assured given the way the deficit is defined — is a long way from 'fiscal responsibility' in view of the magnitude of the acknowledged debt problem.

Conclusion

It is refreshing to witness the start of a semblance of debate on fiscal responsibility. But two ingredients are missing. First, there is insufficient attention to the rules and presentation of the accounts produced by Australian governments. The accumula-

tion and total level of government debt are, respectively, not fully revealed and not highlighted in the GFS budget accounts. Second, there is too much concern in the target-setting proposals about the (albeit incorrectly measured) accumulation of debt at the expense of the totality of that debt.

Despite real progress since 1991, there is still a long way to go towards presenting accounts in a way that reflects the government's net economic position. Governments should not be permitted to run up superannuation liabilities without presenting them as negative budget items or to continue to treat asset sales in a totally illogical way. At the very least, additional features need to be grafted on to the GFS presentation so that it approximates an accrual basis, and the total debt situation must become a central part of the budget.

There must also be more focus on total debt. Merely slowing down or even eliminating the growth of debt is a feeble response to the enormous accumulations of debt in Victoria, NSW and the Commonwealth. These governments are all starting from weak economic positions, and improvements that seem large in themselves may have little effect on debt totals. Significantly, both Victoria and NSW showed improvements on their corrected accounts in 1993/94. But future Victorians and New South Welshpersons remain saddled with the costs of the fiscal profligacy of their forebears.

The Prime Minister is perhaps unwittingly correct in his dismissal of the 'deficit Daleks'. What we really need is an army of 'debt Daleks' dedicated to the extermination of debt.

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The Excess Burden of Taxation in New Zealand

W. Erwin Diewert and Denis A. Lawrence

New Zealand's economy has undergone considerable reform in the last decade. Reform of the tax system has been an integral part of this process. More reliance has been placed on indirect taxes with the introduction of what is regarded as one of the most comprehensive and 'pure' goods and services taxes in the world; the income tax base has been broadened and its structure flattened; and import tariffs have been scaled down.

However, tax revenue as a proportion of gross domestic product (GDP) has continued to increase and, although it has fallen somewhat since its peak in 1989/90 and is projected to fall further, it remains very high by OECD standards. In 1990/91 taxation revenues amounted to 38.2 per cent of New Zealand's GDP, compared with 29.9 per cent in the United States and 30.8 per cent in Australia. That figure was also higher than those for Germany, the United Kingdom and Japan. All these countries' tax shares have increased over the last 25 years, but none as rapidly as New Zealand's. Furthermore, the tax shares of OECD countries tend to be very high compared to the dynamic Asian economies. For instance, South Korea, Singapore, Thailand and Indonesia all had tax shares of less than 17 per cent in 1991. In a world of increasing globalisation and capital mobility, high-tax countries will find it increasingly difficult to compete.

New Zealand's government expenditure consistently exceeded taxation revenue by a large margin in all but one of the twelve years to 1992/93, by which year net public debt had risen to 55 per cent of GDP (Richardson, 1992). High levels of government spending and consequent increases in public debt imply the need for higher taxation levels in the future to cover interest and repayments on borrowings.

But what are we to make of the rapid growth in government spending over the last 20 years? Has that growth been a bad thing? Indeed, should the government be spending more? The question of the optimal size of government is a very important one. To answer it requires a balancing of the cost of additional government spending against the extra benefit it generates.

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Increased government spending is often favoured by special-interest groups, and the benefits to them of such spending are usually apparent. But what is the cost of government spending to the general community? Apart from those central and local government programs that are financed by user charges or miscellaneous forms of income, government spending must be financed out of taxation or compulsory levies. It's usual to think of government spending of a dollar as costing the taxpayer a dollar; after all, a dollar going out requires a dollar coming in. However, the government's spending of a dollar costs the taxpayer more than a dollar. This is because the process of raising the dollar through taxes is itself costly.

The Costs of Raising Revenue

The costs of raising tax revenue include collection costs, compliance costs, and deadweight costs.

Collection costs. In a free society individuals arrange their affairs so as to minimise the amount of tax paid. This can be done legally (by means of tax avoidance as less preferred mechanisms are adopted to split income and substitute less heavily taxed goods for more highly taxed ones) or illegally (by means of tax evasion as income is hidden from authorities). In both cases significant resources of individuals, firms and specialist advisers are tied up in socially 'unproductive' activities. This is best summarised by Slemrod (1990: 157): 'Taxation is a system of coercively collecting revenues from individuals who will tend to resist. The coercive nature of collecting taxes implies that the resource cost of implementing a tax system is large.'

Compliance costs. Compliance costs arise from the account-keeping and form-filling that the tax system requires. A recent study by Sandford and Hasseldine (1992) found that the compliance costs of pay-as-you-earn, fringe-benefit and related taxes in New Zealand ranged up to 2 per cent of the revenue collected; those of the Goods and Services Tax exceeded 7 per cent of the revenue collected. Complying with the tax code was estimated to take up 46.5 million hours of the time of proprietors, partners, directors and other staff, and cost over NZ$600 million in external advisers' fees as well as other miscellaneous costs. Moreover, compliance costs were found to be highly regressive in their impact. Among smaller businesses, the equivalent of 13.4 per cent of the firm's turnover was taken up in compliance costs as against only 0.03 per cent for the largest businesses.

Deadweight costs. The costs of collection and compliance are clearly large. But raising government revenue through taxes also imposes costs in a much more important but less visible way. It's not feasible to tax everything, and the tax system makes those activities that are taxed relatively more expensive than those activities that are not. Taxes thus change relative prices and, consequently, people's behaviour. Such tax-induced changes in behaviour impose an additional type of cost known as the *deadweight cost* or the *excess burden* of taxation. In a multiplicity of ways, taxes distort people's willingness to work, save, invest and take risks. These

distortions impose costs on the economy by reallocating resources from their most productive uses to less productive ones.

Consider the taxation of labour income. Because taxation adversely affects the incentives people face, as taxes increase people tend to substitute towards leisure, work less intensively, undertake more do-it-yourself work and shift into occupations with relatively large non-pecuniary benefits. In New Zealand's case, the way many social-security benefits are provided also has a major negative impact on the incentive to work.

The total cost of a tax is thus not just what the tax raises and the collection and compliance costs. It also includes what a taxpayer would need to be paid in order to be made just as well off with the tax as without it. These deadweight costs of taxation are typically ignored. This is because they are technically difficult to estimate. Government expenditure is, at best, treated as costing no more than the dollar amount spent. The deadweight cost of tax is effectively assumed to be zero.

The size of deadweight costs is influenced by a range of factors. But it is likely to be largest when the actions of producers and consumers are highly responsive to after-tax prices, when existing marginal tax rates are high, and when savings are highly responsive to after-tax returns. International studies have typically found that the deadweight costs associated with raising taxation revenue range from a minimum of ten cents to well in excess of one dollar for each additional dollar of revenue raised. In percentage terms this corresponds to a range of 10 per cent to over 100 per cent of the additional revenue. For instance, the only study of deadweight costs in Australia (Findlay & Jones, 1982) found a range of 23 per cent to 65 per cent, while key studies of the US have found ranges of 17 per cent to 56 per cent depending on the assumptions made. No such studies, however, have previously been undertaken in New Zealand.

Against this background, the New Zealand Business Roundtable commissioned us, through Swan Consultants (Canberra), to estimate the marginal deadweight costs of taxation in New Zealand. This article is based on our report.

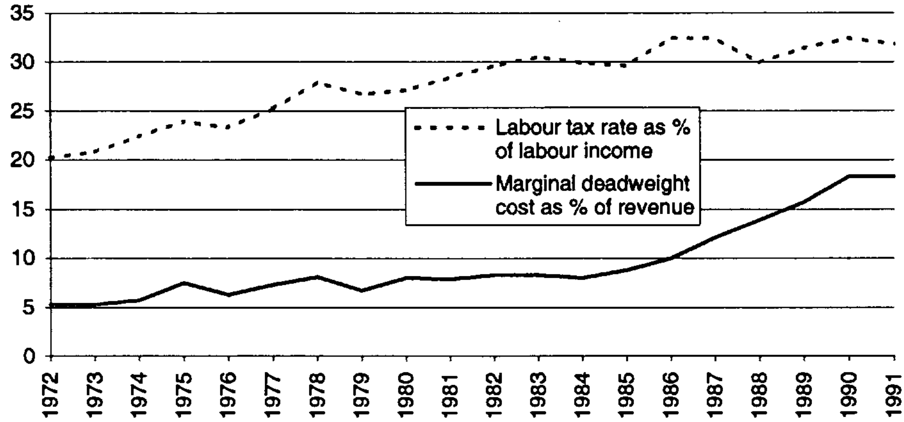
Estimates of the Marginal Deadweight Costs of Taxation

The key findings of the study (Diewert & Lawrence, 1994) are that the marginal excess burdens or deadweight costs associated with labour taxation have increased from 5 per cent to over 18 per cent in the last 20 years (Figure 1). This near-quadrupling is not accounted for solely by increases in labour tax rates, since these increased on average by only around a half — from 20 per cent of labour income to 32 per cent — over the same period.

Even though marginal deadweight costs tend to increase more rapidly than the increase in the tax rate (all else equal), much of it is accounted for by the increased flexibility and responsiveness of the New Zealand economy in recent years and increasing international capital mobility. Figure 1 shows that the rate of increase in the labour tax rate eased off after 1983, while the marginal deadweight cost of labour taxation increased rapidly after 1984.

Figure 1

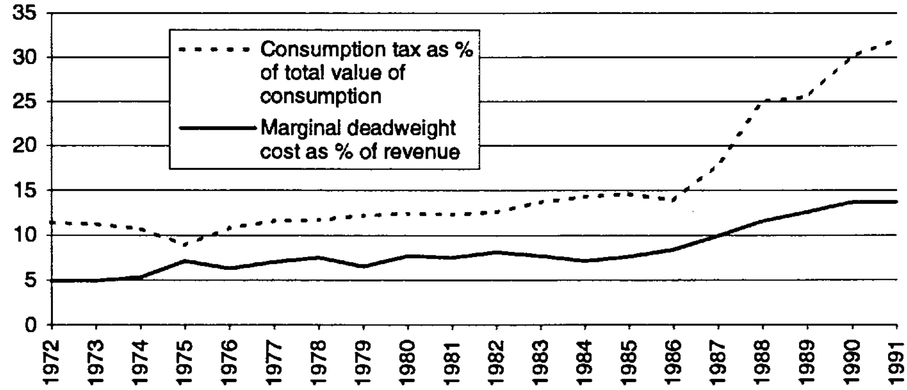
Labour tax rate and marginal deadweight cost, 1972-91



Source: Diewert & Lawrence (1994).

Figure 2

Consumption tax rate and marginal deadweight cost, 1972-91



Source: Diewert & Lawrence (1994).

Over the last 20 years the marginal excess burden of consumption taxation (all indirect taxes other than property taxes and import duties) has increased from 5 per cent to around 14 per cent (Figure 2). This near-tripling of the consumption taxation marginal deadweight cost coincided with a near-tripling of the total consumption tax rate from around 11 per cent to 32 per cent. Most of this increase in the consumption tax rate occurred after 1986 coinciding with the introduction of the goods and services tax.

Though they fall at the lower end of the range of previous estimates of marginal deadweight costs for other countries, both of these excess burdens are quite significant. Importantly, our estimates are the first to use key parameters calculated from consistently specified statistical models of the economy being examined; previous studies have typically assumed relatively high values for these parameters. As well, our estimates are based on a rigorously specified general equilibrium model that takes account of interactions between different parts of the economy without imposing restrictions on the price responsiveness of demand and supply. Most other empirical studies have employed either a partial equilibrium model or an applied general equilibrium model that uses rather restrictive functional forms for producers' production functions and consumers' preference functions. A non-technical summary of our methodology is presented in the Appendix.

Implications

If the economic cost of labour taxation at the margin is around 18 per cent, a government project would need to return $1.18 net of collection costs for each dollar spent on it just to cover the opportunity costs to the community of the dollar and the marginal deadweight loss. If it doesn't earn that return, society is better off not undertaking the project. That last dollar spent on defence, administration, income support, health or education means forgoing $1.18 of benefit that would otherwise accrue to taxpayers. If the dollar of government spending were only worth a dollar to the taxpayer, the gain from reducing government spending would be 18 cents — effectively an 18 per cent return.

The growth in the tax take in New Zealand has been driven by high levels of government expenditure, particularly on social services, and increasing government debt levels. While a reduction in government spending financed by reduced labour taxes would have led in 1991 to a real rate of return on this 'investment' of 18 per cent (assuming that the marginal dollar of government spending is valued at a dollar by taxpayers), a more urgent priority is likely to be a reduction in government spending accompanied by a period of unchanged taxation levels to facilitate the reduction of government debt. This would pave the way for a sustainable long-run reduction in taxation levels and associated gains to the New Zealand economy.

It is important to note that our marginal deadweight loss estimates are likely to be relatively conservative as we have not calculated the marginal excess burden of capital taxation. Other studies that have attempted to introduce dynamics and model capital accumulation decisions have shown that the marginal excess burden of capital taxation is generally higher than that of labour. This is particularly likely

to be the case for a small economy (such as New Zealand's) trading in a world of ever increasing capital mobility.

However, our study does not imply that less government spending is always to be preferred. The optimal level of government spending is not zero. The government has an important role to play, for example in providing public goods and physical and legal infrastructure that would not be supplied — at least in desirable quantities — through private transactions. It is worth incurring the marginal deadweight costs of taxation up to the point justified by the returns to such expenditure. Our study highlights the high opportunity cost of public funds and the need to spend those funds very carefully.

Policy Implications

Despite an impressive range of reforms to its structure of taxation, New Zealand's tax share of GDP has increased rapidly over the last two decades. It is high by OECD standards and more than double those found in the dynamic Asian economies. The costs that this high level of taxation have imposed on the New Zealand economy have increased rapidly as the economy has become more flexible and integrated with the rest of the world as a result of the general deregulation and liberalisation of the economy. This should not, however, be interpreted as reflecting badly on the reforms that have flattened the tax rates and broadened the tax base. Rather, if the old structure of taxation with its disparate tax rates had been left in place while the economy was being freed up and the tax share of GDP increasing, the growth in the marginal deadweight costs of taxation would have been much higher.

Continuing reforms in New Zealand and elsewhere and ever-increasing international capital mobility will further increase the costs of high levels of taxation. Indeed, as globalisation continues, governments will face increasing pressure to be competitive in terms of its taxation system as well as the overall range of services it provides and regulations it administers. In New Zealand's case, this highlights the need for ongoing reforms and the imperative of reining in government spending levels.

Allowing government spending and levels of public indebtedness to increase unchecked would be to bequeath high levels of taxation to New Zealand's future generations. Far from being free, government expenditure comes with a high price tag and should therefore be spent well on high-yield projects or not at all. The overriding priority should be to reduce government expenditure and public-debt levels, and to pave the way for sustainable reductions in taxation levels.

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Appendix

Summary of Methodology

The critical determinant of the size of deadweight costs is the responsiveness of economic activity to changes in after-tax prices. Consequently, a major part of our study was concerned with obtaining accurate estimates of the key price elasticities for both consumers and producers. These elasticity estimates are then a key input to the small-scale general equilibrium model from which deadweight cost estimates are derived making use of duality theory.

In the case of New Zealand there is little consistent time-series data available and few econometric studies from which to obtain elasticity estimates. Since a consistent database of prices and quantities of goods and services consumed and of outputs produced and inputs used by producers for at least a 20 year period is a prerequisite for obtaining credible elasticity estimates, the construction of such a database was a major undertaking. The database covers the years 1971/72 to 1990/91.

The producer model estimated contains three outputs — motor vehicles, general consumption (excluding housing and transport) and investment, and exports — and two variable inputs (imports and labour) along with two fixed inputs (capital and land). A normalised quadratic profit function was estimated for the aggregate private production sector. This provides for fully flexible modelling of production relationships between all outputs and inputs. By placing a minimum of restrictions on the production technology, this technique makes it possible to derive accurate elasticity estimates.

The consumer model estimated contains four consumption goods — motor vehicles, general consumption (excluding housing and transport), housing and lei-

sure. A normalised quadratic expenditure function model was estimated for the representative consumer incorporating a linear spline on utility levels. This methodology again places a minimum of restrictions on the consumer's preferences and makes possible the derivation of accurate elasticity estimates. At this stage the consumer model is static. Intertemporal considerations have not been included.

The small-scale general equilibrium model equates supplies of goods from producers with the demand for them from consumers and the government. Consumer and government budget constraints are included and the balance of payments on current account and the budget deficit are specified exogenously. Producers' supplies are specified as price derivatives of the profit function in terms of producer prices, while consumer demands are specified as price derivatives of the expenditure function in terms of consumer prices.

The difference between producer prices and consumer prices represents the price wedges or distortions introduced by taxation and government subsidies. The marginal excess burden associated with changing a given tax rate is calculated as follows. Consumers' utility levels are held constant by means of transfers following a change to the tax rate. The change in overall welfare resulting from the change to the tax rate is then equal to the change in the value of the government's consumption of goods and services (what the government can purchase after it has compensated consumers to return them to their original utility level). The marginal excess burden or marginal deadweight cost is defined as minus the rate of change in welfare divided by the rate of change in revenue with respect to the given tax rate.

Marginal deadweight cost estimates are derived for four major tax categories: labour taxes, general consumption taxes, motor vehicle consumption taxes and import duties. Because the model is not dynamic (it does not have an intertemporal dimension), deadweight costs resulting from the taxation of capital cannot be calculated. Capital is instead assumed to be in fixed supply each period and investment is treated as being exogenous.

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Health and Welfare: The Third Last Frontier of Microeconomic Reform

John Paterson

Microeconomic reform of the Australian health and welfare system calls for the cleansing of intergovernmental arrangements. Pricing instruments can be used to replace 'command' arrangements if and only if catastrophic risk and income distribution issues are dealt with directly. Fiscal neutrality between existing funding sources (Commonwealth, State, and local government, and private payments) can be maintained while an efficient payment system is created. Agency arrangements can overcome market imperfections. User co-payment obligations should be enforced for all non-catastrophic health and welfare services. The 'gap' should be insurable but on a strictly commercial basis. Mandatory community rating can be abandoned if catastrophic risk is reinsured through the income tax system. Private health insurance is currently unsustainable but would then become viable. Improved organisation of primary care, reduced outlays on secondary and tertiary referral facilities and greatly improved levels of service would be the economic pay-off. Agency arrangements will decisively transfer control from provider to consumer — a major bonus.

Why Health Is Not Different

Microeconomic reform has rocked the corporate sector, reshaped primary industry, and stirred up government business enterprises. The Industrial Relations Club has demanded and received immunity. Teachers and academics also seem pretty safe: ALP branches are full of them. That leaves health and welfare as the only large chunk of the economy currently open to a national program of microeconomic reform. What would it mean?

The RAND Corporation demonstrated through massive experiments in the 1970s and 1980s that health care is amenable to conventional economic analysis: patient charges cut consumption; fee-for-service medicine increases consumption; other things equal, the rich consume more than the poor. These conclusions are reinforced by casual observation.

Health-care markets are imperfect, but what market is not? Health care contributes to long and healthy lives. So too does proper food, clothing, and exercise, which are usually treated as personal consumption choices. So why pretend that in

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health care there is always a life at stake and invoke the full regulatory, organisational and financial might of the state as, at present, we do?

The utterly conventional and robustly stable economic character of health services is highlighted by the international consistency of the ratio of per capita spending on health to per capita GDP. Among the rich nations, international variations in health service consumption are 80-90 per cent associated with differences in real per capita income levels: that is, with an economic variable. The richer the country, the more spent, in relative terms, on health care. The residual variation in expenditure can be put down to politics.

Health care alone, even excluding welfare, is arguably the developed world's biggest industry; it typically accounts for 7-10 per cent of GDP. How strange it is that virtually every country has invented its own system, partly as a sentimental reflection of national traditions, and partly in the belief that health is 'different'. Most national motor vehicle industries used to possess distinctive ethnic characteristics. Then the Japanese came along and threatened to wipe them all out. Now they are all pretty much the same, and the Japanese are having a little trouble competing. Unfortunately, health and welfare services are not readily traded. If they were tradable, all rich countries would have something close to a world best-practice health industry. Instead, most have something as idiosyncratic as French agriculture, where one peasant can live well from running a herd of five cows, or to Japanese rice cultivation, where one farmer tends 2ha of crop.

Regulatory Losses

The reasonable approach is to use market instruments where they can be used, and to separate 'life and death' elements of health and welfare for control by direct means. Our present elaborate regulatory system is premised on the opposite view; it tacitly assumes that every sniffle is life-threatening. We bear a heavy cost for this, through inefficiency in the bulk of health and welfare provisions that are not of a life-and-death character.

Of course, not all regulation is bad. Some regulations produce direct benefits that outweigh the systemic losses they cause. Most health-service consumers, for example, draw great comfort from the information that their practitioner is qualified and registered. They are willing to tolerate some reduction of competition in the interest of better information and assured minimum standards of competence. The aim must be to obtain that assurance as cheaply as possible. Providers can gain monopoly power by manipulating barriers to entry. If they are permitted to do so they corrupt the regulatory system by extending its application beyond the point where it serves only informational and quality assurance objectives. Losses then begin to outweigh the gains originally sought from the regulation.

There are many ways of corrupting a market. Australia's health and welfare system exhibits most of the recognised techniques for corrupting by regulation. Examples include:

- different pricing rules for close substitutes;

- 'truck' systems that tie spending of 'company dollars' to purchases from the 'company store', through sharp demarcation of public and private provision and components thereof;
- legal differentiation by irrelevant attributes such as institutional history;
- monopolies, licences and patents that go beyond basic requirement for public information and quality assurance; and
- restrictions on trade across jurisdictional boundaries, whether geographic or administrative.

A multitude of overspecialised programs ties funds to providers. As a result, our national funding and providing system is like a giant egg crate. Governments place an eye-dropper full of dollars in each well; over-specialised niche providers drink from each well. A massive barrier exists between each well. This ensures that the integrated needs of the final consumer are impossible to meet unless a fortune is spent on 'coordination' to defeat the fundamental fragmentation of the system.

Each well is politicked over and administered. The different parties watch one another like hawks for signs of cost shifting and partiality between wells. At the same time, we all work away quietly doing a bit of cost shifting in our own favour if we can get away with it. The Commonwealth instinctively tries to play the States off against one another, partly for financial reasons, but substantially for hegemonic ones.

All this would be just fine if the sole objective was to keep politicians and officials entertained. Along the way, however, we all pretend that we want to provide some health and welfare services, at least as a by-product, of the real game. The long-suffering public remains deluded that their well-being is our concern.

If we were serious we would immediately play a different, and much simpler, game. Programs and jurisdictions would largely be abolished, entitlements would be attached to consumers, and providers would obtain business through a competitive market for the consumer dollar. There would be worthwhile reductions in bureaucratic overheads. The real gains, however, would accrue at the client/patient/customer interface, because the products of the system would change, and the biases introduced by differential financing and non-market allocation between similar services would be removed.

Health Care *Sans Doctrine*

Before seeking to unravel the present arrangements it is useful to understand their origins. A successful High Court challenge to Commonwealth pharmaceutical benefits arrangements in 1944 led to a constitutional amendment, which created new Commonwealth powers under section 51(23a) of the Constitution. These allowed the Commonwealth to make the laws that now underpin or buy in on an array of 'social' programs, including pharmaceutical, sickness, and hospital benefits,

home care, emergency and supported accommodation, disability services, psychiatric services, the regulation of medical and dental services, and accreditation of child-care centres. The Commonwealth has made laws, raised taxes, paid out money. All parties have hired lots of officials to watch the officials of other governments, who in turn, watch them back.

Section 51(23a) was a charter for 'health services without doctrine'. It was not prescriptive about any hierarchical allocation of responsibility between Commonwealth, State and local governments, so no coherent hierarchy emerged. Everyone is in everything and no one is accountable. It never directly articulated roles for the public and private sectors respectively, in matters either of service provision or finance, so in effect we got two largely separate systems. Its inevitable result was a tangled web of intergovernmental arrangements marked by incomprehensible complexity. Its maintenance costs alone are enormous, because at the client interface there is not one service channel, but hundreds.

The recent precipitous decline in private health insurance is merely one small symptom of an out-of-joint system. Another is the emergence of a boarding-house-dwelling underclass consequent upon de-institutionalisation of psychiatric services. You can defeat the logic of production systems with money for just so long. Then they break open, providing nasty surprises at every turn.

Technology Hierarchy and Organisational Change

The concurrent Commonwealth and State powers created by the Constitutional amendment meant that there was no single act of administrative design in Australia comparable to the Beveridge-inspired National Health Service in Britain. Each element of the system is defined more by its origins than by any serious consideration of its role in an integrated modern service system.

Australia's State hospital systems mostly had benevolent and charitable origins. The Commonwealth did not deal with the hospitals, apart from offering tax concession to their benefactors. The Commonwealth dealt with the States, which in turn licensed the lotteries, chocolate wheels, chook raffles and charity drives that paid for the ancestral public hospitals. The States, at the lower hierarchical level of government, retained the administrative control and held most of the property of the hospitals, the secondary/tertiary facilities sitting at the top of the health hierarchical system.

When Medibank was introduced the Commonwealth in effect took over the direct funding of primary medical care, the bottom of the treatment hierarchy. This is a paradox indeed: the central or hierarchically superior element of government financed and largely controlled the most 'local' or primary care elements of the health system. The State level of government retained the secondary and tertiary level facilities: an inversion of the normal hierarchical assignment.

Technological advances have progressively shifted the boundaries between hospital in-patient, day-procedure, and outpatient services, relative to GP services, community-health services, maternal and child health programs, school medical and dental programs and domiciliary support services. These boundaries will continue

to change. Defence against cost shifting inhibits the adaptation of the services to changing technology.

People 65 years and over account for between 40-50 per cent of acute hospital bed-days. Improved access to Health and Community Care (HACC)-funded services can prevent some hospital admissions altogether, and can reduce average length of stay for those admitted. HACC is permitted to do the former, but not the latter! Oddly enough, both the Commonwealth and States gain financial relief through any reduction in hospital bed days, but the urge not to be beaten in the cost shifting game seems to defeat even financial self interest.

We have an incoherent hierarchy and minutely differentiated horizontally neighbouring service elements. For example, within the wider health and welfare system, primary care is not just the GP and the community health centre. It includes the HACC domiciliary services, home nursing, local counselling, support and relief agencies, respite facilities for relief of carers, accommodation under the Supported Accommodation and Assistance Program (SAAP), and even the private unsubsidised multiple-occupancy residential and boarding-house sector. Where these don't work, social conditions suffer. This has its most costly effects where it does the most damage — at the level of the most dependent and least self-reliant users of the service system. The big losers are the frail aged, the long term injured, people with chronic physical and psychiatric conditions, intellectually disabled people, substance abusers and so on, as well as the taxpayer who supports them all.

When local primary care arrangements fail these people, unnecessary demands are then placed on the much more expensive and often inappropriate, secondary (referral) elements of the systems: hospitals, nursing homes, hostels, and supported accommodation. These are often called upon for no other reason than that the narrow, over-specified local services cannot legally be packaged around the (often quite modest) needs of otherwise self-sufficient people.

Australia appears to have an unusually high rate of per capita admissions to hospital care relative to other OECD countries. One might speculate that it is the shambles of our primary-care system that forces many people into unnecessary hospital admission. The improved organisation of primary care is an absolute precondition to further evolution of the total Australian health, welfare and aged-care system. It can be done only at the local level, from pooled funds, but based on 'higher level' rules of eligibility and entitlement.

The primary-care system we have created contains abundant resources, and contains fragmentary elements of most of the services that would be in demand. They also exhibit absolute unmanageability, designed by a random walk, and operated by a command system straight out of Soviet orthodoxy.

Structural Reform in Health

Structural reform calls for three sets of measures. The first is to separate the catastrophic event and life-and-death elements of service demand from those consumption elements where market instruments can be allowed to mediate demand and supply.

The second is to remove the 'imperfect information' road block which stands in the way of reasonable consumer choice. An 'agency' or case-management system can serve the informational needs of the market-based services as well as providing an organisational framework to service victims of catastrophic life events.

Third, the technical issues of output measurement, pricing, insurance, co-payments and subsidisation must be addressed to recreate a transactional system in which contracts between governments and providers, or consumers and providers, can be made and enforced.

Catastrophic Event Risk

I know of no one in Australian public life who would argue (at least in public) that people suffering serious illness or injury, or a chronic disabling condition should be left to die in a gutter or subsist in poverty and filth. As a nation, we already make a big, if disorganised, effort to ensure that they don't.

The combined effect of our egg-crate style financing system and our weak primary care system is to guarantee great inconsistency in the level of care and support between different people in equally catastrophic circumstances. Some people eligible for intellectual disability services collect their pension and/or benefit and also get $50,000 to $100,000 of direct services per year each.

Some people in equally dire circumstances get no direct services at all and have their pension or benefits income ripped off by unscrupulous providers of last-gasp accommodation. Some get methadone treatment and tender loving care in therapeutic communities. Others do burgs, turn tricks and sleep rough to support their habit.

Our support systems for the most dependent are a lottery. They will remain so until we separate administration from the financing of care. There is already enough being spent to provide a decent basic standard if it is properly organised, and if it is regulated to proper service objectives rather than primarily with an eye to system maintenance.

At least half of the public direct service dollars in the health and welfare pot (exclusive of income security payments and private outlays) are spent on a small number of heavily supported people with chronic-acute conditions who are receiving a complex range of services. We might call them the victims of catastrophic events. They account for 5-10 per cent of the population. Most of the people concerned are old: some are physically and intellectually disabled; some have long term mental illnesses, drug and alcohol dependence, or are otherwise seriously ill. Most are supported by social security pensions and benefits, have next to no private resources, and make some, often quite some, demands on direct services in addition to their income security entitlements.

These people, together with the small number of privately insured or compensable people who are receiving intensive services at any particular time, can be 'insured' only through the public purse. These are the people for whom 'value of human life' rather than economic principles apply. Governments almost wholly support them now: at great cost, haphazardly and often poorly. They can be re-

garded as claimants on reinsurance, toward which the whole tax system subscribes. Government should fix a pooled global budget to support their service needs and make it available through authorised agents of the beneficiaries.

Catastrophic event risk, including the risk of a life of chronic dependency, can only be insured through the tax system, with the whole population sharing the cost and obtaining the cover. In principle that situation prevails now: government steps in when all else fails. But it's not done very well because of the unevenness of categorical funding and service provisions and the fragmentation of primary care services. Our primary care system, in effect, forces the least resourceful people to be the biggest risk-takers.

The situation of 'catastrophic event' victims must be dealt with from both the service (supply) angle, and the financing angle. Australian experiments in the accident compensation field and American experience with managed care suggests that individual case management for victims of catastrophic event risk can control costs, radically improve quality of care, and remove most of the Kafkaesque nuances of life in the clutches of the system.

An Agency Market

In spite of mind-blowing institutional complexity, and an extraordinary degree of product differentiation, the international travel market is characterised by something approaching perfect information and perfect competition. Information is placed in the hands of even the least informed consumer by the travel agent. It rests on a handful of (competing and privately owned) booking systems. Those massive information systems allow modern travel arrangements to work. To the consumer they are invisible and travel looks like the simplest, purest, competitive market. Yet the degree of product differentiation and organisational complexity of the industry greatly exceeds even that of our gratuitously complicated health and welfare system.

An information base comparable to the international travel and accommodation booking systems would be required to make our health and welfare service work. Parts of this already exist in the medical, pharmaceutical and hospital service systems. There are no practical reasons why the health and welfare systems cannot be as well serviced with consumer information as the travel industry, and no reason why they cannot be as consumer responsive. The people working in health and welfare are at least as bright, the scale of the business is of similar order, and the stakes are much higher. There is, however, a threshold question to be faced: that of the privacy issues inherent in data matching. Data matching is inescapable if we want a better health system.

To 'perfect' the information available to the ordinary consumer, and to provide managed care for the highly dependent, we would also need to recognise an 'agency' function and be prepared to pay for it. Models exist in the GP Budget Holders in the new British system, the Health Maintenance Organisations and managed-care providers in the United States, and in elements of Australia's aged care, statutory welfare, and intellectual disability service systems that provide case management.

Agency arrangements are vital for managing the care of victims of catastrophic events. The other half of health and welfare direct service spending is mostly incurred on a 'walk in walk out' basis by the other 90-95 per cent of the population. It might involve a visit to the GP, some tests, perhaps referral and specialist treatment in or out of hospital, and then it is over. For the 90 plus per cent of the population using services this way, no universal case management beyond the 'provider-to-provider' referral system is warranted.

However, if an otherwise healthy person has an episode calling for complex choices, such as a surgical procedure, then an agent may be useful. The agent may be a referring GP or some other. The agent should have screen-based and instantaneous access to a list of hospital/surgeon combinations operating within the preferred locality, and available at the preferred times. Unlike the GP in present conditions, an effective agent should also be able to advise, in respect of the possible providers: length of experience; number of procedure of the specific type performed in each recent year; statistical outcome indicators for cases treated by alternative providers; comparisons of the above with professional norms; and charges faced by consumer after insurance and any fee relief. That is where formal information systems come in.

There is no reason why 'agency' services could not be completely market-based, come from a variety of fields and offer a wide range of alternative contracts. Obvious providers could include GPs, community health centres, local government welfare departments, non-government not-for-profit agencies, and even commercial profit-seeking businesses.

Case Payments and Output as the Organising Principle

Any market-based system requires unique descriptors of the goods or services traded; otherwise there is no contract. Case-payment systems call for cases to be well defined. Such descriptors already exist for medical services, pharmaceuticals, and some allied health services. Victoria now uses diagnosis-related groups (DRGs) for reimbursement of public hospitals. There are, however, many remaining elements of the health and welfare system where useable basic descriptions do not exist. There are gaps to be filled, but in Victoria, at least, these gaps are being filled quickly.

Apart from meeting the technical requirement of market allocation, a case payment system is also a powerful antidote to bureaucratic games and consequential overhead costs. In Victoria until 30 June 1993 we at the Department of Health and Community Services sure regulated hospitals. But then we also met the cost of their inputs, regardless of how little output they produced, so we paid for our fun. We ran the public hospitals' industrial relations for them. We rained circulars down on them like confetti. We told them who should do their laundry, which ambulances to use, and when they could replace their bedpans. And we kept the hospitals guessing about how much money they would get from year to year. But the hospitals knew that no matter how hopeless they were, they wouldn't be forced to leave the game. On the other hand to keep them respectful, we made sure that

no matter how good they were, they would not be allowed to get far ahead of the pack. This kind of thing also applied in children's welfare, intellectual disability services and so on. It was made possible by cost reimbursement funding and non-market (i.e. administrative) allocation of product to consumers.

Under the hospital-case payments and the other output-based payment systems introduced in Victoria in 1993, hospitals and most other funded bodies now get paid for what they do: no more and no less. The price is realistic: the DRG price we paid all public hospitals in 1993/94 was enough to fully cover the costs of the best hospitals as they stood in 1992/93.

There is no originality, and definitely no particular genius about output based payment systems: you buy your groceries that way and it seems to work. Nevertheless, it is a revolutionary measure in government, and produces immediate and dramatic gains in efficiency if properly used.

Transitional Funding Pool

It is much easier to corrupt a market than to uncorrupt it. We can uncorrupt the national health and welfare market (carefully) by using pooled funding to preserve fiscal neutrality while reassigning administrative responsibilities and building a system of consumer entitlements, insurance, agency and co-payments. Funds pooling, properly used, means death to the sport of cost shifting.

It is possible to identify fairly precisely just who, in any past year, was spending what. Any move to uncorrupt our health and welfare markets could easily start with a funds pooling treaty, allowing sources of funds to be detached from regulation of services during a finite period of structural adjustment.

Victoria is showing right now that it is perfectly simple to detach cost reimbursement grants from privileged providers, and then to use the funds to pay for provision of specific services at prospectively determined prices. It is also easy to arrange a greater or lesser degree of contestability between providers.

It is also possible to grandparent in case-payment arrangements: in 1993/94 in Victoria we paid each non-benchmark hospital a 'compensation grant' equivalent to about 40 per cent of the fat that was in the respective cost structure of that hospital last year, giving them a little longer to adjust to the chill winds of competition.

Reassigning Roles

There is little congruence at present between the hierarchy of government and the hierarchy of health and welfare functions, and there is much to be gained from reordering roles.

There are usually large economies of scale available from centralised payment systems. This should be the role of the Commonwealth. On the other hand, inspection, supervision, licensing, and so on, is often best done fairly locally, at State or regional level.

My Department runs the case payment system for Victoria's 157 hospitals with around 100 officials and a little outside computing and auditing help. When the

system settles down it will be less than 100. Once public hospitals across Australia are on a case-payment system the Commonwealth could win benefits of scale by paying all the nation's hospitals on an identical basis. The Health Insurance Commission could post the cheques. It already pays private medical practitioners and could at little cost make case payments to community health centres and public hospital outpatient departments.

Where does that leave the States? My Department directly funds several thousand providers of what could be broadly described as primary care (walk-in walk out) services or secondary care (low technology referral based) services. It is those we are now progressively moving over to output based payment at benchmark prices. Most of these providers are fairly specialised health and welfare agencies. Generally they run good to excellent supported accommodation, therapy, counselling, community health and other services for those lucky enough to find a place in them. Most are not well integrated with other local services. This is largely because their balkanised, programmatic and overspecialised funding base makes integration difficult and sometimes even illegal. Just think about SAAP and the 'community' facilities earmarked respectively for psychiatric, intellectual disability, drug and alcohol, or transitional criminal justice clients. You can't mix them without shrill charges of cost shifting from Canberra. There is a major 'State level' job to be done in completely reorganising 'small end' primary care systems.

Beyond directly government-funded services there are private facilities that accommodate, at various levels of dignity, comfort and support, aged, infirm, disabled, psychiatrically ill, itinerant and all manner of other people. The bulk of the occupants are supported by Commonwealth pensions or benefits. The lucky ones also receive some direct health, welfare and recreational services.

Private accommodation in Victoria includes Special Residential Services (SRS) and boarding houses. The best of the SRS make an international hotel look ordinary. Other SRS and some boarding houses are reasonably clean, comfortable, and well run. Others are disgusting. We and/or the Commonwealth, and/or local government, and/or in some cases, no one, registers or licenses them and, for the most part, it is done badly.

The cost of doing a lot better would generally be pretty modest, but there does need to be an effective administrative oversight authority and a tie in with local services. State/local government agencies are probably best equipped to do that.

Within a single grotty boarding house you might find ten residents: three with a history of psychiatric illness, two who are registered as intellectually disabled, a couple of people with substance-abuse histories, one recently out of prison, and two who are down on their luck. All have pretty similar needs. The Salvation Army and a handful of other non-profit bodies do provide services to people just because they are in need, regardless of their 'primary diagnosis'. Otherwise, the only way of servicing those ten people is through a minimum of five separate, vertically integrated programs which have very weak horizontal interconnections locally. Yet all that is really needed is someone to keep an eye on things, to check on personal cash management, hygiene and medication, sort out squabbles, identify personal crises

and acute health events, and so. It doesn't need to be expensive, but we usually do it either at exorbitant cost or (more often) not at all.

The British National Health Service worked in spite of its resemblance to the economy of the USSR because it was based on effective primary-care arrangements. GPs were gatekeepers for health services, and most local authorities were reasonably capable providers of basic welfare and support services. That was its strength. Its weakness was the characteristic weakness of a large bureaucracy: it lacked the capacity for adaptation and change. It tolerated high cost providers long after the market would have buried them. Until we introduced case mix, we in Victoria did the same. The rest of Australia is still doing it.

Rebuilding the Funding Base

The hot topic right now is private health insurance, which is collapsing before our very eyes. Its salience arises from its political symbolism, not from its significance in overall health and welfare financing: it supplies only the marginal dollar. Private health insurance is an artefact of a regulatory divide between public and private hospitals. It creates two 'insurance' markets, and a dual health services system.

The one-to-one connection between hospital funding source and hospital service provider creates a bizarre distortion of the market for services. It is only in part public regulation which enforces the division. Benevolent societies were the ancestors of contemporary private health insurance. Their membership bases were typically based on affiliation rather than risk status, so they could be said to be 'community rated'. Modern markets for risk know no sectarian affiliation. Insurance markets are structured in horizontal layers of risk rather than in vertical slices of affiliation. Our health insurance system is an oddity. The attempt to enforce community rating on all private funds is, in effect, an attempt to reinforce and perpetuate the anachronistic 'vertical' or sectarian organisation of health insurance, and to perpetuate a dual health system.

Given Medicare bulk billing and free public hospitals, the fact is that basic medical and hospital services are guaranteed de jure, though, of course, not de facto, to everyone. Hospital waiting lists and some restrictions on choice impose a small gap between the de jure and de facto situation. Private insurance can offer better patient choice/control, better hospital accommodation, and a ticket to jump queues, but the benefits are at the margin whereas the insurance offer is priced for the total service.

Private insurers have been forced by regulation to price the product not to cover the quite marginal advantages it confers, but to cover the whole 'community rated' cost of care. This includes the deepest layers of catastrophic risk. No wonder the customers are voting with their feet. Private insurance is grossly overpriced for the limited de facto advantages it confers.

The effort to force community rating on private insurers is self-defeating because it kills the private insurance market. It is a ludicrous misapplication of regulatory effort. This is apparent to everyone, and yet it continues. How can this be? It stems from a confusion of means and ends in the minds of (federal) legislators. In

theory, they want to prevent cream-skimming by the private funds; but in practice their efforts merely load up the public system — for which, however, they are unwilling to pay.

Reconstructing Co-payments

If we can create adequate local support systems to deal with chronic dependency and catastrophic illness, we can then treat the remainder of health and welfare services as economic phenomena. This does not mean emulation of the American health care system. It means using a mix of income redistribution, public regulation, public funding, private insurance, self insurance, and 'public health' (i.e. environmental) measures to produce the level of service and the distribution of costs and benefits we choose. It removes the regulatory junk that stands in the way of an efficient and responsive health system.

Consumer sovereignty supported by an agency system would ensure that providers are competition exposed. That happens to be perfectly consistent with the use of managed care for the five to ten per cent of population who are 100 per cent financed from the tax base. They will be comprehensively 'case managed' by an agent acting on their behalf or at their instruction. Agency services will also be used by the wider population on an episodic, as needed, basis.

In almost every existing element of the 'non-catastrophic' service system there are already some elements of co-payment, of fee relief, and of status-based entitlements to free service. These devices are inconsistently, and even capriciously applied. The range of service choices available to the consumers is generally much narrower than a competitive system would produce. We in Victoria are actively sorting out those distortions, but we are seriously constrained by the conditions of funding established by the Commonwealth.

Competitive neutrality between providers of an identical service is a *sine qua non* of an efficient market. The contribution made respectively by the insurer (say, the Health Insurance Commission), 'the Treasury' (as the source of income-related fee relief) and the user should be independent of whether the provider is a GP, a community health centre, a public hospital outpatient department or any other recognised provider.

Concluding Remarks

I do not pretend that microeconomic reform of health and welfare will be without distinctive difficulties. But there is enough at stake to justify the effort. It is possible to proceed piecemeal, so long as there is a general agreement about the direction to take. The essentials are:

- separate out victims of catastrophic risk and case manage their care;
- build upon existing large-scale information systems so that they eventually coalesce;

- complete the system of product or unit output descriptors;
- ensure that all payments, even by governments, are for outputs and not inputs;
- gradually move government funded providers over to fee charging status;
- abandon community rating obligations in private insurance; and
- allow complete freedom in the nature of the insurance contract, subject to rigorous prudential requirements.

All that is needed to make a start is political leadership. The technical requirements are routine.

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The Struggle Over Teacher Training

Alan Barcan

Over the last seven years strenuous efforts — only partially successful — have been made to reform teacher training in Australia. The two main initiators of reform have been the Commonwealth and New South Wales governments. But their efforts between 1989 and 1991 to change the structure and content of teacher training lost momentum in the face of resistance from several interest groups.

Reform was attempted for two reasons. First, the quality of teacher training deteriorated considerably following the replacement of teachers' colleges by teacher preparation in universities and colleges of advanced education (CAEs) in the early 1970s. This brought a more theoretical and ideological and less practical character to teacher preparation. Starting about 1978, attempts were made to restore the quality of teacher training, without avail. Second, in the late 1980s politicians and their advisers became convinced that students in Australian schools required a more strongly vocational curriculum, as well as higher standards of achievement in the skills. Improvement in schooling required improvement in teacher training.

A struggle ensued between the politicians (tempted by the idea of transferring most teacher training into the schools) and the teacher educators (the university professionals) many of whom feared the loss of their jobs. Soon the educational bureaucracy joined in, attracted by new opportunities for research and report-writing associated with the search for less radical alternatives. In particular, the identification of teaching competencies opened up tremendous possibilities for research. But just when the 'professionals' could congratulate themselves on diverting the radical proposals for reform into more moderate schemes, they met a new problem. An apparent decline in the demand for teachers led to a fall in the number of teacher educators and of students enrolling in education. Lecturers in teacher training face heavier teaching loads, less time for educational theory and pressures for a strong practical emphasis.

The Deterioration of Teacher Training

From the early 20th century until the late 1960s teacher training was conducted mainly in small teachers' colleges, controlled by State Departments of Education. The colleges trained primary teachers in two-year courses. Secondary teachers obtained a university degree and then completed a one-year Diploma in Education course given at a college. The colleges had close contact with the schools and de-

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vised their courses to suit the local school system. The lecturers were recruited from successful teachers in state schools. The students held Departmental scholarships and in return signed a bond to serve in government schools, usually for three years, wherever required. After the probationary teachers had taught for three years, inspectors, aided by school principals, confirmed that they were of adequate standard.

The constant shortage of teachers from 1941 to 1975 made it hard to set very high entry standards, and some poor-quality candidates were recruited. On the other hand, the shortage until the 1960s of alternative jobs, in a pioneering society, for educated men and women ensured that many entrants into teacher training had fairly high academic qualifications. By and large, this centralised, state-dominated system produced 'fair average quality' teachers.

During the late 1950s and 1960s the proportion of students proceeding to secondary school grew rapidly. But the proportion of graduate teachers in State secondary schools fell. Between 1955 and 1960 the proportion of full-time secondary teachers with degrees fell in NSW State schools from 52.2 per cent to 42.0 per cent; in Victoria from 66.9 to 65.8 per cent; in Queensland from 50.8 to 26.9 per cent (Barcan, 1977:151). To supplement the supply of teachers, the colleges introduced 'junior secondary' courses. These were 'concurrent' rather than 'end-on' training courses; students studied the academic subjects they would later teach while simultaneously taking method subjects, attending demonstration lessons and engaging in practice teaching.

Between 1967 and 1974 the teachers' college system was dismantled. Teacher training was transferred from small specialised State teachers' colleges to the newly-established, large, autonomous, multipurpose, CAEs. The courses were lengthened to three years. The curriculum expanded; more time was found for educational theory. The universities began to offer their own training courses, mainly for secondary teaching. Both the universities and the CAEs were farther removed than the old teachers' colleges from the culture of the schools. Their lecturers often had little teaching experience.

This new system was established for political and financial reasons rather than educational ones. The new CAEs in country regions were short of students; they needed to take over teacher preparation to survive. State governments would save money by transferring teacher training to the Commonwealth-funded CAEs.

Teaching in secondary schools was becoming more difficult and less attractive. Two changes in the mid-1960s exacerbated this trend. The minimum school leaving age was raised from 14 to 15 in 1963/64 (NSW and Tasmania already had a higher minimum leaving age). And many States abolished the external Intermediate Certificate examination, usually taken at age 15, partly because many of the candidates were now unsuited to an academic examination, partly to save money, and partly because in a time of full employment adolescents could get jobs without an examination certificate. But the effect was to reduce standards. Increasing discipline problems further reduced the attractiveness of teaching as a career.

The Arrival of Neo-Progressive Education

In the late 1960s a new pedagogy, progressive education, swept through Australian schools. Strictly speaking, this should be called 'neo-progressive' education, for it was a new version of earlier 'progressive' principles about a child-centred curriculum, activity methods of learning and integrated subjects. To this the neo-progressives added 'open education'. This could be physically open — several classes in a large open space, with team teaching — but also intellectually open, in the sense that teachers should not impose their ideas on students. This latter view, asserting that all beliefs were equally valid, was an expression of cultural and moral relativism.

Another progressive reform making teaching more difficult was a new approach to the curriculum. Around 1971, departments of education ceased to issue syllabuses; teachers were expected to devise their own 'school-based' curricula. Inspection was almost abolished. The resignation rate rose rapidly, particularly in secondary schools. In New South Wales, for instance, the resignation rate in state secondary schools rose from 9.6 per cent in 1965/66 to 13 per cent in 1968/69 (Barcan, 1977:154). Teachers' salaries fell relative to other vocations. More money was found for education, but it was spent on buildings, on equipment and materials, on expanding the non-teaching ancillary staff and on increasing the number of teachers. More teachers meant smaller classes, but this was not sufficient to restore the attraction and prestige of teaching. Moreover, by the late 1960s a much wider range of jobs was available for those who once would have had few alternatives to teaching.

Many lecturers in 'teacher preparation' courses in CAEs and universities welcomed the new progressive pedagogy. But the progressives lacked a strong theoretical base. It was the neo-Marxists, the radical educationists, who had the theoretical strength. Unlike classical Marxism, which regarded education as part of the 'superstructure' of society, neo-Marxism held that the schools were vital agents for changing society; the 'traditional' curriculum was a 'social construct' reflecting class interests and possessing no intrinsic validity; working-class 'kids' should not be forced to acquire 'middle-class' knowledge. These ideas gained theoretical expression and respectability through the 'new sociology of education' and its offspring, the sociology of knowledge. These new ideologies were expounded in many teacher-preparation courses by lecturers who compensated for their limited knowledge of or interest in school realities by developing an enthusiastic appetite for social theory.[1]

Many schools soon abandoned the more extravagant experiments, but in the training institutions many lecturers clung to progressive and/or radical ideologies. Teacher-preparation courses often served to alienate trainee teachers from their future profession.

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[1] For the new sociology of education and teacher preparation, see Barcan (1993:193-203.)

The problems facing future primary and secondary teachers differed. In secondary schools, particularly senior secondary schools, academic subjects remained strong and future teachers needed a firm foundation in subject content and in related teaching skills. But in primary schools, and to some extent in the junior years of secondary schools, the absence of external examinations, syllabuses or inspection encouraged a shift of emphasis from content to process. It was argued that 'learning how to learn' was more important than learning specific content. Inappropriate methods of teaching reading and writing in infant classes, justified by the findings of 'educational research', weakened standards in later primary and secondary grades.

The shortage of teachers meant that no matter how inadequate their preparation, the products of university and CAE teacher-preparation courses could get jobs. This situation started to change in 1976 when, for the first time since 1940, a surplus of teachers appeared.

Concern at the quality of teacher preparation led to the appointment of six committees of enquiry between 1977 and 1981: one in each of the mainland States, and a Commonwealth enquiry. Not much eventuated, if only because, as Professor J. J. Auchmuty of the Commonwealth Committee discovered, 'There is no consensus in this country about education, either between parents and institutions or amongst institutions' (*The Australian*, 19 November 1980). In any case, the autonomy of the universities and the CAEs made reform difficult. The main outcome was attention to in-service education — improving teachers after they had completed their initial training. Little benefit was apparent.

Commonwealth Reform Initiatives

What was wrong with teacher education? The short answer is suggested by the changing nomenclature. Until the 1960s the term 'teacher training' was widely used to describe pre-service courses for future teachers. Then vaguer, more ambitious terms, such as 'teacher education' and 'teacher preparation', became popular. When John Dawkins, Commonwealth Minister for Employment, Education and Training, presented his statement *Strengthening Australia's Schools* in May 1988, he revived the older, more practical, term: 'We must examine means of improving the initial and ongoing training of teachers to meet the demands of a changing educational, economic and social environment' (Dawkins, 1988:8). But the problem was not simply one of adapting teacher training to a changing environment. It was also one of reversing the deterioration in the quality of teacher training over the preceding two decades. This would necessitate strengthening the training element in teacher preparation and reducing the place of an educational theory that often carried messages quite antagonistic to the preparation of effective teachers.

John Dawkins saw the improved education and training of Australian adolescents, particularly in State schools, as essential for the reshaping of the economy to make it more effective both at home and in a competitive world. The quality of teachers is an important element in the improvement of education; hence the need to attend to teacher training. In addition, reform might reduce the cost of teacher training.

The Commonwealth bureaucracy generated a variety of reports and discussion papers. Dr Graeme Speedy prepared a *Discipline Review of Teacher Education in Mathematics and Science* for the Department of Employment, Education and Training (DEET) in October 1989. (Auchmuty had noted in 1980 that many primary teachers lacked competence in maths.) A month later came a Schools Council report for the National Board of Employment, Education and Training (NBEET), *Teacher Quality: An Issues Paper.* The Australian Education Council (AEC), consisting of the nine ministers for education of the Commonwealth, States and Territories, commissioned a Working Party whose report, *Teacher Education in Australia,* appeared in July 1990. This was the key document. The NBEET analysed the three 1989-90 reports in *The Shape of Teacher Education: Some Proposals* (December 1990). In the same month a Schools Council paper, *Australia's Teachers: An Agenda for the Next Decade,* included a chapter on the training of teachers.

Then came a pause. The universities and CAEs were engrossed in the restructuring required by Dawkins's Unified National System. Where CAEs merged with universities, the faculties, departments and schools of education also gradually merged.

These documents identified as one major weakness the limited practical experience of many teacher educators: 80 per cent had not taught in schools since the 1970s. Another weakness was the insufficient time allocated to practical aspects, notably practice teaching. A third problem was the uncertain quality of students entering teacher training courses and the shortage of applicants in some teaching subjects. A discussion paper from DEET, *Teacher Education,* published in August 1992, commented on 'the obsolescent teaching experience of staff in education faculties'. More than 50 per cent had not taught in schools in the previous 20 years (Deer et al., 1993:86-7). A report by the House of Representatives Standing Committee on Employment, Education and Training (*The Literacy Challenge,* December 1992) complained of the neglect in many teacher preparation courses of language and literature, early childhood education and special education.

The reforms suggested in the 1989-90 documents included: internship or apprenticeship (transferring a major share of teacher training to master teachers in the schools); lengthening all courses to four years (despite some objections on the grounds of cost); sending education lecturers back to the schools at regular intervals to refresh their knowledge of teaching; seconding outstanding teachers to education faculties; and revising the curriculum of training courses (implying less attention to theory, new courses and more attention to basic problems, such as methods of teaching reading and special education).

The structural solution proposed by the AEC's working party report, *Teacher Education in Australia,* was a three-year program leading to a B.A. (Teaching) or B.Sc. (Teaching). Graduates who obtained a half-time appointment in a school as an 'associate teacher' would then take a part-time two-year course, involving some academic study and some school induction work. This was an attempt to solve the

tension between the teacher educators (who feared the loss of their university jobs) and the politicians (who favoured a more practical teacher training).

New South Wales Initiatives

New South Wales had been extremely energetic and radical in school reform. But the controversies this stirred up distracted the attention of Dr Terry Metherell, the Liberal Minister for Education, from teacher training. In any case, he had to await the completion of John Dawkins's restructuring of higher education. Little had been done about teacher training when Dr Metherell resigned in July 1990.

His successor, Virginia Chadwick, produced a discussion paper in September 1990, *Teacher Education: Directions and Strategies.* It was surprisingly moderate — for reasons that will emerge below. The discussion paper referred to Britain's Council for the Accreditation of Teacher Education, which could approve initial teacher-training courses and had recently been reconstituted to increase its bite. But its section on 'Alternative Pathways to Teaching' simply mentioned, without elaboration, the radical concept of 'licensed' and 'articled' teachers and did not mention current British initiatives to encourage an apprentice-type, on-the-job, training. It also mentioned American attempts to identify specific competencies for future teachers and various American alternative certification programs, 'outside the mainstream'. But it failed to elaborate on the alternative certification approach. It warned that whereas teacher shortages might necessitate more flexible pathways, the use of teachers without formal qualifications might be seen as 'unduly diminishing the relative value of pedagogical and educational knowledge and skills' (Chadwick, 1990:42-3).

Mrs Chadwick took up a British idea when she suggested in November 1991 that education lecturers would be 'encouraged' to return to the classroom for one term every five years (Totaro, 1991). But the *Teacher Education Action Plan* that she issued in February 1992 took a moderate line. It resulted, in May 1992, in a Ministerial Advisory Council on Teacher Education and the Quality of Teaching.

In June 1992 the NSW Director-General of School Education, Dr Ken Boston, momentarily revived the radical agenda. He warned that 'tinkering at the edges of the teacher training system will no longer work'. Adopting recent English and American ideas, he suggested that up to 80 per cent of training (i.e. four days out of five) should be in schools; schools should have an input into teacher training policies; universities should attempt to recruit more mature-age graduates into teacher training; and educational theory was, perhaps, better placed in in-service rather than in pre-service training (Totaro, 1992).

But it was too late. The teacher professionals had rallied their forces.

Teacher Educators Fight Back

When the reform of teacher training was first proposed the teacher educators were mute. They had fallen silent as public discontent over the outcome of two decades of progressive and radical nostrums found forceful expression in a drift of enrol-

ments from state to non-state schools. By the mid-1980s ideological theorising had diminished. Neo-Marxism and the new sociology of education suffered an eclipse. In education courses systematic educational theory evaporated as students turned to courses that promised practical utility. Like the rest of the academic world, teacher educators were silent when John Dawkins's Unified National System turned higher education upside down.

But two forces fuelled a counter-offensive by the teacher educators. One was their hostility to John Dawkins's new instrumentalism, whose emphasis on practical, vocational, education threatened to dominate teacher preparation. A second was their fear that they would lose their jobs if the preparation of teachers were transferred largely to the schools. We will consider these forces in turn.

Despite the collapse of neo-Marxism, radical theories survived in teacher education programs. The new emphasis on practicality meant that they were often introduced surreptitiously, for instance in curriculum studies courses. Some sociology of education courses survived in their own right. A degenerate version of Marxism persisted under the name of 'critical theory'. Concern with power and with local groups rather than grand theory became a feature of the 'postmodern' outlook. Feminism was another radical theory, incorporating elements of both critical theory and postmodernism. Some educational theorists borrowed ideas from literary criticism. Deprived of their policy-making roles and diminished in prestige, some academics now found compensation in elaborating complex theories. But the less intellectual contented themselves with applying simplified sociological concepts to educational issues, with much emphasis on 'social justice'.

The hostility of critical theorists to instrumentalism is evident in an attack by three Queensland academics in *The Australian Teacher* of August 1990 on the AEC report, *Teacher Education in Australia.* They argued that the report did not understand the needs of the profession, did not realise the importance of student teachers 'reflecting on how children learn', provided an 'unthinking resolution' of practical problems and did not appreciate the industrial implications of creating associate teachers. The report, they said, was part of a drive to corporate federalism based on neo-corporatism, economic rationalism, corporate managerialism and human capital theory (Lingard et al., 1990). Responding to this, Robert Bluer, a counsellor of the NBEET and a member of the AEC working party, said that these educators were not disinterested observers but partisan participants with a barrow to push. Teacher educators, he said, were alarmed because they were being asked to improve their performance. 'Employing authorities must be given a greater role and influence in the training of its (*sic*) future workforce' (Bluer, 1990).

The teacher educators were no small pressure group. They had an empire to defend. The number of teacher educators grew from 2,063 in 1987 (10.8 per cent of the total of 19,137 academics) to 2,576 in 1991 (11.3 per cent of the 22,867 academics). At stake, too, was a significant proportion of university enrolments. In 1991 education accounted for 74,300 — 22.8 per cent — of the 325,500 'effective full-time' enrolments. The statistics (taken from DEET's 1993 *National Report on Australia's Higher Education Sector*) must be treated cautiously, and not all educa-

tion lecturers or education students were directly engaged in teacher preparation; yet they all derived their sustenance ultimately from this activity. But the fear of being superseded was real enough. The Australian Teacher Education Association (ATEA) held its mid-1992 conference in an atmosphere of gloom. 'We may all become redundant', said a Queensland critical theorist.

However, the professional educationists rallied their forces. In New South Wales they formed the NSW Teacher Education Council in 1990, in time to have some input into the September 1990 Discussion Paper. This helps explain its subdued approach to reform. The subsequent February 1992 *Teacher Education Action Plan*, published by the NSW Office of Education and Youth Affairs, reassured the teacher educators. It asserted that the emphasis in the Discussion Paper had been 'on strengthening and enriching existing models of pre-service education rather than on promoting structural changes'. The *Action Plan* likewise sought to 'strengthen existing pre-service courses'. It emphasised the importance for teacher education students of a mastery of subject matter. They also needed a mastery of 'essential and broad professional teaching competencies'. A new advisory council on teacher education and the quality of the teaching profession would direct its attention to these competencies. The idea of 'alternative pathways into teaching' was seen as related only to 'areas of shortfall' and was deprecated as generating concern 'that standards would be lowered'.

The Ministerial Advisory Council on Teacher Education and the Quality of Teaching set up in New South Wales in May 1992 had 36 members and was chaired by the Director-General of School Education. It represented the major pressure groups: the vice-chancellors, representatives of the Department, the Ministry, the Board of Studies, the Catholic Education Commission, the Association of Independent Schools, the Director of TAFE, the two teachers' unions, the Parents and Citizens Association, teachers from government and non-government schools and nine nominees of the Minister. The Advisory Council reoriented the reform movement. The topics for its first five monthly meetings were: Beginning teacher competencies; Guidelines for teacher educators to have recent school experience; Alternative pathways into the NSW teaching service; Current programs for preparing teachers; and Strategies for ensuring commitment to improving standards (Deer et al., 1993:85).

At the national level, too, the resistance of teacher educators was strengthened when an Australian Council of Deans of Education was established in January 1991. When the DEET issued its discussion paper, *Teacher Education*, in September 1992 it received 700 responses, the majority hostile. The Commonwealth, with a new Minister for Education (Kim Beazley) and an election in the offing, placated the professionals. The Ministerial Statement *Teaching Counts* (15 January 1993) reassured educationists in carefully chosen words that the government 'values the role of universities in teacher education, not least because of their responsibility for keeping teaching practice at the forefront of knowledge'. It endorsed the proposal for a National Teaching Council. It told teacher educators that the government 'would not support an apprenticeship model', but that it supported ' a competency-

based approach' in teacher education. To help 'Education Faculty Renewal' it would fund the early retirement of teacher education staff.

Control through Accreditation and Competencies

So the educational professionals (academics and bureaucrats) seemed to have won. After five years of reports and discussion papers the drive for reform had been dissipated into a variety of administrative committees, schemes for certificates and research projects. An oblique control would be exercised through registration of teachers based on a variety of criteria, including achievement of competencies at the end of teacher training. A National Teaching Council of 40 elected teachers and 19 others was approved in June 1993 and met in December.

The National Teaching Council had been foreshadowed by the prime minister in an address to the Australian Teachers Union on 15 January 1993. It would accredit new teachers on the basis of their possessing specific competencies, which would include broad skills such as communications, classroom relationships and planning and evaluating student learning. The scheme was supported by the DEET, the Council of Deans and the Australian Teachers Union. The Education Faculties would be prodded with competencies, cajoled with special funding. *Teaching Counts* promised 'up to' $130 million over the next three years to assist teachers to update their skills and for further work on key competencies, including a 'prototype training and development package for teachers/trainers'.

But who would control the Council, and what policies would it implement? Some observers feared that the Council would become an extension of the teacher unions. The education systems were given representation on the Board, but at the December meeting only two of the eight States and Territories, the ACT and South Australia, had taken their places (Australian Parents Council, 1994). Some administrators (such as Dr Tannock, Director of Catholic Education in Western Australia) disliked the idea of a National Teaching Council. Some States, such as Victoria, were hostile, preferring their own accreditation bodies. New South Wales had no system of registration of teachers but could use the Ministerial Advisory Council on Teacher Education and the Quality of Education to influence the training institutions.

The notion of competencies was not new. Its latest reincarnation arose out of a 1990 Commonwealth/State Training Advisory Committee document, *A Strategic Framework for the Implementation of a Competency-Based Training System.* The idea was given wider currency in the AEC's *Young People's Participation in Post-Compulsory Education and Training: Report of the Australian Education Review Committee* of July 1991 (the Finn Report) which identified six 'key competencies' essential for employment and recommended national standards in assessing and reporting key competencies. The adoption of competencies had several attractions for teacher educators. It avoided that danger of direct prescription of content by an external authority. While competencies might provide some basis for external appraisal, their assessment promised to be very vague. But some teacher educators

resented even the mild control of competency-based training. Some feared that the pursuit of competencies might reduce attention to content.

On the other hand, the compilation of teacher-education competencies provided a new bandwagon for the educational bureaucracy. The National Project on the Quality of Teaching and Learning, which had generated the idea of a National Teaching Council, commissioned Professors Ken Eltis and Cliff Turney of the University of Sydney to devise a statement of 'general competencies' for beginning teachers. Conceivably, these could be used to guide teacher training institutions. Sceptical teacher educators could accept 'competency-based training' as a harmless if pointless alternative to closer scrutiny. Eltis and Turney's report (1993) identified 22 'generic competencies for beginning teachers', such as 'demonstrating and enhancing curriculum expertise', 'planning for learning' and 'developing and integrating theoretical understandings' — worthy but evasive concepts.

A New Threat: Reduced Demand for Teacher Training

The professionals had defused the threat that they might lose their jobs through school-based training. But now a new threat appeared: redundancy because of falling demand. A DEET discussion paper, *Teacher Education*, published in August 1992, argued that there was an oversupply of teacher education graduates, that fewer than 50 per cent of graduates would find work as teachers and that this would be the case till at least the middle of the decade.

The argument that falling demand for teachers justified a reduction in the number of teacher educators alarmed both teacher unions (seeking lighter class loads, i.e. more teachers) and the professional organisations of academic educationists (seeking to maintain jobs). A battle of statistics developed. 'Education deans are beginning a push to win back resources for their faculties', wrote Jane Richardson, editor of the Higher Education section of *The Australian* on 20 July 1994. A consultant hired by the Australian Council of Deans of Education had carried out a survey that predicted 'a substantial and widening gap between supply and demand for teachers to 2001'.

Theoretically, any shortage could still be met in the schools themselves, by a system of internship or by employing mature adults with little or no teacher training ('alternative pathways'). But during 1993 both policies were discarded. Another solution would be for the academic professionals to take heavier teaching loads. Indeed, this had happened in the new universities as the gap between the teaching loads of the old universities and the CAEs shrank. Whatever the solution, a reduction in the number of teacher educators would, presumably, encourage reduced attention to educational theory and a concentration on practical training.

To assist 'Faculty Renewal' *Teaching Counts* had promised to fund the early retirement of education staff. Early retirement offered two benefits. First, the new universities had to reduce costs and the easiest way was by reducing the number of lecturers. The easiest faculties in which to reduce staff were arts and education. Second, it made it possible to recruit education lecturers with recent experience in

schools. It might permit employment of part-time staff (cheaper than full-time), who could combine teaching and lecturing (often a desirable arrangement.)

Generous early retirement schemes started at the end of 1993. But policies varied from institution to institution. In Victoria, where the demand for teachers slumped when the new Liberal government imposed cut-backs on schools, the University of Melbourne declared 59 members of the Institute of Education 'surplus' (average age 46, average years of tenure 20) (*The Australian*, 20 July 1994). On the other hand, Deakin University decided to dispense with 23 contract staff in education. Staff levels in the education faculty were expected to more than halve in the two years 1993-94 (*Campus Review*, 25 November 1993). In May 1994 the University of Newcastle was reported to be planning to reduce student numbers in the education faculty by one-third over the next five years, redistributing some 800 full-time student places among the other faculties (*The Newcastle Herald*, 13 May 1994).

Whatever the reason, student numbers were falling. The number of higher education students enrolled in education peaked at 78,982 in 1991, and by 1993 had fallen to 75,613. Yet this was still more than in 1990 (Higher Education Council, 1994:42).

The Current Situation

The annual conferences of the ATEA provide a barometer of the changing climate. The 1992 conference at Ballina, New South Wales, was marked by considerable gloom (Barcan, 1992). The 1993 Fremantle conference was characterised by 'considerably more optimism than one might have expected' (Ryan, 1993:2). The program for the 1994 conference, 'Empowering the Professionals', showed that, although threats persisted, the teacher educators had hopes of a recovery.

In March 1994 the ABC Radio National's *Education Report* devoted two sessions to a discussion of the current state and future directions of teacher education. Two academics from the University of Melbourne defended the redesign of their university's teacher education program as a chance to change the community's view of the standards of teachers. Some speakers welcomed competency-based training. Bill Lowden of Edith Cowen University warned that competencies might be too narrow; they should be 'somewhere between a 1000 tiny parts and something so mysterious you can't write about it'. Other speakers seemed enveloped in an unreal world of theory, advocating critical reflection, a conflation of critical theory and reflective teaching (a pretentious name for an obvious activity: teachers reflecting on what they were doing). A lecturer from the Queensland University of Technology told how she used stories to develop ideas about what it means to teach and 'how it is we understand about teaching'. Her teacher-training work focused on the changing metaphors teachers use as they increase their experience. The speakers were uncomfortable when asked about criticisms that they neglected the particularities of teaching. Many of them accepted this, but identified obstacles to implementing reform. Ken Eltis and Bob Meyeen, explaining the provocative title of their recent paper 'Teacher educators as a pod of middle-aged beached whales', said that

teacher educators had become good at protecting their territory, but needed to be more realistic and honest. They were hesitant about change, which often meant a loss of jobs. But they argued that many lecturers did go into schools and had contact with school reality. One academic who supported change, Lawrence Ingvarson, wanted a national agency to accredit courses; academics had not been sufficiently accountable (Perry, 1994).

Nonetheless, a considerable swing towards more emphasis on in-school preparation was occurring. At the end of 1992 the Dean of the Institute of Education at the University of Melbourne announced that the four-year B.Ed. degree would be phased out in favour of a two-year postgraduate Bachelor of Teaching degree, including a year's on-the-job internship.

Does it Really Matter?

Does the form of teacher training really matter? For more than 50 years beginning teachers arriving at their first school have been greeted by the old hands with the advice to forget what they had been told at college. Now they were in the real world. And it is true that teachers really learn to teach in their first three years in schools.

But it is also true that future teachers do pick up attitudes in training courses: dedication to the cause of teaching, or scepticism about the purposes or value of teaching. They pick up some basic survival techniques during their supervised practice teaching: the need to have work ready when a lesson begins, the importance of varying procedures in the course of a 30- or 40-minute period, the mannerisms of a professional teacher. Some basic skills can be imparted in prior training: in English, the importance of phonics for teaching reading and the value of grammar for clear expression, for correction of written work and as an aid in learning foreign languages.

Possible defects in university preparation of teachers include lack of commitment to teaching on the part of some lecturers, excessive attention to progressive or radical theory, neglect of practical teaching skills, and isolation from schools and classroom teachers. But would internship be much better? Teachers can be cynical, use bad methods, or provide a faulty model, such as laziness. The quality of internship would rest heavily on the quality of the master-teacher. Apart from the need for a careful choice of master-teachers, the neophyte must be inducted by graded stages into the difficult art and skill of teaching.

Perhaps the system of teacher training is less important than recruitment of the right sort of teacher. Perhaps there should be better selection, using academic, psychological, and moral criteria. Perhaps better teaching requires better guidance and supervision of teachers inside the school.

Options for Change

The politicians seeking in the late 1980s to reform teacher training had confronted powerful vested interests. Once the initial enthusiasts—John Dawkins in Canberra

and Terry Metherell in New South Wales — disappeared, once the initial momentum slowed, the educational-bureaucratic complex was able to block serious reform. In school reform Metherell, and in higher education reform Dawkins, both adopted policies of 'crash through or crash'. Their reforms were introduced speedily and with limited discussion. The educational-bureaucratic nexus had little time to rally in opposition. But in the reform of teacher training both Dawkins and Metherell adopted a 'softly softly' approach. This reasonable, gradualist approach gave the vested interests time to organise and fight back.

Because of the obduracy of many teacher educators, educational bureaucrats and the professional and union leaders, vast sums of money were wasted on devising solutions that were at best unhelpful. They are unlikely to improve the quality of teacher training and will strengthen rather than reduce the vast educational-bureaucratic complex.

Some vocations, such as journalism and nursing, are better taught on the job and have suffered from being shifted in recent years into institutions of higher education. Transferring the bulk of teacher education to the schools would reduce or eliminate radical or progressive waffle and give teacher training a strongly practical character. It could save money — which should appeal to politicians and public servants. But it would threaten the very existence of old, entrenched, teacher educators. School-based training would have problems, of course. It would be difficult to ensure an adequate supply of competent 'master-teachers'. Too early an exposure to the stiff challenges of many schools might deter some candidates. The AEC's three-year plus two-year internship compromise is a reasonable one, but might be expensive. Another proposal, the extension of three-year courses into four years, is of dubious value, though if the three years were devoted to advancing the general education of the trainees and the fourth year to in-school experience, it could be beneficial.

Perhaps improvement in the quality of teaching is better promoted at the point of entry into the profession, by the school as an employing agency. The selection of teaching staff by merit (by open advertisement arranged by each school council) might stimulate quality. Of course, no scheme is proof against abuse. Schools in less salubrious parts of Australia might receive applications from the more poorly qualified — though salary and other adjustments could correct the balance. And there is always the danger that assessment of teaching quality would degenerate into assessment of elegant but specious application portfolios.

If internship cannot be achieved, one alternative could be for each State to establish one model training school, to set standards for the other teacher-training institutions. This would revive some of the better features of the former teachers' colleges. It could offer a postgraduate two-year course, using demonstration lessons and providing considerable practice teaching. It would be small. The instructors would be recruited from the teaching service and would emphasise practice, not theory. Special arrangements to recruit mature adults to be trained in the schools should also be considered.

For the moment, however, we are promised a tortuous form of indirect control through a National Teaching Council, using the dubious concept of competencies. The restoration of accountability in teacher training would be advanced not by a national body issuing vague descriptions of necessary teaching skills but rather by regional bodies that do something to restore the earlier system of examination and inspection of beginning teachers. But instruments of control can be given new orientations. What if a National Teaching Council were, in a few years, to require that all entrants to the teaching service should have spent 80 per cent of their professional preparation in the schools?

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Open Streets or Taken for a Ride? Reforming Australia's Taxi Markets

Christopher C. Findlay and David K. Round

Taxis have long been subject to regulation in Australian metropolitan areas by means of entry restrictions, quality and safety standards, and fare-setting procedures, ostensibly in order to protect the interests of taxi users. Entry is restricted by the obligation to own a licence; the monopoly rents attached to this regulation-induced scarcity have become capitalised in licence values. Such regulation is often inequitable, has restricted consumer choice, has reduced product diversity, and has sheltered the market from the dynamic forces of innovation and competition that promote efficiency. Yet governments have been reluctant even partly to deregulate the industry by issuing significant numbers of new taxi licences.

Regulatory barriers to entry and the absence of real substitutes at a comparable price have removed the incentive for taxi operators, whether individually or in the form of business organisations, to compete for business on any factor other than location. Jobs are apportioned by queuing at ranks and through use of the radio network. Apart from corporate accounts, little brand loyalty exists. Centralised setting of fares by taxi boards in all the major metropolitan markets has effectively removed price competition.

In recent years, however, several changes have forced taxi operators to re-assess their business strategies. Mobile phones have rendered drivers less reliant on radio networks. Hire cars have become more common, due to fewer regulatory restrictions, and have offered greater competition to regular taxis, such that some taxi operators now offer higher standards of comfort, cleanliness and driver courtesy. Talk of possible deregulation, formation of new breakaway cooperatives, and the emergence of niche operators offering specialised services have prompted existing drivers and firms to introduce new competitive strategies. Some people now own many taxi licences and employ large numbers of drivers. Yet individual independent owners have re-emerged, working entirely from mobile phones or from ranks, or in small informal networks. The industry is in a state of flux and uncertainty, especially as urban-transport options are being re-assessed by State governments, after proposals for regulatory reform by the Industry Commission (1994), and drawing

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on experience of regulatory reform in other countries, in particular New Zealand (New Zealand Ministry of Transport, 1991) and the US (Teal & Berglund, 1987).

In our view, the potential for competitive behaviour is robust enough to justify substantial deregulation of the taxi industry. But whenever losers from a policy change can be identified, the question of compensation must be considered.

Barriers to Entry

All States control entry into the taxi market, by means of a licence system. In Sydney, Melbourne, Brisbane, Perth and the Northern Territory licence owners are required to be members of a radio network. Except in Brisbane and Melbourne, licence owners do not have to belong to an approved cooperative; and no State regulates the number of radio networks that can operate. All States stipulate maximum fares. In most cities the numbers of hire cars have also been controlled; in an attempt to confine them to a particular market and to differentiate them from taxis, they are often subject to other regulations relating to vehicle quality and age.

Licences (plates) have attracted prices in different cities in the ranges illustrated in Table 1. The price of a plate reflects the barriers to entry created by the licensing system. Such barriers reduce the total number of taxis and probably raise the average price of taxi fares above its free-market equivalent. When the demand for taxi services is strong and expected profits are high, the demand for plates is strong, and potential entrants into the industry have to bid higher prices for the right to enter. The rate of return on their investment is therefore reduced, given regulated fares, to one that is not much more than the rate of return on an investment of equivalent risk. This leads owners to press, through the regulatory system, for higher fares in order to provide a higher return on their investment in the plate.

Table 1

Estimated plate values (A$,000), 1988-93

Sydney		Melbourne		Adelaide		Brisbane	
Jan 1988	130.3	Jan 1988	95.7	Aug 1989	108.5	1989	153.0
Jan 1989	179.6	Jan 1989	134.9	May 1990	80.0	1990	134.0
Jan 1990	148.5	Jan 1990	21.5	Dec 1990	87.0	1991	137.5
Jan 1991	148.5	Jan 1991	117.6	Jun 1991	88.0	1992	175.0
Jan 1992	175.5	Jan 1992	120.5	Jan 1992	90.0	1993	190.0
Jan 1993	198.0	Jan 1993	133.0	Feb 1993	117.0	1993*	125.0

*August

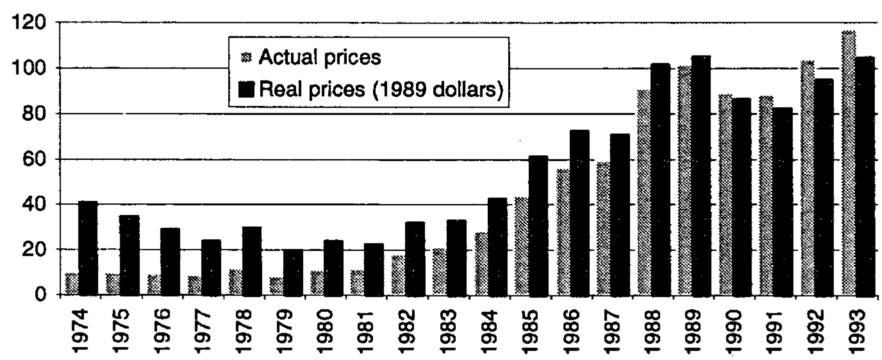
Source: State taxi industry associations and taxi boards.

The barriers to entry do not confer riches on new owners, who pay all their expected profits to the previous owner of the plate. So the beneficiaries from regulation are those who bought plates at low prices and later sold them at higher prices. The Industry Commission (1994:393) has estimated that on average every taxi ride costs two dollars more than in the absence of restriction on entry.

Changes in plate values reflect the impact of a number of factors. Figure 1 shows the trends in plate values in Adelaide from 1974 to 1993. Prices dipped noticeably in 1990 as a result of government proposals to issue more plates to hire-car owners. The rising values suggest that the supply of plates has not kept pace with demand. Of course, many factors other than expectations about changes in the regulatory system affect the prices of plates, including driver costs, unemployment rates, redundancies in occupations with large pay-outs that increase the demand for plates, swings in demand for taxis, patterns of urban travel, and the costs of fuel and public transport.

Figure 1

Taxi plate prices in Adelaide (A$,000), 1974-93



Note: 1993: two quarters only

Source: Private communication, SA Department of Transport.

Under a regulated market the operating licence constitutes a fixed cost that is not sunk so long as the market continues to be regulated and no new licences are issued (or at least so long as the number of new licences matches the rate of growth of demand). However, the licence immediately becomes an irretrievably large sunk cost if the industry is deregulated or if there is an imminent likelihood of deregulation. Such a loss in capital values is an important effect of deregulation.

The Impact of Technological Change

A review of the number and size distribution of firms in major taxi markets indicates that in all cases the biggest operator has a large market share, and that those in Sydney and Melbourne enjoy a substantial advantage over their closest rivals (TPC, 1993). In all cities other than Sydney and Melbourne, the markets are supplied by four or fewer firms. This may reflect scale economies in the radio network that preclude the profitable existence of more, smaller, firms, or it may reflect the coordination difficulties of sharing radio networks once a certain critical number of taxis is reached. Yet the recent emergence of small taxi groups in some cities, operating through mobile phones, and the re-emergence of individual taxi owners also doing business on ranks and through mobile phones, indicate that changing technology will reduce the need for large cooperative radio facilities, though probably never to the point of irrelevance.

Estimates from various taxi industry groups suggest that between 10 per cent and 20 per cent of major metropolitan area cabs now carry either fixed or handheld phones, and that in most States this proportion is increasing. Of an estimated 600 Melbourne cabs with mobile phones, between 250 and 300 are believed to carry pagers so that personal overflow bookings can be handed off to other cabs rather than putting them through the radio network, possibly to be picked up by cabs offering lower standards than those expected by the passenger who called the original taxi. These developments, more than any other factor, have provided the impetus for the emerging segmentation in taxi markets, which is creating the background for better consumer service and choice and paving the way for the successful deregulation of taxi markets.

Some drivers, recognising that a demand exists for higher grades of service, have introduced innovations and offered special services to differentiate their taxis and secure repeat business. Some taxi firms have sought to differentiate some of their taxis by presenting them as 'Elite' taxis, which are generally newer vehicles with higher standards of presentation and uniformed drivers. Such taxis do not charge a fare premium for casual hirings. Most are fitted with mobile phones, and their drivers seek to establish passenger loyalty and secure repeat business by, for example, encouraging clients to make advance reservations. Elite-taxi owners have a strong incentive to win reputations for good service, since they can be summoned on demand by mobile phone. In contrast, little, if any, such incentive exists for taxi owners relying on the radio network, who cannot easily be allocated to passengers asking for them specifically. Mobile phones lead to cooperative radio networks spreading their fixed network costs over fewer jobs, though most drivers with mobile phones choose to remain associated with a radio network so as to be able to bid for jobs during times when they are not servicing their own clients.

However, a taxi driver cannot meet the demands from two or more customers simultaneously, unless some informal networking emerges with other operators who provide a service similar to that which a customer has received from the original driver. Network scale and scope economies, together with operational flexibility,

could thus be developed by subsets of drivers who can certify that their services have desirable common characteristics.

Market Failure in Deregulated Taxi Markets

Although regulation of taxi markets has given rise to problems, there are many potential sources of failure in a free taxi market, although none of them is either inevitable or insoluble (Frankena & Paulter, 1984). They raise issues about the abuse of market power and the quality of taxi services.

Waiting times too long. In an unregulated market, the number of taxis on the road could be smaller than is socially optimal. The more taxis there are on the road, the shorter the average waiting time is for all users. However, the individual taxi owner, in deciding to enter the market, will not take into account the benefits to all the users of the service that occur because of entry. As a result, the number of taxis could be too low relative to the socially optimal number. However, this is an argument for *promoting* entry into the market, not restricting it. Furthermore, current licensing and fare regulations provide drivers with little incentive to expand taxi services when demand is greatest, namely, at peak hours and in wet weather. If drivers could charge a premium at these times, they would be compensated for the opportunity cost of lost leisure time or for the extra strain of driving in inclement weather.

Service quality too low. Other aspects of service quality that have allegedly suffered in a deregulated market include the mechanical quality of taxis, driver skills, and the personal safety of travellers. Taxis offering high-quality services may not be able to charge correspondingly higher prices when consumers cannot distinguish their services at the time of purchase from those of the lower-quality taxis (as when they hail on the street or at a rank). If so, lower-quality taxis charging lower prices will tend to push higher-quality suppliers out of the market or into personalised-booking niche markets.

Yet the market might cope with these problems. New companies could emerge in order to act on behalf of consumers in monitoring the quality of the services their members offer. This service of brand identification and certification would reduce consumers' search costs and significantly lower their risk of making bad decisions. Such companies could identify themselves and their services by appropriately marking their cars.

The 'airport problem'. After deregulation, some consumers may hire taxis under disadvantageous conditions, such as late at night, at a fast moving queue at an airport or at a busy city rank. They may, as a result, suffer first-degree price discrimination.

However, if the problem is lack of information, or if taxi drivers can exercise monopoly power only in particular well-known locations, then a variety of solutions can be provided. For example, airport authorities or local tourist promotion authorities could offer advice to travellers or even offer the services of preferred taxi

companies at prices that they negotiate on behalf of travellers (though this could involve cosy deals with particular taxi companies). Tourism authorities or hotels could offer specialised or contracted pick-up services for customers (with telephones available at the airport), or with taxi companies providing direct, free phone links to their control rooms.

The case is sometimes made for controlling taxi fares where taxi drivers have considerable short-run monopoly power. However, such controls may not be enforceable: the situation that creates the problem (immediate need for transport, lack of information and lack of current alternatives) will make it difficult to enforce the solution. As well, if maximum fares are set, fares will gravitate towards this maximum. Furthermore, setting maximum fares tends to discourage entrepreneurship. Taxi owners should be able to charge higher fares if they offer a higher quality of service, and should also be able to experiment with fare structures. An unregulated taxi market would provide a range of price and service options that are unlikely to develop under the dead hand of regulation.

Regulatory Reform

Safety and quality issues in the reform process can be dealt with, as the Industry Commission (1994:Section B4.3) suggests, by setting standards for vehicles and drivers. However, the mechanisms employed should not be used to create or entrench new monopoly rents.

Entry and safety considerations. Any operator whose vehicle meets stipulated safety and cleanliness standards, who carries adequate passenger insurance and who passes a comprehensive test of local geographic knowledge should be licensed to operate a taxi. However, certification would be necessary to ensure that minimum safety standards are met. To be effective, and to avoid capture by incumbents, certification would have to be carried out by bodies that are independent of the industry. The inspection scheme could be self-funding. To help ensure compliance with road-worthiness and insurance requirements, taxis could be subject to random inspection on the road.

Drivers must be licensed so that passengers can be confident that they are socially acceptable providers of public transport. In addition, taxi users would benefit if drivers could gain certification only if they can demonstrate a high standard of knowledge of the geography of the relevant metropolitan area. Examinations could be conducted by State motor-vehicles departments, which are already equipped to test applicants for a normal driver's licence, or possibly by State occupational licensing authorities, or through TAFE colleges, some of which offer courses in taxi driving.

These recommendations are aimed at protecting consumers from matters that might otherwise be beyond their control or knowledge. They do not constitute the re-emergence of regulation under a different guise, as the key competitive factors relating to taxi operation would still lie entirely with individual operators. Certification should be designed only to protect the public, not as a back-door method of

controlling entry into a deregulated taxi industry. As it could be implemented through existing public and private infrastructure, its costs would be moderate, and could be recovered as charges on taxi operators. The impact of these charges on taxi fares should be minimal.

Avoidance of mechanisms for the creation or protection of monopoly rents. The substantial benefits of deregulation with respect to entry conditions and fare controls could be lost if monopoly controls remain or emerge in other key parts of the package after deregulation. Thus, it is essential that any new entrant into the market should have access to credit services and communications facilities, and that care be taken to ensure that new communications technologies cannot be captured by any one particular group such that it develops significant monopoly power in the market, or repressed by those with an interest in maintaining the pre-deregulation status quo.

In particular, in the short to medium term those who control radio networks must not be able to use their power as owners of a commercially essential facility to become de facto controllers of parts of the taxi market. If existing cooperatives were to exclude new entrants, taxi users who relied on phone bookings would be cheated of the benefits of competition. Equality of access to a radio network must therefore be guaranteed for all new entrants who can meet their fair share of the costs of running the facility. To achieve this, radio networks could operate independently of taxi cooperatives, although this could lose any benefits of integration and scope economies available through the joint provision of these two services. It is more important, however, that drivers who chose to remain members of existing radio networks should retain the commercial freedom to adopt additional new communications.

The traditional form of payment for taxi services has been cash, with some large users maintaining credit accounts. However, because of the advent of the Cabcharge credit system, to which most of the major taxi groups belong, cash fares from regular and corporate users of taxis services are now relatively uncommon. That Cabcharge is regarded almost as a universal currency among taxi drivers is clear from the emergence of a secondary market in Cabcharge vouchers. In this market, owners who do not belong to an officially accredited Cabcharge group accept Cabcharge vouchers, and then find acquaintances in the industry to cash them in for them, or sell them to other drivers at a discount, or exchange them for fuel or other vehicle services. In addition, some fleet owners who see cost advantages in remaining independent or having most of their cabs affiliated with a non-Cabcharge-accepting cooperative, affiliate one of their cabs to a Cabcharge-accepting group and through it submit for payment Cabcharge vouchers from all their cabs.

After deregulation, access to Cabcharge could be denied to new entrants, with a view to putting them at a competitive disadvantage *vis-à-vis* incumbent operators; and operators who wanted to offer credit systems in addition to Cabcharge could be threatened with the loss of their Cabcharge franchises. These possibility are made

even stronger by the fact that Cabcharge is owned jointly by the major radio companies.

Fares. With taxi operators setting their own fares in a deregulated market, some supervisory mechanism would be necessary to ensure that taxis display prominently, both inside and outside, the current flagfall and distance charges.

Fares could increase after deregulation for taxis offering superior standards of comfort and accessibility, but with posted fares passengers could tell at a glance whether the cab's standards matched the posted price. A range of available prices, with drivers free to change them at will, and customers free to choose their desired price/service combinations, would be signs of competition at work.

It should not be expected, therefore, that in a deregulated taxi market all taxis would have the same fare structure. The range of prices would reflect varying degrees of product differentiation as the taxi market evolved into quality-based segments (for example, customers might be asked to pay more for an air-conditioned taxi). In addition, different drivers may have different goals, and different estimates of market demand conditions, so that posted flagfall and distance charges could vary between taxis, both at any given instant as well as from time to time as drivers respond individually to market forces of supply and demand.

Compensating the Losers

Should plate owners be compensated for the consequent fall in the value of their plates? Apart from the establishment of driver and vehicle certification procedures, compensation is the only significant hurdle standing in the way of immediate and total deregulation.

Governments might buy back plates after deregulation, in the interests of equity and fairness, but it would not be easy in practice to devise an equitable compensation scheme for current plate owners. In theory, this could be done if it could be shown that the gains from deregulation outweighed the losses in plate values. But in practice the mechanics of compensation are fraught with difficulties. A variety of mechanisms exists for compensating plate owners, each with different implications for the distribution of the capital loss. Compensation could be based on the original purchase price, as adjusted for inflation, the current market price, or some average of past values. The Industry Commission (1994:Table B4.1) estimates that the total value of plates in December 1993 was $2.5 billion. Anything short of full market value compensation would be politically difficult; but the social opportunity cost of such payouts at a time of high budget deficits may render full compensation neither possible nor even socially desirable.

There are other difficulties. Should all plate holders be compensated equally? Should people who bought plates many years ago not be compensated, as they have enjoyed the opportunity to earn monopoly rents, whereas recent purchasers who have not been able to recoup their investments should be compensated more highly? But how should account be taken of the fact that there has been speculation for some time now that the taxi industry might be deregulated, and that the

purchase price of plates in recent years might accordingly have reflected a discount to allow for that risk?

One possible solution is to tax the users of taxi services, but only for sufficient time to buy out existing plate holders at the lowest price thought to be politically feasible. A fund could be set up to buy out the existing plates, the fund being repaid by revenue from a tax on fares. The advantage of this proposal is the time limit placed on the burden borne by consumers. The disadvantage is that for some time taxi users will continue to carry the deadweight costs of regulation, thereby considerably negating the benefits of deregulation. A variation on this proposal would be an industry restructuring fund, financed by a levy on all annual taxi licences under a deregulated market, with existing licence holders able to apply to have their licences bought back. Applications could be dealt with by ballot or in some order of precedence (the rules for which would be controversial), with payments continuing until the fund is exhausted (Bitter, 1991:7). Under such a scheme, the industry pays for the buy-back of licences, although it is likely that the levy would be reflected, in a free market, to some extent in increased fares.

Other compensation possibilities were suggested by the Industry Commission (1994:Section B4.7). The industry could be gradually deregulated by selling new licences, equal to 5 per cent or so of the existing number of licences, say, every six months. Licence values would be reduced over time (although, depending *inter alia* on the rate of inflation, market demand for taxi services and the rate of increase of new licences, they might not change much in monetary value, even though the real value might fall), allowing the losses to be amortised by existing operators (Cousins & McGinley, 1985:10). Sale proceeds could be redistributed to current licence owners.

Although deregulation of taxi markets would result in substantial net benefits to the users of taxi services in general, it is not necessarily true that all users would gain by the same amount, or that there would not be any losers. The current owners of plates would lose as the capital values of their licences virtually disappeared overnight. And if it is thought politically appropriate to subsidise these losses in some way, the payments would need to be financed either through general tax revenue, creating distortions and deadweight losses, or by a specific short-run user tax on users of taxis, forcing those who gain from deregulation to help provide compensation to licence holders for the capital losses that they will have incurred.

Conclusion

The seeds of deregulation have already been self-sown in the taxi industry. Innovative entrepreneurs have sought to lift themselves above their less progressive rivals by introducing new taxis, new services and greater levels of convenience and comfort for passengers, and by adopting new technologies. These operators stand to benefit most from deregulation.

Deregulation would significantly change the industry. Although the number of taxis on the road would almost certainly increase, especially in peak hours, New Zealand experience suggests that fares may not fall as much as might be anticipated.

In addition, fares may cluster quite tightly around an industry 'norm' not because of collusion but because of the inherent forces at work in competitive markets. The market would probably still have for some time as its organisational focus the value of association with a radio network. This factor, together with access to Cabcharge credit facilities, holds the greatest potential for the maintenance of anti-competitive practices by incumbents as they try to forestall the competitive process in the taxi industry.

There is not likely to be a shortage of new entrants, as sunk costs are low; new providers of what might have been termed essential facilities could appear; and the competitive process would generate new ideas and mechanisms for providing information to consumers and for offering a range of services and prices. There is no case in a deregulated market for either an upper or a lower prescribed limit on fares. Upper limits inhibit entrepreneurial behaviour, resulting in less differentiation of taxi services than is socially optimal, and provide a benchmark below which taxi operators might not compete. Lower limits thwart the effective operation of the competitive process.

Consumers have suffered from taxi-market regulation in Australia. As communications technologies have developed, market forces have begun to assert themselves, offering consumers more choice and better taxi services. But until the barriers to free entry and independent behaviour by taxi operators are removed, and the streets opened up to competition, consumers will continue to be taken for a ride.

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Statutory Power and Agricultural Marketing: The New Zealand Experience

Veronica Jacobsen and Grant M. Scobie

The marketing of a major share of New Zealand's exports is conducted within a regulatory structure that has been in place for much of this century. Agricultural exports account for more than 70 per cent of New Zealand's total merchandise exports. Of these, more than one half are influenced by statutory powers. Under these powers, agencies have been established whose functions include significant holdings in commercial ventures, R&D, promotion, quality control and the setting of standards, allocation of access rights, and varying degrees of control over exporters (almost complete in the case of apples and pears and dairy products, partial in the case of meat, and minimal in the case of wool). Until just three years ago, price stabilisation was another of their functions.

This pattern of intervention has created a regulatory environment that restricts choice, limits competition, creates barriers to entry, encourages wasteful rent-seeking and generates signals that distort the way scarce resources are allocated (ACIL, 1992; Finlayson, 1993). Moreover, agricultural marketing regulations affect the way in which resources are used throughout the economy generally, creating a broad spectrum of stakeholders in the performance of agricultural marketing. Over the last decade, farming interests have contributed to the process of reform in non-farm sectors in New Zealand. In the same way, other sectors may legitimately consider the appropriateness of statutory power in agricultural marketing.

How can the persistence of agricultural marketing regulations be explained, especially in view of the substantial deregulation of New Zealand's economy over the last decade? And if a case is established for some type of intervention, what form might it best take?

Historical Background

Statutory marketing arrangements in New Zealand have a long history. The Dairy Industry Act 1892 was the first of a series of statutes — such as the Meat Export Control Act 1921/22, the Fruit Control Act 1926, and the Wool Board established in 1944 — that eventually covered most of New Zealand's agricultural exports. They had different powers but all were backed by legislation. The creation of the Kiwifruit

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Authority in 1977 continued the established pattern and extended it to non-traditional exports.

Almost without exception, the marketing agencies were set up in response to depressed prices. Little if any analysis was undertaken of the underlying causes, nor was any consideration given to other possible policy responses. Producers, dissatisfied with the returns they were receiving, felt typically either that international prices were inequitable, or that their shares of the world price were unjustly low. Producer-controlled statutory marketing authorities seemed the appropriate response to both problems, by providing producers with countervailing market power and enabling them to avoid the excessive costs imposed by 'middle-men'.

But what explains the persistence of the statutory powers for agricultural marketing? One explanation, an 'efficiency hypothesis', is that they are a response to market failure that lead to more efficient outcomes, and are hence justified by reference to the public interest. Another explanation is that, like all interventions, statutory powers for agricultural marketing create winners and losers, and that the winners succeed in the political market in having statutory powers retained at the expense of the losers. These two explanations are examined in turn.

The 'Weak Selling' Explanation

The traditional case for statutory power in agricultural marketing is that it is a response to 'weak selling', a form of market failure. According to the chairman of the Apple and Pear Marketing Board, weak selling occurs when 'an exporter . . . accepts a lower price than that which could, and should have been achieved. This action could also result in a generally lower price level being established for that product across the market' (Pope, 1988:39). The concern is that there exists a market premium that, in the absence of state-imposed collusion, will be eroded away by competing New Zealand suppliers.

Yet the fact that the observed price is low (however that might be measured) cannot of itself be taken as evidence of weak selling. The market price actually paid is composed of three elements. The first is the underlying element of price that reflects the supply and demand conditions in the market at the time. The second is a premium for value added through quality, packaging, delivery, credit or goodwill. Third, there may be a premium for market power, which economists call a 'monopoly rent'.

A particular seller or selling country is typically unable to affect the underlying market conditions that lead to a low price. However, it is possible to attain a higher price in the market through the provision of marketing services or value-adding activities. There is nothing intrinsically superior about attaining a higher price in this way: 'price premiums clearly can be obtained from market differentiation backed up by services targeted on those markets' (Industry Commission, 1991:46). Whether the pursuit of such premia is justified is a commercial decision best left in the hands of individual exporters.

This leaves the third component of price — monopoly rent — as the only legitimate concern in the weak-selling debate. It is true that if there exists some market power that might be exploited to enhance returns, failure to restrict access can result in

the dissipation of the rent by competing suppliers. Were New Zealand to be the only supplier of a particular product for which consumers had few if any substitutes, then the standard argument for an optimal tariff would apply. That tariff, or, more precisely, export tax, should be set so as to capture the benefits of the monopoly power. The size of the tax, whose purpose would be to restrict supplies to the export market, would be inversely proportional to the (absolute) elasticity of demand faced by New Zealand exporters.

Such evidence as there is (Scobie, 1973) indicates that New Zealand is not so blessed. But suppose for a moment that it was. In order to capture the premium for market power, that power must be exercised. Its only form of expression is through the ability of New Zealand suppliers to act as a cartel to reduce supplies. On the presumption that New Zealand's share is significant enough, then the world price would rise. However, such a rise could be sustained only if there were restrictions on domestic supply. No board actually operates any explicit form of supply control. They accept whatever quantity producers offer. If they are successful in extracting a premium that is passed to producers in the form of higher prices, this will elicit more, not fewer, supplies. Attempts by the Kiwifruit Marketing Authority to restrict the export supplies through severe quality standards have arguably led to a higher per unit price for New Zealand suppliers. But that is a reflection of a quality premium (albeit one that is artificially induced) rather than of the genuine exercise of market power.

Were the boards to control domestic supplies (which they do not), extraction of market premia would still require two other conditions to be fulfilled: that consumers lacked substitutes, and other suppliers would not respond to the higher prices induced by the New Zealand cartel. The nature of New Zealand's agricultural exports are such that it is improbable that such conditions apply. Zwart and Moore compared prices received for a range of New Zealand exports with those received by other countries. They concluded, 'the evidence . . . while limited, does little to support the notion that they [the boards] have provided increased returns to New Zealand producers' (1990:272). Kraft, Piggott and Wright conclude that 'any premia which are achieved [in rice exporting] are most likely payments for the services embodied in the Australian product rather than "pure profit" associated with monopoly power' (1991:ix).

The Industry Commission (1991:49) notes,

> . . . export licensing or single-desk selling themselves can impose costs, since they limit market entry and can prevent competitive pressures from ensuring that sales into premium markets are undertaken at least cost. . . Thus the objective of capturing a market power premium on export markets through controls on competitive access would only be sound if any extra costs imposed by those controls were less than the extra income obtained.

So even if statutory intervention could capture market premia, it might still be more costly than the market failure it was designed to cure.

The structure of statutory monopolies suggests that it is. Such bodies have the power to coerce growers to pay levies. The open palm and iron fist foster a cost-plus

mentality, and raise problems about accountability to growers (Weir, 1992). Moreover, the ownership of the boards by growers is illusory: growers do not have tradable assets reflecting their equity in these organisations (Ireland, Wallace and Associates, 1994). Commercial accountability permits owners of firms to assess the performance of a company, and to act by trading shares. With no commercial mechanisms for owners to control managers, second-best political accountability prevails. And statutory monopolies have few incentives to be efficient, since it is competition that drives firms to seek new, profitable opportunities such as new apple varieties and new lower-cost methods of production to stay in business.

The costs of intervention are not always obvious. Statutory monopolies deter new entrants, and the unborn can raise no voice in opposition. Not only are the potential entrants themselves denied the opportunity to make profits, but growers are denied the benefits of competition among providers of farming services. It is the growers who should ultimately decide whether the services offered by a competing exporter are superior to those provided by the board.

Statutory monopolies also stifle the emergence of new organisations that could offer the same or similar services at lower prices. A particular problem is that producer boards act as both players and referees. The Meat Producers Board owns commercial ventures, yet influences the access to markets through the Meat Planning Council and has the ultimate power of sanction through its delegated statutory power to issue licences. The Apple and Pear Marketing Board has held a complete monopoly on apple and pear exporting. As a result of the Producer Boards Amendment Act 1993, it now sets guidelines and issues licences for competing exporters. Predictably, the guidelines are set, not to ensure efficiency, innovation and higher returns to growers, but to preserve the monopoly position of the board, which can use its role as referee to deny applications.

If New Zealand's agricultural markets are not characterised by serious failure, and if statutory intervention is costly, the 'public interest' explanation for the persistence of that intervention would appear to be refuted. In contrast, the alternative explanation, which stresses the role of private interests, seems much more consistent with the facts.

The Private Interest Explanation

The private interest explanation of the persistence of regulation focuses on the incentives that the state provides for some groups to invest in the political market in order to capture benefits in excess of those that an unfettered market system would have provided. This view of economic regulation, which emerged from the law and economics school (Stigler, 1971; Peltzman, 1976), has increasingly been used to obtain insights into agricultural-marketing regulatory system (Rausser, 1982; Sieper, 1982; Scrimgeour and Pasour, 1994).

The explanation proceeds from the fact that there are always gainers and losers from the use of the state's coercive power. Typically, the benefits are concentrated among a relatively small number of well-organised and vocal supporters, whereas the costs are generally obscure and diffused among a large number of people. Because the costs imposed on each are small (or even unknown) relative to the costs of lobby-

ing, opposition is often weak and disorganised, even though the overall costs of the intervention may exceed the benefits. Inefficient and inequitable legislation may flow from legislators providing special status to effective interest groups who can help their electoral prospects. Edwards (1993) paints a clear picture of the political markets that control regulation in the Australian primary sector.

Where political rents are available, competing groups use resources to obtain and preserve favourable policies, and to oppose unfavourable ones. Each group has an incentive to spend up to the amount it expects to gain from its quest. Such activity is wasteful because it not merely transfers benefits and costs from one group to another, but uses up resources that could be profitably spent elsewhere. The grower levies used to fund publicity campaigns and to lobby politicians have an opportunity cost in terms of on-farm and off-farm investments.

Current attempts to reform the boards have met with limited success. Some decisive political moves by the Labour government in the late 1980s did result in the deregulation of the town milk, eggs, wheat and flour sectors (Sandrey, 1990). Notably, all of these were non-traded or importable goods. Reform is proving much harder for the major export industries. Reforms face 'the inherent conflict between the pursuit of economic efficiency and the domination of the boards by producer representatives, who will inevitably be preoccupied by short-term political agendas as they seek to placate their constituents in farm organisations and keep the peace with politicians on whose favours their powers depend' (Watson, 1990:9).

It is not hard to find private-interest reasons why producers would support statutory powers in agricultural marketing. One is the expectation that at times of extreme adversity the state will use taxpayers' money to bail growers out. An implicit government guarantee shifts the risk of poor decision-making by producers' boards from growers to taxpayers. This 'insurance benefit' may well offset the costs of statutory power to growers. Certainly the writeoffs of debts accumulated by poor commercial judgments have been very substantial. Again, the boards allegedly protect growers from exploitation by greedy 'middle-men'. By maintaining ownership and control of processing and channels, growers feel they avoid the risk of exploitation.

However, growers' support for statutory intervention may well be artificially sustained by the boards' sophisticated public relations and control over information. The boards use the producers' own funds to convince them that their returns would fall were the boards to lose their statutory powers. Significantly, their support falls when alternative sources of information are available to producers, or when boards react strongly to counter unflattering external views of the their performance. Yet the information that the boards supply is simply not sufficient to enable to growers to assess their performance. The use of proxy indicators, such as price per unit rather than profitability to the grower, obscures their effect on the bottom line. 'Bundling', in which the profits of commercial activities are distributed as part of the price that dairy farmers receive for their milk, gives a distorted picture to growers of the board's performance. At present they have no way of distinguishing the effects of their own efforts as suppliers from the performance of their cooperatively owned processing and marketing facilities, or from conditions in world markets. They receive a return to

their own labour and capital that is bundled together with that of returns to their off-farm investments (Hussey, 1993).

Is Any Intervention Warranted?

The economic climate, both domestic and international, is now very different from that which prevailed when the majority of the existing marketing structures were set up. In the domestic economy, the role of the state in commercial activity has been reshaped. Corporatisation or privatisation has occurred in areas where the state was traditionally the sole equity holder, maintained a monopoly position and operated with a direct line to the national fisc to cover operating losses. Social-policy goals have largely been separated from commercial activities. Decisions on investment, capital structure, pricing and marketing are now freed from political dictates, and can be driven by the need to generate market returns from providing improved services. Wage setting has been depoliticised, and employees and employers have considerable freedom in establishing contracts that serve the interests of both. In short, the provision of services is now largely a matter for market forces. Any past justification for the need for agricultural marketing agencies backed by statutory power in order to provide producers with countervailing bargaining power has been removed by the liberalisation of the domestic economy.

A parallel burgeoning of market forces in the international economy, while arguably less complete than that within the New Zealand economy, has altered dramatically the conditions facing the agricultural processing and marketing sectors. The rapid growth of international trade, the greater diversity of products and market destinations, the integration of global capital markets, and the continuing economic growth in Asia expanding the demand for imported agricultural products from the temperate zone, have all combined to change the nature of the international market place. No longer is a limited range of agricultural exports directed principally to a single market. In an increasingly competitive international market, success depends on innovation, the development of new markets and products and associated services, and the formation of alliances with other players.

To what extent are the existing regulatory mechanisms, designed to address very different circumstances in both the domestic and international operating environments, still appropriate? The most obvious candidate for continued intervention is investment in R&D. To the extent that there are benefits that cannot be appropriated by providers of R&D services, there can be a case for collective action. New Zealand has recognised this need with the Commodities Levies Act 1991, a generic statute that allows any group, following a referendum of its constituents, to raise levies. Recent evidence from the grain industries suggests that rural trusts formed on a purely voluntary basis can be used to fund R&D.

Beyond this, the case for statutory powers appears thin. Any group of investors can initiate a commercial venture if they believe the returns on such an investment are comparable or better than those they could command in alternative activities. Many industries impose their own quality standards and arrange their own generic promotion without statutory backing. A role for continued generic promotion of increasingly

differentiated products produced by different companies would seem to be open to question. The combined efforts of wine producers to levy themselves voluntarily to promote New Zealand wines in Britain suggest that statutory intervention is not a necessary precursor to generic promotion by exporters.

Currently, export quota rights are allocated by the Meat Planning Council under the authority of the board. In contrast, quotas for international trade have traditionally been allocated by the Ministry of Commerce. This Ministry ran the system of licensing and import quotas for New Zealand, and the revenue generated by tendering went to the Crown, not the footwear or textile industry.

In short, it is not clear that any net loss of national income would follow from the abolition of producer boards' powers. Adequate mechanisms already exist to assume certain functions. The rest are either commercial ventures or the lobbying activity of any industry group.

The Future

The last decade has seen a significant shift in the approach to statutory intervention in economic activity. In the past, reliance was placed on *prescriptive legislation* setting out particular goals, specifying how activities were to be controlled and disputes settled. The Acts setting up producer boards are of this type.

There is a growing awareness that granting powers to monopoly boards, with extensive reliance on accountability to Ministers through the political system, may be neither necessary nor efficient. In contrast, *enabling legislation* provides a framework within which individuals and groups have greater flexibility to develop mutually beneficial arrangements for allocating resources and resolving disputes. This approach is reflected in the Employment Contracts Act 1991, the Companies Act 1993, and the Commodity Levies Act 1991. This type of legislation has the potential to provide a stable framework in which voluntary transactions can take place. The evidence mounts that such an approach could enhance efficiency and accountability in the provision of marketing services for New Zealand's agricultural exports.

The persistence of inefficient statutory power can be explained only by reference to gains to special interests. However, the new domestic and international operating environment will increase the costs of intervention over time, and make them ever more obvious. Several sources of pressure signal change. Potential entrants, such as Applefields, seek to compete with statutory authorities. Producers appear to be increasingly disillusioned with the performance of the boards. A lobby group, Farmers for Change, has sought changes to the electoral procedures for grower representatives in an attempt to enhance accountability. Meanwhile, growers of fine wool have been attempting to make the Wool Board better reflect their interests. Consumers who have benefited from the freeing up of the domestic apple market and the town milk supply are increasingly aware of the benefits of deregulation.

Just as efficient markets are irrepressible, inefficient legislation is unsustainable. As the costs become apparent, pressure by lobbyists becomes irresistible. The boards are creatures of political markets. It will be economic forces operating through those same political markets that will result in change.

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Getting into Bonds

Ian R. Harper

In early 1994 there was substantial turmoil in international bond markets. Bond prices slumped, sending yields (interest rates) on bonds and related financial instruments soaring. Bonds denominated in Australian dollars were caught up in the rout, as a result of which interest rates on long-term government bonds in Australia rose from 6.35 per cent in January 1994 to 9.35 per cent in August 1994. Rising long-term bond yields eventually induced the Reserve Bank of Australia to raise short-term interest rates (tighten monetary policy), a move which saw a subsequent brief rally in bond yields.[1] Figure 1 shows the recent history of long-term bond yields in Australia and a selection of other developed countries.

Many people believe that price instability connotes market irrationality. Rational prices, it seems, must always be stable. The sharp movement of bond prices in 1994 has been interpreted in some quarters as a speculative bubble that could not have been 'driven by fundamentals'. The implication is that markets were seized by a wave of hysteria and temporarily broke loose from their rational moorings.

Financial economists do not dismiss the claim that markets are subject to bouts of irrationality. Indeed, the technical literature recognises that asset price bubbles (departures from fundamentals) may even be rational.[2] The difficulty lies in distinguishing bubble behaviour from sudden changes in the fundamental determinants of asset prices. If there is good reason to believe that 'fundamentals' might have changed, the hypothesis of bubble behaviour becomes less plausible.[3]

But whereas the notion of asset price bubbles, rational and irrational, has a respectable intellectual foundation, the view, held by some commentators, that asset markets are mere casinos in which 'high rolling' speculators drive prices from pillar

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[1] Since the market price of a bond is the discounted present value of a stream of future cash flows, bond prices move inversely with interest rates or yields. A period of falling bond yields is referred to as a 'rally' since it corresponds to rising bond prices.

[2] See LeRoy and Gilles (1992) and Weller (1992) for discussions of rational and irrational asset price bubbles.

[3] Garber (1994) re-interprets two famous historical episodes of alleged bubble behaviour — the Dutch tulip mania and the South Sea bubble — and concludes that they were entirely the result of sudden changes in fundamentals rather than departures from fundamentals.

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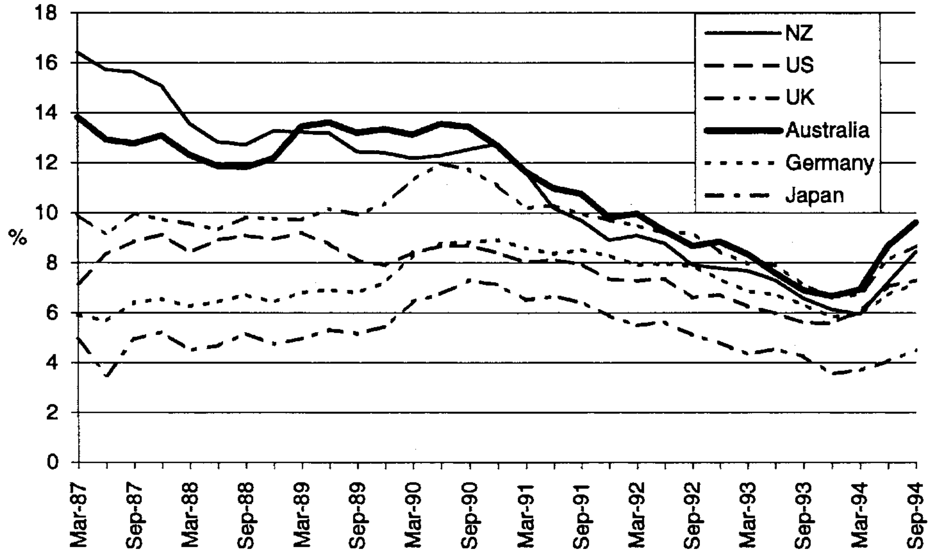
Figure 1

Long-term bond yields in Australia and selected countries, 1987-94



Source: Reserve Bank of New Zealand.

to post for their own financial gain, does not. For these observers, the idea that fundamental economic forces play any role in asset price determination is akin to admiring the emperor's new clothes. There are many obvious differences between a gaming casino and the international bond market. For example, whereas participants in gaming casinos expect (statistically speaking) to lose money, bond traders expect to make money, and generally succeed in doing so. Casinos play no role whatsoever in the allocation of society's scarce resources amongst competing productive enterprises; they represent pure consumption. Asset markets, on the other hand, and bond markets in particular, are financial switching mechanisms, directing resources towards those enterprises most highly valued by the investing public and away from those considered less profitable. There is a world of difference between the (creditable) claim that asset prices occasionally depart from fundamentals and the (discredited) claim that there are no fundamentals to depart from!

This article seeks to provide some background on bond markets for the general reader.[4] In particular, it describes institutional aspects of bond markets and the mechanics of government bond issue in Australia. Rather than adjudicate on whether or not bond prices are subject to bubble behaviour, an issue that requires

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[4] Several textbooks treat the subject matter of this paper in even greater detail. Jüttner (1990) and Davis and Lewis (1993) are two popular examples.

more than passing familiarity with a highly technical literature, the article proceeds from the orthodox perspective that bond prices reflect fundamentals. It then asks what fears and/or expectations might have been responsible for the bond price collapse of recent times. We begin, however, with some basic facts about bonds and their economic function.

Debt and Taxes

A 'bond' is a debt instrument. It represents an agreement on the part of a borrower (the issuer of the bond) to make a series of regular payments ('coupons') to the lender (holder of the bond) plus a final repayment of the principal (face value of the bond) at a specified maturity date. The difference between bonds and other types of debt instrument, such as mortgages, is that bonds are always tradable. Bonds are designed to be exchanged, so that the original lender of funds who purchased the bond when it was first issued may not be the same party to whom the principal is paid upon maturity.

The tradability of bonds implies that a bondholder need not wait until the maturity date in order to 'get his money back'. Sale of the bond part-way through its term will return principal and accrued interest to the lender. If bond prices have risen in the meantime, reflecting lower interest rates available on alternative investments, the bondholder may even make a capital gain on his investment. For the borrower's part, she is indifferent to the identity of the lender and simply needs to know in whose favour the cheques for coupon payments and principal should be drawn.

Bonds can be held in one of two forms: as bearer securities, or as inscribed stock.[5] The advantage of inscribed stock over bearer securities is that a record of ownership is kept at a central registry. Thus, title to the bonds is not affected by loss or theft of the bond certificates. Ownership of bearer securities is evidenced by physical possession of the certificates, leaving them vulnerable to theft or accidental destruction. On the other hand, bearer securities leave no traceable record of transaction or ownership, which makes them popular with bondholders who wish to avoid entanglements with regulatory or taxation authorities.

Traditionally, the most active sellers of bonds have been governments, which sell bonds to finance expenditure in excess of their taxation revenue. There are only three ways for a government to finance its expenditure: taxation, sale of bonds (borrowing from the public) and printing money (borrowing from the central bank).[6] Responsible governments avoid the third of these alternatives except in

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[5] While this is true in principle and also in practice in international bond markets, Australian government bonds are no longer issued as bearer securities.

[6] A fourth way in which governments finance expenditure is through the sale of public assets, such as public trading enterprises. Under the cash accounting conventions adopted by most Western governments, however, the proceeds of asset sales are regarded as negative expenditure rather than financing transactions. There are therefore only three ways of financing *measured* government expenditure.

dire necessity.[7] Borrowing from the public via bond sales should also be kept within limits on account of the adverse impact on private-sector fund-raising (the 'crowding out' problem).

The great bulk of bonds traded on Australian bond markets are issued by the different levels of government and their associated public authorities. The (domestic) market for corporate bonds opened only as recently as 1987 with the first local issue of unsecured notes by BHP Finance Limited. Since then, the market has developed strongly, following the growth of mortgage securitisation and the issue of subordinated debt by banks. But it is still small relative to the market for Commonwealth and semi-government debt.[8]

On the other side of the market, the main purchasers of bonds are financial institutions, especially managed investment funds. Bonds are attractive to investors for three reasons: they offer a predictable income stream extending over a long period of time; there is, generally speaking, a low risk of default by the bond-issuer; and, because of their long maturity, bonds offer good prospects of capital gains as bond prices move in response to changes in general economic conditions.

Financial institutions that issue long-term liabilities, like life insurance companies and pension (superannuation) funds, seek long-dated securities to hold as assets against their liabilities. They are natural investors in bond markets. Banks and depository non-bank financial institutions also hold bonds under regulatory requirements imposed upon them to hold a proportion of their asset portfolios in the form of 'prime assets'. Mutual funds or 'unit' trusts assemble portfolios of bonds and/or other financial assets against which they issue shares or 'units' to the public. This is an increasingly popular vehicle whereby individuals participate directly in the income and capital-growth opportunities available in domestic and international bond markets. Some bond market mutual funds in the United States are larger than most commercial banks.

Eurobonds

The greatest fillip to bond trading internationally came with the development of the Eurobond markets beginning in the 1960s. Technically speaking, Eurobonds are bonds sold by foreigners into a domestic market which are denominated in either their own or a third currency. Thus, bonds issued by BHP into the London market and denominated in Australian dollars or US dollars would qualify as a Eurobond issue. The reference to Europe merely reflects the history of these instruments, which dates from the Vietnam War and the associated growth of foreign-domiciled US dollar bank balances. Restrictions on capital inflow into the United States

[7] It is, of course, appropriate for the central bank to allow the money supply to grow in line with the increasing demand for money occasioned by the growth of the economy. This is effected by central bank purchases of securities (domestic or foreign government bonds) in secondary markets. As explained below, financing the government's budget deficit and managing the growth of the money supply are both conceptually and operationally distinct.

[8] For more detail on the Australian corporate bond market, see Bruce et al. (1991:216-17) and Davis (1993:275-7).

through traditional banking channels around this time also spurred the search for alternative means for US corporations to raise funds abroad. In the intervening 30 years, the Eurobond markets have flourished, producing an amazing variety of bonds and bond-like instruments. Many Australian corporate and official borrowers have tapped the Eurobond markets, either directly in their own names, or in association with banks.

Although the bonds traded in international markets are many and varied, especially in the Euromarkets, they share certain common features:

- most bonds have a specified maturity date[9] and are issued for terms of at least one year;[10]
- most bonds carry coupons payable at regular intervals (annual or semi-annual);[11]
- coupons are either fixed as a proportion of the face value of the bond or vary in line with a published international interest rate (e.g. the London Inter-Bank Offer Rate);
- as debt instruments, bonds confer no equitable interest in the borrower upon the lender, although bonds may be 'convertible' into equity on specified terms;
- bonds can be denominated in any currency, including currencies foreign to the country of domicile of both the issuer and the bondholder, and there is no need even for coupons and principal to be paid in the same currency; and
- bonds are rated by international bond rating agencies according to their perceived risk of default, those failing to reach the minimum rating necessary to qualify as 'investment grade' being known colloquially as 'junk bonds'.

Australian Bonds

Bond prices in Australia are heavily influenced by two factors: borrowing decisions of the Commonwealth government and bond prices struck in offshore markets (most especially, the United States).[12] Bond prices vary with the perceived riskiness

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[9] Bonds without a specific maturity date, so-called 'perpetual' bonds, are not unknown but are extremely rare.

[10] Tradable debt instruments issued for terms of less than one year are referred to as 'bills' or 'notes'.

[11] Bonds without coupons are known as 'zero coupon bonds' or 'zeros'. The coupons attached to a 'straight' bond (a bond whose coupons are fixed rather than variable) can be 'stripped' and sold separately, thus creating a zero coupon bond synthetically.

[12] While bonds issued in different currencies are not perfect substitutes, they are close substitutes, once allowance is made for exchange-rate risk. The prices of bonds in different national markets should therefore move in sympathy with one another, again allowing for changes in the outlook for exchange rates.

of the issuer. Generally speaking, sovereign borrowers (governments) have the lowest perceived risk of default.[13] This is because governments possess the sovereign right to raise revenue through taxation. Short of revolution, governments can use their coercive power (backed by military force) to extract tax revenue from their citizens. Furthermore, responsible governments go to great lengths to avoid defaulting on their obligations, both to ensure their own continued access to bond markets in future and so as not to disturb the waters for private borrowers within their jurisdictions. All of this paints governments a deep low-risk hue in the eyes of potential bondholders.

Private agencies (like Standard & Poors and Moody's) specialise in rating the riskiness of bonds. Not surprisingly, government bonds are ranked among the least, if not *the* least, risky of all bonds traded on bond markets. The risk rating awarded to a sovereign borrower is important not just because it influences the price of government bonds but because the rating of the sovereign will influence the prices of all bonds, private and public, denominated in the currency of the country in question. The price of sovereign debt sets a floor for the prices of all other debt denominated in domestic currency.

Commonwealth Government Debt: The Mechanics

The Commonwealth government issues bonds to finance its budget deficit and to meet repayments of principal on maturing debt. Sales of bonds to finance the budget deficit add to the stock of outstanding debt, whereas sales of bonds to meet amounts due on maturity serve to refinance part of the existing stock of public debt. In its capacity as the Commonwealth government's banker, the Reserve Bank of Australia assists the government to plan the issue of new bonds into the market. Commonwealth bonds are sold at irregular intervals by public tender and in lot sizes determined by the Commonwealth Treasury in conjunction with the Reserve Bank.

Commonwealth bond tenders are auctions at which licensed bond dealers submit bids to purchase various parcels of bonds at specified prices (yields). The Treasury accepts bids in ascending order of yield (that is, it sells bonds to those who bid the highest prices first, and works down the list of bids). In this way, the government ensures that its debt is financed on the most attractive terms available in the market. The maturity structure and coupon rate of the bonds tendered for sale is determined by the Treasury in consultation with the Reserve Bank. From time to time, the Commonwealth government has issued bonds denominated in foreign currency directly into international bond markets. It has even placed debt privately with large individual and institutional investors offshore. In recent years, however, the Commonwealth has redeemed most of the outstanding stock of its foreign-currency denominated debt and has not sought to reissue.

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[13] Governments of some less developed countries, especially in Latin America, are an obvious exception. Even in these cases, however, rates of interest on sovereign debt set a floor for rates on private debt raised in the same currency.

As a general rule, the Reserve Bank does not purchase Commonwealth bonds in the primary market (that is, newly-issued bonds). It may do so on occasion but only to replace stock maturing from its portfolio. By avoiding the purchase of newly issued bonds from the government, the Bank insulates the money supply from the impact of government deficit financing.[14] Were the Bank to make net purchases of Commonwealth bonds directly from the government, it would effectively finance the government budget deficit through the issue of its own liabilities. Since Reserve Bank liabilities represent money, such an exchange would be tantamount to financing the deficit by means of money creation. This practice is to be avoided since it is highly inflationary if conducted for any length of time.

On the other hand, the Reserve Bank is an active trader of Commonwealth bonds in the secondary market. By buying or selling bonds in the secondary market, the Reserve Bank raises or lowers the rate of growth of its balance sheet, which in turn affects the degree of liquidity in the money market. Such trading activity on the part of the Reserve Bank is referred to as 'domestic market operations' and constitutes the principal means by which the Bank administers monetary policy. As the Bank sells (buys) Commonwealth bonds, it engineers a shortage (surplus) of cash in the official short-term money market, which in turn places upward (downward) pressure on overnight interest rates and subsequently on interest rates further along the yield curve (i.e. on longer-dated securities).[15]

Deficits vs Surpluses

Whenever the government runs a budget deficit financed through the sale of new bonds to the public, the stock of government bonds on issue increases. Whether or not this increase is *real* depends upon the rate of inflation. If the rate of inflation exceeds the percentage increase in the nominal value of the outstanding debt, the real value of the debt declines. This provides a way to determine how much of an increase in the government's fiscal deficit is real and how much is nominal. One simply calculates by how much the deficit raises the real value of the stock of outstanding public debt.[16]

When the government runs a budget surplus, on the other hand, it repays outstanding debt. The more surpluses a government runs, the more it draws down the stock of its outstanding debt. Eventually, the public debt would disappear, and the government would begin to accumulate claims on the private sector.

When the Commonwealth government declared a series of budget surpluses in the late 1980s, it held 'reverse' bond tenders in order to repurchase outstanding debt. The Reserve Bank conducted the tenders on behalf of the government and repurchased Commonwealth bonds in descending order of yield (that is, the lowest priced bonds were repurchased first). Reverse tenders were also held overseas as

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[14] For a discussion of the separation of Commonwealth deficit financing from monetary policy, see Reserve Bank of Australia (1993).

[15] For a detailed discussion of the mechanics of monetary policy, see Carmichael and Harper (1994).

[16] For a discussion of real and nominal budget deficits, see Makin (1990).

the government sought to repurchase foreign-currency denominated bonds that it had issued into foreign markets.[17]

Bond Pricing

A 'straight' bond represents a sequence of cash flows of predetermined value at prespecified dates. A coupon payment will be received by the bondholder at regular intervals throughout the life of the bond together with a final coupon plus the principal upon maturity. This pattern of cash flows is perhaps the simplest available in modern financial markets, and is straightforward to price. Potential purchasers of such a cash flow discount the various payments at appropriate interest rates to calculate their present value, and add the different amounts together to obtain the market price of the bond.[18] The price of the bond thus represents the amount that would need to be invested today to generate the stream of future cash flows promised by the bond issuer at interest rates prevailing in the market at the time of purchase. Bond pricing obeys the classical principles of price theory: the market price of a bond is driven by the return available on the highest-valued alternative investment opportunity of equivalent risk available to potential investors.

Of course, as in standard price theory, such a price is the market equilibrium price. Can the price depart from its equilibrium value in real markets? Should the price of bonds rise above its equilibrium value, many borrowers will seek to issue bonds to take advantage of their low yields (indeed, to exploit the arbitrage opportunity implied by such a disequilibrium to borrow at the low bond yield and simultaneously invest at the higher interest rate available on the equivalent alternative investment). Similarly, should the price of bonds fall below its equilibrium value, many investors will clamour to purchase high-yielding bonds, if possible even short-selling the equivalent alternative investment, and in the process drive bond prices back towards their equilibrium value. It cannot be ruled out that bond prices depart from equilibrium (and hence that opportunities exist for riskless arbitrage in long-term funds markets), but powerful forces are thereby set in train to eliminate disequilibrium and return bond prices to their equilibrium level.

Bond Prices and Real Returns

Bond prices, like all asset prices, are underpinned by opportunity cost. The price of a bond is determined by reference to the most nearly equivalent alternative investment instrument. The same is true of a piece of real estate; it can be priced only by reference to what we know the market will pay, or has paid, for an equivalent site elsewhere. If bond prices change over time, it is because the returns available on alternative investments of equivalent risk change commensurately.

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[17] For more detail on the management of budget surpluses, see Harper and Pearce (1990).

[18] The interest rates used in this exercise are those applying to alternative investments of identical maturity that carry the same risk as the bond. Technically speaking, the interest rates used will be those drawn from the 'zero-coupon yield curve'.

One reason that bond prices move is that *real* returns available on alternative investments change. If the returns available on real investment projects rise, even if they are somewhat riskier than bonds, bond prices will be affected. Potential investors will be attracted by the higher real returns available outside the bond market and sell bonds in order to secure those higher returns. The net sale of bonds will accordingly induce a fall in bond prices (a rise in bond yields) until potential bondholders are satisfied that bonds are priced commensurately with the real returns available elsewhere.

Can a rise in real returns on alternative investments explain the collapse of bond prices earlier this year? It is unlikely to be the only explanation because real returns do not change suddenly. But expectations of such changes can be volatile. One source of uncertainty about real returns available in the world economy might be the rapid growth of China. The Chinese economy is growing at a rate in excess of 10 per cent per annum. China is the most populous country on the face of the earth, with about a fifth of the world's population. When a country of this size grows at such a blistering pace, the likely demands imposed on world capital markets are extremely difficult to predict. There is no historical evidence upon which to call in order to discern how strong a demand for capital such growth will precipitate, and how capital markets are likely to respond. The growth of China could touch off a worldwide capital shortage, in which case real returns available to investors would certainly rise. Underpinning these rises would be projects in China offering massive returns to investors based upon the exploitation of China's relatively underdeveloped economy and gargantuan domestic market.

China clearly has the potential to generate higher real returns to capital worldwide. The fear or expectation of this event might have gripped bond markets and could have assisted the sell-off of recent months. It might be more than mere coincidence that bond yields are rising as the world's largest nation embraces market capitalism and opens the throttle of economic growth.

Bond Prices and Inflation

A far greater source of volatility in bond prices, however, is inflation. The long maturity of most bonds renders their prices especially sensitive to expectations of changing rates of inflation and/or currency depreciation. The longer the maturity of a bond, the more its nominal payoffs (coupons as well as principal) are exposed to the potential ravages of inflation. Investors uncertain of the future effect of inflation and/or currency depreciation on the real value of a bond's cash flow will discount its present value (price).

Since expectations of inflation are closely influenced by the perceived independence of central banks from their host governments, the recent experience of New Zealand is instructive. Since 1989, the Reserve Bank of New Zealand has operated completely independently of the New Zealand government under a charter that defines its sole objective as the maintenance of low annual rates of inflation (0–2 per cent). The enhanced credibility of the Reserve Bank of New Zealand as an inflation fighter has substantially lowered expectations of inflation in New Zealand.

Commensurate with lower expectations of inflation, long-term bond rates in New Zealand have fallen steadily since 1989, falling below Australian long-term bond rates for the first time during this period (see Figure 1).

Heightened expectations of inflation could well have been fuelled, both in Australia and in the United States, by the prospect of a strong recovery in the world economy and by perceived laxity in Australian and US monetary policy. Whereas the Japanese economy is still mired in recession, the German economy has recovered surprisingly quickly and strongly. This, coupled with continued strong growth in the United States, has forced some upward revision of growth forecasts for the world economy.

While this would be sufficient by itself to fuel concerns over the outlook for world inflation, particular concerns have been expressed about the present and future setting of US monetary policy. Some analysts claim that the US federal funds rate (the key rate for the transmission of US monetary policy) should be 50–100 basis points (0.5–1 percentage point) higher than its current level. The fact that it is not, and that the Fed seems unlikely to raise the rate by this margin in the near future, has contributed to fears that US inflation will surge over the next 18 months to two years. These fears are exacerbated in some people's minds by recent appointments to the Board of Governors of the Federal Reserve System. Fairly or unfairly, the individuals concerned are regarded in certain quarters as inflation 'doves'.

At least the first of these concerns has also been expressed in Australia. Standard indicators of the stance of monetary policy (for example, the slope of the yield curve, or the difference between the yields available from short-term and long-term investments) were interpreted by some as requiring a tightening of monetary policy. Recent moves by the Reserve Bank to raise the cash rate (the Australian equivalent of the federal funds rate and the key transmitter of monetary policy in Australia) by a total of 175 basis points may have alleviated fears over the outlook for inflation. If so, long bond yields can be expected to stabilise or even to rally.

Widespread fears of future inflation are quite consistent with a bond market sell-off of the magnitude witnessed in the United States and Australia in recent months. It is a feature of high rates of inflation that they are volatile. The fear of a return to relatively high and variable rates of inflation in the medium term, on top of fears of a world capital shortage, could well have led investors substantially to discount future cash flows from bonds. Whether or not such fears are justified, however, is a matter about which economists are significantly divided in their opinions.

Bonds and Bubbles

There is a respectable and growing literature on the economics of price bubbles. The maintained hypothesis of this literature is that so-called 'fundamentals' are not the sole determinant of asset-price behaviour. In certain circumstances, asset prices can be subject to forces, rational or irrational, that lead them to depart from values implied by fundamental factors. Moreover, there may be no way of predicting when a bubble will form or when it will burst, which makes detection of bubbles in

empirical work extremely tricky. Even arch-rationalists of the 'efficient markets' school have conceded the existence of 'noise traders', traders who buy and sell on useless, irrelevant or false information and yet who survive to tell the tale. Fundamentals dictate that such traders would be stripped of their wealth by merciless arbitrageurs, poised to exploit ignorance and irrationality as soon as they spot it. And yet markets are simply not so perfectly arbitraged as the theory of efficient markets suggests. Prices can and do depart from fundamentals, whether rationally or otherwise.

Yet to concede the existence of bubble behaviour is not to imply that it is pervasive. Bubble theorists themselves admit the difficulty of empirically separating price movements based on fundamentals from those based on bubble-induced extrapolation. In any case, it is not necessary to resort to bubble hypotheses in order to explain recent behaviour in international bond markets. Of course, by the same token, one cannot rule out bubble behaviour. But there are reasonable grounds for interpreting recent turmoil in international bond markets within the standard paradigm of bond pricing. The uncertain outlook for both real and nominal interest rates in the face of unprecedented growth in the world's most populous country, and the fear of lax monetary policy in the world's largest economy, may together explain a good deal of the recent instability in bond prices.

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REVIEW ARTICLES

Insulating the Technopols: The Politics of Economic Reform

R. C. Duncan

R. H. Bates and A. O. Krueger (eds), ***Political and Economic Interactions in Economic Policy Reform,*** *Blackwell, Cambridge, Mass., 1993*

John Williamson (ed.), ***The Political Economy of Policy Reform,*** *Institute for International Economics, Washington, D.C., 1994*

How to implement economic reform is an extremely important issue. Broad agreement exists on the set of policies that should be implemented. But successful implementation of them has proved elusive in many cases. Unsuccessful reform has bedevilled countries in Africa, Eastern Europe, and Latin America, as it has the international finance and other institutions that have been trying to help them. These setbacks have provided critics of the multilateral institutions with plenty of ammunition. Attempts to implement reform through the structural adjustment programs of the international finance institutions without the commitment of the country's leaders were seen to have failed only after some years of trial. It has also taken some time to recognise the relevance of the specific cultural, institutional and political features of individual countries.

Bringing together economists and political scientists to investigate this issue (as do the two publications under review) seems, therefore, to make sense. However, the two collections ask somewhat different questions and research them in different ways. Whereas Bates and Krueger appoint a political scientist and an economist to jointly analyse each country's experience, Williamson presents country reports from insider economists that are then analysed by political scientists. In my judgment, Bates and Krueger's approach is the more successful.

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Different Research Methodologies

Williamson asks 'how it proved possible to mobilise and maintain the political support that made reform possible' (p.25). To research this question, nine economists (most of whom have held key political positions in their countries' governments) write about the experience of policy reform in a range of developed, developing and transition countries: Australia, Colombia, Indonesia, Mexico, New Zealand, Poland, Portugal, Spain and Turkey. These so-called 'technopols' were asked to focus on how they managed to get their programs accepted. The nine countries were chosen because they had managed to consolidate all or most of a program of economic reform. The volume also includes an earlier paper on Chile's success with economic reform, as well as papers on Brazil and Peru in order to provide some coverage of countries that had attempted but failed to consolidate reforms. In addition, three economists with experience in the policy reform efforts in Bulgaria, Russia, and Ukraine were invited to write on the implications of the other studies for reform of these so-called economies in transition.

The country papers were discussed at a conference that involved several political scientists who have been writing on economic reform or structural adjustment programs, such as Robert Bates, Stephan Haggard, Joan Nelson and Barbara Stallings. (Many of the same caste of political scientists were involved in the Bates and Krueger project.) The panel discussions are included, as are an after-lunch speech by Enrique Iglesias, the president of the Inter-American Development Bank, and an after-dinner speech by Jeffery Sachs, which prompted a written response from the IMF (published together with Sachs's response).

The country authors were asked to discuss the applicability of 13 often-competing hypotheses for explaining when policy reform is possible. These include Mancur Olson's idea that reform is most likely after a crisis; Joan Nelson's suggestion that reform becomes possible when the opposition is discredited; and the claims that it happens when the reforming government has won a mandate for change or when there is a visionary leader or an authoritarian or rightist government. The authors were also asked to discuss the length of time taken for politically significant groups to realise that they were benefiting from the reform program and what efforts were made to mobilise public support for the measures.

In the Bates and Krueger project, teams of political scientists and economists were asked to analyse 'the economic and political issues associated with the need for reform, the reform measures undertaken, and the outcome of the reform process' (p.2). The countries chosen were Brazil, Chile, Ecuador, Egypt, Ghana, Korea, Turkey, and Zambia. This list includes countries that have been very successful in consolidating economic reform, such as Chile and Korea; countries that have been reasonably successful (Ghana and Turkey); and countries that have had little success with economic reform despite several attempts (Brazil, Ecuador, Egypt, and Zambia). For each country the researchers were asked to consider, *inter alia,* the impact of interest groups on the success of the reforms and the institutional context in which the reforms were carried out. They were asked to review the country's history over three periods: pre-reform, reform, and post-reform.

The two volumes are put together in much the same way, with comprehensive introductory chapters setting out the questions the country studies were asked to consider. Following the country studies, there are an extensive analyses of the country studies by John Williamson and Stephan Haggard in the Williamson volume and by Robert Bates and Anne Krueger in their volume. The concluding chapters provide a good summary of the main points made in each book.

Understanding Political Processes

Williamson's approach doesn't work well, for several reasons. First, in several cases the economists spend most of the time describing the reforms and little time writing on the political processes at work. This leaves the political scientists little information to work with. It is reasonable to assume that in some cases the economists would not feel confident writing about things on which they have little expertise. There are some exceptions. Leszek Balcerowicz's report on Poland's experience has insightful comments on the political process, and the technopols' role in that process, in a country in crisis. Balcerowicz differentiates between times of 'ordinary politics' and times of 'extraordinary politics': during the latter kind of period, when a country is in deep crisis, there may be no professional politicians in power, so that public choice theory as elucidated by James Buchanan and Gordon Tullock may not apply. For instance, during the period when they hold power, technopols may be more inclined to act in the common interest than professional politicians would be. Miguel Urrutia's chapter on Colombia gives a very detailed account of the reform efforts and of the parts played by the various technocrats and politicians as well as by the interest groups in the private sector. By contrast, José Córdoba's paper on Mexico is mostly about the details of the economic reform: which is a pity, as the Mexican story of economic reform and its underlying processes must be one of the most interesting of recent times. I found the comments on these reform stories by the political scientists, who are all well versed in the political economy literature, to be the most insightful. The fact that most of these people had been involved in the earlier Bates and Krueger project helps to account for this.

Being part of the process of reform itself also made it difficult for the country authors to provide useful information about that process. But probably the main reason why the Williamson approach is less successful is the methodology used. Williamson asked the country authors to say whether the country's circumstances fulfilled the conditions required by the 13 hypotheses explaining successful economic reform. I agree with Carol Lancaster's comment from one of the discussion sessions that this approach is 'potentially misleading and uninteresting' (p.485). Trying to give 'yes' or 'no' answers to these various hypotheses of undetermined weight distracts attention from the task of developing an understanding of the complex set of factors at work in each case and defining behavioural determinants to these processes.

The Williamson volume concludes that the evidence strongly supports the hypotheses suggesting the need for a strong political base, for visionary leadership, and for a coherent economic team. Negative findings are also seen as important, such

as that authoritarian or right-wing governments are not necessary for successful reform. However, there is little here in the way of insights into the political processes or the institutional arrangements that make effective implementation possible.

The Political Economy of Reform

This is not the case with the Bates and Krueger volume, which attempts systematically to derive an understanding of the political processes at work behind the initiation and implementation of economic reform and to develop theories (or, at least, apply existing theories) that explain them.

The analysis is based on interest-group theory. The starting point is to ask why interest groups appeared to have little or no role in initiating the reforms. The conclusion is that the outcome of reforms is subject to such uncertainty that interest groups' decisions are influenced more by the rhetoric of particular economic theories or ideological positions than by statements about the incidence or effects of policies. (This raises questions about the role of estimates from trade models as opposed to the rhetoric restating the economic theory of free trade in influencing the outcome of trade negotiations.)

Because of the uncertain future size and distribution of the benefits of reform and the more immediate and concentrated nature of its costs, the *status quo* is likely to be maintained — unless there is a change in government. Economic reform 'appears to emerge as a by-product of political struggles' (p.457). But there are exceptions. For example, reforms were initiated by President Carlos Salinas de Gortari in Mexico without any change in government. Bates and Krueger pose the question: what determines the behaviour of politicians? For an explanation they examine the structure of political institutions, including the rules that shape political competitions. For example, in Latin American countries such as Ecuador and Mexico presidents cannot hold office for more than one term — in which case (as in Mexico) they may well undertake actions that would not even be considered were they able to run for office again. Compare this result with countries where the political term is not fixed and the political leaders struggle to stay in power. These differences within democratic systems lead to an interesting conclusion as to why no significant difference emerges in these studies between democratic and authoritarian governments in terms of their willingness to undertake economic reform programs. The explanation advanced for this is similar to what is known in agricultural science as the 'within plot-between treatment' problem: a phenomenon common to much scientific research. The variation in the results from applying the same fertiliser or seed treatment to several plots of ground is so much larger than the variation from applying a different treatment to the same plot of ground that it is difficult to obtain a scientifically significant result from the different treatments. Bates and Krueger argue that differences in the political rules between democracies lead to very large differences in the behaviour of politicians. So large are these differences that a significantly different outcome cannot be detected between democracies and authoritarian regimes. This result highlights the need to understand fully the political rules

and processes at work in each country: a point that the authors could have stressed more than they did.

Bates and Krueger also examine the implementation of reforms through the interest-group prism. They find that variations in the pattern of interest groups fail to account for variations in the success of reform programs. They do find that the reform efforts led to the restructuring of interest-group representation and to changes in political institutions. One such change that they highlight is that successful economic reform involves a strengthening of the executive branch of government and, within the executive branch, a strengthening of the financial ministry. An important role of this restructuring is to protect the technocrats within these core ministries from interest-group pressure — except, of course, from the group that benefits from the reforms.

Under what circumstances will technocrats be given such power over and through the economic bureaucracies? (Treating the technocrats as a part of a complex process points up the difficulty with the Williamson project's approach of asking the technocrats involved to analyse the whole process. It is difficult for people so involved to be able to stand back and see the whole process at work.) One answer is that, in order to avoid the problem — the 'politicians' dilemma' — of all politicians distributing benefits to interest groups with the objective of remaining in power, institutions are created — a form of delegation — that can commit them individually to strategies that are collectively rational. These agencies gain special status by acting in defence of the public interest. This explains why making political appointments to such public agencies as courts, central banks, and even statistical offices generates such critical reaction in many countries. Conversely, in many countries a lack of political independence in central banks, courts, and so on is a source of policy and political instability (to say nothing of corruptive practices). Another answer draws on so-called 'partisan theory': economic institutions are created to institutionalise policies that serve particular interests.

The authors do not say which explanation they prefer, concluding that 'the country studies offer evidence in support of both theories' (p.467). Maybe Bates and Krueger differed over the conclusion and decided to leave it at that. In the later Williamson book, however, Bates declares that he prefers the partisan model to the politicians' dilemma model. As I understand them, however, these are not competing explanations. Bates's favoured partisan model is an explanation for empowering technocrats for any purpose. That is, all policies can be thought of as favouring one group of interests over another; for example, the application of *dirigiste* policies requires giving power to certain agencies and not to others. If the politicians' dilemma is an accurate explanation of the emergence of economic institutions that impose a collectively rational discipline on government expenditure, this would explain empowering specifically *economic* technocrats, not technocrats in general. As with any other policy, it will favour some groups over others, even if these policies are thought of as being for the 'common good'. Those groups who were previously receiving rents from industry protection will be disadvantaged from inflation, or from over-valued exchange rates.

What Have We Learned?

Bates and Krueger make a convincing case for some form of safety net to protect those who lose their jobs as a result of the reforms. Otherwise, it becomes too easy for the vested interests that suffer from reform to use the workers who have lost jobs as pawns in a political struggle to overturn the reforms.

Both volumes touch only lightly on the role of organised labour in underpinning or undercutting reforms. Bates and Krueger mention briefly the role of labour in the 'corporatist' small, industrial state. Ross Garnaut's chapter (in Williamson's volume) on economic reform in Australia provides an example of this. However, very little research has been conducted into the role of organised labour in the newly industrialising, reform-minded economies.

Above all, the two projects suggest the importance of a well-trained team of policy advisers who are somehow protected from interest-group pressure. This conclusion highlights the importance of education in developing groups of highly-skilled advisers, as well as the need to understand the country's political, cultural and institutional system so that an effective mechanism for insulating the technocrats can be devised. It leaves to be decided the appropriate institutional mechanism in each case. It may be possible to initiate reforms under a range of circumstances: revulsion against the previous economic system; visionary leadership; a change of government; or a crisis of some sort. But can the conditions for initiating reforms be fostered, even by external forces? Or does a country have to stew in its own juice until the desire for reform arises? Perhaps, as John Toye observes in Williamson's volume, 'economically, there is no situation so bad that it cannot get worse' (p.41). Or perhaps, as Bates and Krueger argue, the rents eventually disappear and the politicians no longer have the means to pay off the interest groups.

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Well Being, Welfare and Equality in Australia

James Cox

Peter Travers and Sue Richardson, ***Living Decently: Material Well Being in Australia****, Oxford University Press, Melbourne, 1993*

Peter Saunders, ***Welfare and Inequality: National and International Perspectives on the Australian Welfare State****, Cambridge University Press, Melbourne, 1994*

These two books are examples of the empirical tradition in Australian poverty research. The centrepiece of the Richardson and Travers volume is the Australian Standard of Living Survey, which was designed by the authors and conducted by AGB:McNair. Much of the Saunders volume, which summarises work that has been undertaken by the author and his colleagues over the past ten years, is based on an analysis of Australian data and comparable data for other countries that have been assembled by either the OECD or the remarkable Luxembourg Income Study. Both books defend Australia's welfare state. The authors fear that developments in the 1980s, such as the more vigorous means-testing of benefits and the increasing tendency towards the delivery of social services by non-government organisations, may weaken public support for what they consider to be fragile institutions. But the two books reach very different conclusions about the effectiveness of Australia's private and governmental institutions in providing an acceptable level and distribution of material well-being.

Full Income vs Cash Income

Travers and Richardson take an optimistic view. Their summary is as follows:

> When we use these more complex measures [of poverty and inequality], our account of material well-being in Australia at one point in time is a generally positive one. The broad picture is not one of stark contrasts in terms of inequality or of poverty. In addition, we find only a weak tendency for misery to accumulate in the same groups. That is, those who are on the

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bottom of one measure of well-being are rarely on the bottom of all measures. (p.224)

This quotation encapsulates a major part of their argument: the commonly used measures (such as income statistics and poverty lines) are too simple to capture the wide divergence in individual circumstances that exists in Australia. Several factors determine whether or not a given income is adequate. These include: the number of people who are supported by the income; the amount that is paid in tax; whether or not the household owns its home and consumer durables; the amount of domestically produced food and other goods and services; whether the household has financial assets or debts; and the amount of cash and assistance in kind that is provided by family, government and other organisations, and individuals. 'Full income' would take account of these other components as well as cash income. There is no particular reason to expect that the distribution of full income would be closely related to cash income. Indeed, one might expect cash income to be a particularly unreliable measure of overall well-being since it is frequently used to determine income-tax liabilities and access to government-provided income and services.

Unfortunately, the authors provide rather few details about the Australian Standard of Living Study, and the questionnaire is not printed as an appendix to it. It is not easy, therefore, to retrace the authors' steps. In summary, broadly defined income is more equally distributed than cash income, and those who have a high (or low) cash income do not necessarily have a high (or low) full income. Expenditure is more equally distributed than equivalent income (that is, after-tax cash incomes, adjusted for differences in household needs) (p.47). Certain groups, such as aged couples, are far less likely to be in the lower part of the *full* income distribution than in the lower part of the equivalent income distribution. Those most likely to be in the bottom part of the full income distribution are pensioners and beneficiaries, unskilled workers and couples with children (p.191).

These analyses were concerned with the resources available to support material well being, not the quality of life that is supported by these resources. The Australian Standard of Living Study also examined the levels of health, happiness and participation in social activities of households, and how each of these is related to income. There is a 'positive but small association' between the level of material well being on the one hand, and participation in social activities and assessments of health and happiness on the other (pp.155-6). In summary: 'Australia looks to be highly egalitarian in two dimensions. One is that the distribution of resources and of quality of life is very equal. The other is that these two distributions are largely independent of each other, so that having a high level of material resources is neither necessary nor sufficient in order to have a high quality of life' (p.48). This is, in my view, the most valuable contribution that Travers and Richardson make.

Two other aspects of the book are less admirable. First, chapters 1-5 include essays (on, for example, mobility between social 'classes' defined on the basis of occupation) that appear to be digressions from the main arguments in the book. Second, in their final chapter ('One Nation or Two?'), Travers and Richardson ar-

gue that Australia's relatively egalitarian society is the result of full employment during the 30 years to 1975, 'sensible' housing policies, and the availability of adequate income support and government-provided goods and services. They are concerned that, for example, the growth of superannuation may lead to divisions between insiders (who are able to support themselves) and outsiders (who will have to rely on means-tested pensions), since this could erode support for maintaining adequate levels of means-tested pensions. But it is equally arguable that greater reliance on self-provision in retirement would enable such government assistance as becomes available to be directed to the more disadvantaged, thus maintaining a relatively egalitarian outcome. This would be particularly important if the amount of assistance that government can provide to the aged becomes increasingly limited by Australia's future economic circumstances and the ageing of the population. And although one can readily agree that government should ensure universal access to education and health care, it is by no means certain that government has to provide or (except for low-income earners) to subsidise these services itself. Travers and Richardson do not discuss the relative advantages and disadvantages of government and private effort in the provision of welfare-state services.

The 'Two Saunders' Problem

Peter Saunders' book discusses many issues concerning the relationship between economic growth and spending on welfare, economic rationalism and the welfare state, the distribution of the benefits of welfare-state expenditure, and inequality and poverty. Its use of data from other OECD countries enables Australian developments to be viewed in comparative perspective.

As noted, Saunders reaches a different view from that of Travers and Richardson about the degree of inequality in Australian society. The results of a comparative analysis 'lend little support to the view that Australia is an egalitarian nation, at least in regard to its income distribution' (p.210). Income inequality in Australia and New Zealand 'increased between 1981-82 and 1985-86, reflecting an increase in the income share of the top quintile, the increase in inequality being slightly greater in Australia' (p.127). 'The estimates of poverty presented here reveal a disturbing trend through the 1980s, despite the economic and employment growth in the period and the objectives and policies of the Labor government' (p.275). A possible reason for this divergence of views is that Saunders relies on official income data and hence largely excludes consideration of many of the aspects of material well-being that Travers and Richardson were able to incorporate through the Australian Standard of Living Study. Whereas Travers and Richardson mainly consider data for the late 1980s, Saunders also considers changes during that decade.

Peter Saunders's book has great virtues. He takes particular care to explain his analysis to non-specialist readers and to acquaint them with the strengths and weaknesses of the data under consideration. The implications of statistical analysis are carefully explained. And the book is always pleasant and easy to read. Nevertheless, it suffers throughout its earlier chapters from the 'Two Saunders' problem.

It seems to me that two competing thinkers are battling for supremacy within Saunders's book: the social policy analyst (Saunders One) who is passionately concerned with the achievement of greater equality, and the economist (Saunders Two) who is only too aware that everything (including greater equality) has its cost. Observe the two of them battle things out in, for example, the following passage:

> If the welfare state is to be judged a success at any level, it must be shown to have reduced, if not eliminated, poverty. Existing research which points to the persistence of poverty in rich countries like Australia thus brings into question the effectiveness of the welfare state by challenging its most fundamental achievement. However, the existence of poverty does not, in itself, point to the failure of existing welfare programs, only to the fact that they have not gone far enough. Whilst it is true that poverty still remains amidst affluence in such countries, it is also true that without income support and other anti-poverty programs, things could be much worse. But before one can make such claims with any confidence, the issue of how poverty is conceived and measured has to be resolved. (p.12)

Both Saunders would surely agree with the first sentence. The second sentence is contributed by the economic rationalist, Saunders Two. Saunders One, the social policy analyst, contributes the next two sentences. (If asked, Saunders Two would surely point out that the persistence of poverty does not, by itself, establish either that policies have failed or that they have not been tried hard enough.) Saunders Two then takes over again and writes the last sentence. Indeed, the reader discovers, on finishing the book, that the issue of how best to measure poverty is still far from resolved.

This is not to belittle Saunders's achievement. Many of us, I suspect, are torn in our thinking between the desire to see policies implemented that will reduce the extent of poverty and inequality, and concern about the consequences of such policies for the economy and the wider society. Indeed, I suspect that the tension between the electorate's demand for social justice on the one hand, and the preconditions for growth in an economy where capital and labour are increasingly subject to international competition on the other, will be a major theme in Australian politics during the remainder of the 1990s and beyond. I am disappointed, therefore, that Saunders's book, for all its virtues, provides so little guidance as to how such tensions can best be alleviated or managed. The explanation for this, in my view, is that he presents too rosy a view of the success of Australia's welfare state institutions and is not sufficiently ready to consider modifications to them.

Excessive Optimism

Peter Saunders's view of the welfare state is too optimistic, for three reasons. First, he frequently emphasises his commitment to equality. For example: 'The welfare state must adjust to the constraints within which it operates but the reduction of inequality, which is its fundamental aim, remains the most important and worthy of

objectives' (p.13). A commitment to greater equality is a perfectly reasonable one to make. But devoting public policy to the pursuit of greater equality is likely to involve some sacrifice of society's other objectives. Welfare-state benefits and the taxes that finance them reduce people's need to provide for themselves and for others, and also their capacity to do so. There is, for example, less need for families or neighbours to help aged or disabled relatives, or to care for children, if the government provides or subsidises services to do these things. A desire to reduce the burden for carers was an important reason for government provision of some services. In other instances, the reduction in private effort was an unintended consequence of welfare-state programs. Because of this reduction in private effort, welfare-state programs have been less successful in promoting greater equality than is at first apparent. The effect on private welfare is a factor that should be taken into account in deciding how much government welfare we should have.

Second, there is the vexed issue of the relationship (if any) between welfare-state expenditures, the taxes that finance them, and overall economic performance. Saunders argues that no clear relationship exists between the average rate of economic growth in OECD countries and either total government spending, social spending or spending on transfer programs. These conclusions are based on analysis of differences in growth rates in OECD countries between about 1960 and the mid-1980s. Rather different conclusions flow from historical studies of individual countries over the 50 years since the end of World War II (see, for example, Giersch et al., 1994, for Germany). It may be that similar forces have been at work in all OECD countries and that these have been missed in the regression analyses. In any event, a number of European governments (Germany, Italy, Sweden) are becoming increasingly concerned about whether their social programs can be maintained over the longer term and are proposing unpopular measures to wind back the extent of their commitments.

Third, Saunders does not give much attention to who is paying for the welfare state. The chapter on the social wage presents information on the share of benefits received by groups defined according to the age and composition of the household. But similar information for the share of taxation is not presented. Had this been done, Saunders would have found that couples with children pay a higher share in taxes than the share of benefits they receive. This is a disturbing finding because there is a good deal of evidence in both books to suggest that many families are experiencing financial hardship. For example, of couples with two children in 1988, sizeable numbers claimed that they had, over the past year, experienced situations where there was not enough money to buy food (14 per cent), clothing (34 per cent) and health care (20 per cent). The percentage of aged couples in the same situations were 4.4 per cent, 11 per cent and 3 per cent respectively (Saunders, p.283). But it is the couples with children who are more likely to be paying taxes and the aged couples who are more likely to be receiving benefits. For example, an ABS (1992) study indicated that couples with dependent children paid $251.19 a week in tax on average and received $189.17 in government benefits. The corresponding figures for retired couples aged 55 or more without children were $47.66 a week in

taxes and $295.72 a week in benefits. An increase in taxes to finance a higher level of benefits does not always result in an improvement in equity (see Cox, 1993a, for further discussion).

The Need for Change

Saunders's chapter on economic rationalism and welfare is one of his most interesting. He fears that the liberalising and efficiency-enhancing trends in the public sectors of OECD countries may lead to 'the dismantling of the welfare state as we know it' (p.158).

Supporters of the welfare state naturally fear the consequences of possible changes. Even so, simple opposition to change is unlikely to be very helpful. As I have argued elsewhere (Cox, 1993b), our current and likely future social and economic circumstances will require a good deal of rethinking about how social and economic objectives can best be advanced. Change is already occurring. Superannuation is now being encouraged. The federal government's recent White Paper on employment suggested that the private sector could do more in training disadvantaged job-seekers. Greater competition in the provision of health and welfare, and greater use of 'brokerage' arrangements in providing services to the aged and the disabled, have been much discussed. Above all, there is a need for clear thinking about those things that can best be done by government and those things that are better left to private effort. Social policy research, which is so generously supported by the taxpayer, should be able to contribute to this process of rethinking.

Finally, it may be unfair to criticise an author for writing a different book from the one the reviewer would have written. But it is worth noting that none of the authors of these books discusses the extent to which impediments (such as labour-market regulation) to the smooth working of markets may create the poverty and inequality that social policy must then address. This issue cannot easily be studied by analysing official data but is well worth pursuing.

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NOTES AND TOPICS

Western Australia's Labour Market Reforms

Brendan McCarthy

On 1 December 1993 three Acts of Parliament came into effect in Western Australia with the aim of significantly changing labour-market regulation: the Workplace Agreements Act, the Minimum Conditions of Employment Act, and the Industrial Relations Amendment Act. Not surprisingly the legislation was described by the Minister for Industrial Relations, Mr Graham Kierath, as the most significant reform in WA's labour laws in over 90 years. The Secretary of the Trades and Labour Council of Western Australia, Mr Rob Meecham, saw it differently. Speaking on ABC Television's *7.30 Report* on 8 July 1993, he described the Minister as a Pol Pot and the legislation as the 'killing fields' of workers' wages and conditions of employment in WA.

This note summarises the main elements of the legislation and the experience of it to date.

The Reforms Outlined

The linchpin of the legislation is the Workplace Agreements Act, which enables employers and employees to opt out of the award system.

The requirements for establishing an agreement are simple and do not involve the Western Australian Industrial Relations Commission (WAIRC). A newly established position of Commissioner for Workplace Agreements, which is legislatively and geographically separate from the WAIRC, is responsible for registering agreements. Agreements can be either collective or individual, but individual agreements override collective ones. Unions may be a party to an agreement, but enjoy no right of veto. The sole tests that the Commissioner must apply in registering agreements are that:

- the agreement complies with the Act;
- the parties understand their rights and obligations under the agreement;
- parties to the agreement were not persuaded by threats or intimidation to enter into the agreement; and

- each party 'genuinely wishes' to have the agreement registered.

The Commissioner has no public-interest role in determining whether an agreement should be registered. He has no conciliation nor arbitration role and is specifically precluded from engaging in either.

Workplace agreements are required to include a dispute resolution clause, the presence of names and signatures, and an expiry date. The dispute resolution clause need relate only to the 'meaning and effect' of the agreement itself; it need not provide for the resolution of disputes about the establishment of new rights and entitlements.

The Minimum Conditions of Employment Act overrides the Workplace Agreements Act (and also the Industrial Relations Act) to the effect that all agreements have implied into them a range of prescribed minimums, such as annual leave, sick leave and minimum rates of pay, and also a prohibition on terminating employment harshly, unfairly or oppressively.

All agreements are confidential to the parties themselves (except for public sector employees) unless they wish otherwise. The Commissioner of Workplace Agreements is thus prohibited from disclosing or publicising the content of any agreement.

The maximum term of the agreement is five years. However, relevant award provisions are reinstated unless another agreement is registered or the agreement itself provides for 'some other arrangement' between the parties upon the expiration of the agreement.

The critical effect of a workplace agreement is that it removes the parties to it from the jurisdiction of the Industrial Relations Act. No provisions of any awards or agreements made or registered under that Act have any effect during the term of a workplace agreement. Furthermore, the WAIRC has no jurisdiction over disputes between parties to workplace agreements, unless the parties wish an Industrial Commissioner to interpret the meaning and effect of the agreement and the dispute resolution clause in the agreement allows for such.

Experience with Workplace Agreements

Number of agreements. Data published in May 1990 show that WA's workforce totalled 561,600. Of these, 122,990 were not covered by any award, 116,183 were covered by federal awards, and 321,797 were covered by State awards (ABS, 1990).

Unpublished data from the Australian Bureau of Statistics dated September 1993 reveal that 25,500 of non-award employees were covered by s.41 Industrial Agreements under the WA Industrial Relations Act, 25,000 were covered by Federal Agreements, and 63,691 not covered by formal agreements.

Summary statistics from the Commissioner of Workplace Agreements dated 31 October 1994 reveal that a total of 8,799 non-award employees were covered by workplace agreements. Of these, 5,523 were under individual agreements; the remaining 3,276 employees came under collective agreements. A total of 203 collective agreements had been registered.

Nature of agreements. The content of agreements is confidential to the parties involved. But anecdotal evidence (derived from discussion with the Workplace Agreements Commissioner and with agents for employers who have registered agreements) suggests that many agreements are relatively simple and consist of only one or two pages. In many cases both employer and employee understand for the first time what their terms and conditions of employment actually are.

Most agreements are relatively short-term, generally of one or two years. Those of a one-year term often mirror key award provisions, suggesting that both employers and employees are adopting a cautious strategy and moving away from the traditional system one step at a time.

Almost all agreements have benefits greater than the award equivalent when taken as a whole. Common changes include greater flexibility of hours and annualised salaries and flat hourly rates of pay regardless of when they are worked.

Behaviour of parties remaining in the award system. An interesting result of the reform has been its effects on the behaviour of those remaining in the award system. First, annual reports of the Chief Commissioner of the WAIRC show that the number of claims substantially to amend awards has fallen dramatically: from 570 in 1990/91 to 261 in 1993/94. Twelve new awards were applied for in 1990/91, but only five in 1993/94. In November 1994 only five out of the original ten State Commissioners were still performing Commission duties (though the government is expected to make two temporary appointments). This could partly reflect reduced activity on the award front generally or union concentration on other activities, such as moving to federal coverage.

Second, the number of registered industrial agreements under the traditional system has significantly increased: up from five in 1990 to 106 in 1993/94. Some industrial agreements are in fact the result of proposed workplace agreements being acceptable to unions on condition that the union is a party to the agreement and therefore continues to be involved at the workplace. To most employers the instrument is not as important as the outcome.

Third, advocates who regularly appear at the WAIRC claim to have noticed a distinctly less arrogant and authoritarian approach by at least some of the Commissioners themselves.

None of these factors is conclusive, but together they suggest that the mere availability of an alternative system does induce behavioural change even for those who do not avail themselves of it.

Federal Award Logs

There is no doubt that the availability of workplace agreements has brought about a large number of federal logs of claims as unions seek refuge in the Australian Industrial Relations Commission (AIRC). Approximately 50 federal logs have been served for new or extended federal award coverage in 1993 and 1994 in a range of industries.

The AIRC's response and behaviour have been more than a little disturbing. It has not availed itself of the counsel of any of the WA Commissioners who hold a dual role as federal Commissioners. It appears to be administratively hostile to the State legislation; for example, it has set down hearings in Sydney or Melbourne for matters relating solely to WA with as little as two days notice. Some of its members are also apparently ignorant (possibly by choice) of the provisions of the WA legislation when deciding to find disputes, issue interim awards, or bring employers under the scope of existing awards. In my view it is inevitable that some of these AIRC actions and decisions will be overturned.

The unions may be pursuing federal coverage for a number of reasons not all related to avoiding the Workplace Agreements legislation. Perhaps they are merely seeking access to provisions of the federal Act that grant immunity from actions for damages, or simply keeping their options open and 'lining up the ducks' for possible later movement to federal awards.

The WA legislation enables the Minister to react to movement to federal coverage by cancelling State award coverage (most unions use the State system's common rule provisions to mop up smaller employers who are not respondents to federal awards). Although this provision has not yet been used, it is also not without its problems. Its use could indeed be quite counterproductive if the WA government's aim is to stem the flow by its use, since it could have the effect of expanding and increasing the flow to federal award coverage. Cancelling a common rule State award would make the unions even more inclined to seek federal coverage and the AIRC more justified in granting it.

The unions' tactics are also not without their risks. First, those that move to the federal system could at some later stage find themselves subject to legislation that is less hostile to employers, since the federal system will inevitably become less and less reliant on awards and unions regardless of the party in government. Second, forcing employers into an environment against their will would not improve a union's relationship with an employer. That in turn would make it more difficult for unions to participate effectively in enterprise bargaining. Third, workers themselves may increasingly react against union intervention against their agreements. Just as employers must win the support of workers in order to move to workplace agreements, unions must win the support of workers to persuade them not to. At a time when union membership is declining, authoritarian behaviour is hardly likely to reverse union membership trends. To cite a recent example,[1] five workers who wanted a workplace agreement had their affidavit evidence and wishes ignored by the AIRC and the union. The AIRC issued an interim award, but neglected even to interview the workers, who then served the employer with a letter stating their refusal to work under the federal award.

The real irony is that the WA legislation delivers what Prime Minister Paul Keating promised. In his speech to the Institute of Directors on 21 April 1993, Mr

[1] Australian Liquor, Hospitality and Miscellaneous Workers Union and RSL War Veterans Homes WA, 13 September 1994 Print L5228.

Keating said that awards would be less relevant and would set out only basic core provisions, and that non-union agreements would be available. Not even the most enthusiastic supporters of the Prime Minister could honestly say what was promised was delivered (see McCarthy, 1994).

Conclusion

The WA legislation is far from ideal; it leads to slower reform of the labour market than more vigorous legislation might have done. However with the existence of a federal system and the ability of unions to forum shop (that is, to play the AIRC off against a State tribunal and vice versa), the legislation probably goes as far as it realistically could have.

Present indications are that the spread of workplace agreements will gradually increase. On the other hand, federal intervention is also likely gradually to increase.

Finally, given that the legislation has induced behavioural change even on the part of those remaining in the award system, its availability may prove to be a bigger influence on reform than its actual usage.

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The Arts End of the World: Creating a Creative Nation?

Michael Harris

The Australian federal government's 'cultural statement', *Creative Nation: Commonwealth Cultural Policy* (1994), may well be the first document of its kind anywhere. However, the rarity of explicit artistic manifestos does not mean that governments are inactive in the consumption and the production of the arts. There appears to be a sufficiently (which is not to say universally) recognised *prima facie* case for public financial support for arts bodies and individual artists, based on the assumption that the market is a flawed instrument for ensuring the creation of 'sufficient' or 'worthwhile' art and for rewarding artists 'appropriately'. Such support is evident in many (and not just industrialised) countries. (Of course, whether such patronage stems from a desire to rectify the market's flaws or, as in the case of sport, from other imperatives such as national prestige, is another question.)

Public responses to *Creative Nation* have been, at least on one level, predictable. Arts advocates and 'industry spokespeople' seem to approve of the document, whether because of its express intentions or because it shows that the Keating Government is interested in the arts and willing to back them with cash. But equally unsurprising has been the number of commentators expressing cynicism about government-sponsored arts industries.

How then does one evaluate *Creative Nation*? At an economic level, one might assess the degree to which its proposals address market failures: in other words, does the document deal with the *prima facie* case for arts support outlined above? Is it intended to increase the quantity or quality of works of art produced; to increase the public's consumption and appreciation of art; to improve the rewards to artists for work they would have produced anyway; to involve isolated and marginal communities in the creation and consumption of art; to maintain prestigious organisations whose inevitable 'labour intensiveness' results in ever-increasing production costs; to provide short-term subsidies to unknown but promising artists in order to help them become self-sufficient; or something else?

At a cultural level, one might examine the artistic assumptions underlying the document's proposals and their likely outcomes. That is to say, what sort of art might result from their implementation? Does the document aim to produce particular outcomes or to improve processes?

At a political level, *Creative Nation* could be interpreted as part of a broader political framework (another element of which might be the push for a republic) that reflects the vision of, in particular, the Prime Minister. (It seems widely ac-

cepted that Mr Keating played a major role in framing the direction of the cultural statement and that he sees it as an element in his drive to 'reinvent' Australia.)

One way of linking these three levels of analysis is to recognise that arts policies can take 'bottom-up' or 'top-down' approaches. A bottom-up approach involves identifying particular problems and trying to devise sensible solutions, while leaving the actual doing of the art to the artists. Such methods would be addressed to the kind of policy goals, listed above, designed to deal with market failures. They could include augmentation of royalties; fixed-term scholarships for less well-known artists; or investment in particular items of infrastructure only if subject to some form of cost-benefit analysis. A good strategy of this kind would also be mindful of, and try to minimise, the ever-present dangers of politics and of powerful cliques distorting the purposes of the policy.

A top-down approach, in contrast, starts with a 'vision' of where (and perhaps what) the arts should be, rather as an activist industry policy produces a 'blueprint' of the sort of industrial structure a nation should have. The task is then one of creating the *outcome*, rather than the preconditions, of artistic endeavour. The height of the 'top' of top-down policies can vary. Such policies may be concerned with 'art for art's sake', a creative grand design aimed at achieving goals like 'excellence' and 'international recognition' in major fields of the arts. Or they may be, as *Creative Nation* arguably is, handed down from even loftier heights, as part of a design in which the nation's very 'identity' is at stake.

Creative Nation has the hallmarks of a grand design, even before the first page is turned. The fancy label 'cultural statement' rather than the more mundane 'arts policy' suggests big things to come. The document itself is glossy and shiny, reinforcing the notion that art and culture are defined and judged, at least in part, by high production values. By just browsing through the document, the reader can find plenty of indications that this is a statement concerned with big agendas, big institutions and big ideas. Summits are called for, major organisations are given triennial funding, centres of training excellence are proposed, and at least two Sydney institutions — the National Institute of Dramatic Art and the Sydney Symphony Orchestra — get what is arguably privileged status over their interstate counterparts.

Meanwhile, the major body for providing funds to individual artists, the Australia Council, appears to suffer not at all from the criticism it has been receiving recently from individual artists who regard it as clique ridden and politically driven. The shift to triennial funding for the Council may be defensible on other grounds, but those practitioners who feel the Council is in need of major reform will not be heartened by the statement's silence on the subject.

The statement includes a number of examples of government preparing to involve itself in areas where the immediate rationale for intervention is unclear: for example, its proposed high-tech, multi-media ventures into the 'information superhighway'. Since it is hard to get details about these matters from the document, we shall have to wait and see.

None of this is meant to suggest that *Creative Nation* contains nothing of merit. Some of its proposals are better than others (though it is notable that the issue of

relaxing parallel importation restrictions on sound recording is dodged once again). But whereas lip service is paid to the notion of artistic endeavour as a spontaneous and fairly individualistic activity that evolves by means of its internal dynamics, the document endorses, and is firmly based on, the feel-good notion of Culture (with a capital C) as something that can be deliberately shaped so as to make us all feel good about ourselves.

Nowhere is this more evident than in the opening pages of the statement, particularly the preamble attributed to the Cultural Policy Advisory Panel, an elite of movers and shakers in the high art world. Apropos of nothing, the preamble opens with the line 'Democracy is the key to cultural value'. This is, to put it mildly, hard to interpret either in the context of *Creative Nation* or in any other context. Is *Creative Nation* meant to further the cause of art by advancing democracy? In what way is it a democratic document? Surely it is not suggested that quality art is produced only in democracies?

But this is not all that the Advisory Panel claims. Over the page is a succinct discussion of the significance of culture for a society. Here it is claimed that 'culture is the expression of a society's aesthetic, moral and spiritual values, indeed of its understanding of the world and of life itself. . .[and it] is a measure of civilisation, at its best, enhancing and ennobling human existence'. This is the feel-good view of Culture run rampant. At its best, or otherwise, art can be exciting, dull, vulgar, escapist, challenging, confusing, rebellious, conformist, confronting, scandalous, elitist, subversive, funny, depressing, or obscure. The best artistic creations make some of us feel uncomfortable; this may not be incompatible with any 'enhancing and ennobling' effect, but it is not at all clear whether this is always so.

The real purpose of the Advisory Panel's lofty sentiments is to form a beautiful rhetorical backdrop for turning arts policy into a component of a grander social blueprint. The unspoken and unexamined assumption of *Creative Nation* is that, if culture makes us a better nation, then it must be a legitimate role of the state to foster and nurture the appropriate sorts of culture. Any artist of independent mind ought to be concerned at this. A truly creative nation cannot be created. It can be encouraged or stifled; and history seems to indicate that government interventions to do either of these can have the opposite effect.

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REVIEWS

Policy Entrepreneurs vs the Professors

*Paul Krugman, **Peddling Prosperity: Economic Sense and Nonsense in the Age of Diminished Expectations**, Norton, New York, 1994*

*Reviewed by **Michael James***

The dust-jacket of *Peddling Prosperity* tells us that in 1991 Paul Krugman was awarded the John Bates Clark Medal, a prize that the American Economic Association gives every two years to 'the best American economist under the age of forty'. Much in the book shows why Krugman won the prize. His limpid and ironical prose helps him make some difficult economic ideas not just comprehensible to the layman but engaging as well. His critique of strategic trade policy is outstanding. Yet Krugman is unable in the end to offer any solution to the problem he identifies, because he leaves unresolved the central dilemma that arises from it.

The problem is that since 1973, when the postwar 'magic' of America's economy suddenly disappeared and productivity growth dropped from nearly 3 per cent annually to less than 1 per cent, the White House has twice been captured by 'policy entrepreneurs' peddling bogus quick fixes for restoring the magic. In the 1970s the Republicans bought the ideas of the 'supply-siders', a bunch of spivs who seized control of the editorial page of *The Wall Street Journal* and softened up the country for the Reaganomics of the 1980s. Then in the 1980s and early 1990s the Democrats were persuaded by some similarly unqualified publicists that America was becoming 'de-industrialised' by international competition, but could counter this trend by government intervention to promote 'strategic' industries of high 'added value'. But the Clinton administration's current reliance on the ideas of strategic traders like Robert Reich, Ira Magaziner, and Lester Thurow will prove as futile as the Reagan administration's faith in supply-siders like Robert Bartley, Arthur Laffer and Paul Craig Roberts.

Krugman contrasts the policy entrepreneurs to the 'professors' (the academic economists). The entrepreneurs derived their ideas from certain professors, but in order to sell them they had to strip them of their caveats and qualifications, and in the process they grossly exaggerated the potential of economic policy to achieve its official goals. They got as far as they did because they were meeting a demand for simple ideas from politicians eager to restore the American dream. Of course it would be better if the professors were more influential in their own right. But Krugman thinks they are at a disadvantage because, although they can offer useful macroeconomic advice and show that import protection and price controls don't

work, 'they don't know how to make a poor country rich, or bring back the magic of economic growth when it seems to have gone away' (p.9).

Krugman makes short work of the supply-siders. He shows that their two main claims — that tax cuts would either generate enough additional tax revenue to close the budget deficit or produce enough additional private saving to finance it easily, and that a drop in the value of the US dollar would inevitably result in domestic inflation — were decisively refuted and discredited by the experience of the 1980s. His later chapters on the strategic traders are more immediately relevant because their ideas are still current in Washington and elsewhere. Although Krugman himself is one of the 'professors' whose ideas the strategic traders have caricatured, he can fairly point out that he always opposed strategic trade *practice.* He argues cogently that the idea of 'international competitiveness' is really just another version of the mercantilist fallacy, based on a mistaken belief that nations compete in the way that corporations do. In reality, a country's prosperity depends not on its trading performance as such but on its level of productivity. And since America's economy consists mainly of services, a given increase in productivity is worth more if it occurs in service industries than in manufacturing industries. Discussing the push to promote high-tech, high value-added manufacturing sectors, Krugman shows that in 1988 workers in the cigarette and petrol-refining industries added several times more value than those in the aircraft and electronics industries, where the value added was only the average for all manufacturing.

But *Peddling Prosperity* is more than a demolition job on two sets of policy entrepreneurs: it also engages in the macroeconomic debate among the professors over the last 20 years. A strong sub-theme of the book is that the attack on Keynesian economics by 'conservative' professors in the 1970s failed, and that Keynes was in effect rehabilitated in the 1980s (though too quietly for anyone outside academia to notice). In the 1970s Milton Friedman and Robert Lucas argued that recessions happened because workers and firms mistook general falls in demand for falls in the demand for their specific labour or products; Keynesian macroeconomic policies tended only to add to the confusion, thus delaying recovery. Against this, Krugman insists that the 1980s and early 1990s showed that recessions can linger even when everyone is fully aware of what's happening — thus paving the way for the return of Keynes. He himself espouses the 'New Keynesian' argument that untreated recessions can persist because price rigidity reflects behaviour that is sensible, if not perfectly rational in a textbook sense.

Krugman thinks that the good things of the 1980s happened despite Reaganomics, and the bad things mainly because of it. The Fed, in Keynesian mode, is given the credit for the recoveries of 1982 and 1992, and for the low inflation throughout the 1980s. Reaganomics is awarded some of the blame for the sluggish productivity growth of the period, and much of the blame for the growing income inequalities, which, according to Krugman, involved actual falls in the income of the poor. (On the other hand, Krugman thinks that the big budget deficits of the period were not as harmful as widely supposed.) The recent revival of America's productivity growth is noted but not attributed to anyone's policies.

Margaret Thatcher also comes in for a pasting, but here Krugman is less sure-footed. The privatisation of Britain's monopoly utilities has involved mistakes, but to write it off as 'disastrous' (p.172) seems careless in view of the worldwide imitation of the process. The attack on Britain's monetarist experiment of 1981-86 is sounder. But even here Krugman overlooks the fact that, although unemployment was very high throughout, economic growth resumed in late 1981 some months after a savagely *deflationary* budget was brought down, in the teeth of a recession, so as to ensure that the budget deficit continued to shrink. Thatcher was surely right to back her own judgment and to ignore the 364 professors who signed the notorious post-budget letter in the *Times* foretelling imminent ruin.

Nor does Krugman acknowledge that Britain's unemployment rate has been kept higher than otherwise by *microeconomic* factors like trade union power, inflexible housing markets, and unemployment traps. But then, microeconomic factors play only a small role in the book in general. For example, in summarising a range of explanations for sluggish productivity growth, Krugman ignores the highly relevant work of Mancur Olson, who argues in *The Rise and Decline of Nations* (1982) that economic growth tends to slow under conditions of political stability as 'distributional coalitions' form to take advantage of rent-seeking opportunities, an activity that displaces productive effort. The truth is that we know more about how to restore growth to a sluggish economy than Krugman wants to admit. The current high growth rates in New Zealand and Thailand, for example, must be more than a matter of luck.

Yet New Keynesian theory need not rule out technical and institutional changes and microeconomic policies that increase the scope and incentives for prices to adjust promptly to changing circumstances. This point brings us to the unresolved dilemma at the heart of Krugman's analysis. Krugman wants governments to have the discretion necessary to implement Keynesian macroeconomic policies. Yet governments exercising such discretion are vulnerable to capture by policy entrepreneurs. It is Krugman's failure to confront the dilemma that renders his final section, on 'The Role of the Economist', such a let-down. After recognising that good ideas will 'often lose to convenient nonsense', he concludes by noting feebly that 'In the long run we are all dead, but one must have faith that good ideas live on' (p.292). But if policy were more rule-governed, the scope for 'convenient nonsense' would shrink, while the loss of macroeconomic discretion could be balanced by a greater effort to make markets work well.

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

The Paradox of Demand

***Edmund Phelps, Structural Slumps: The Modern Equilibrium Theory of Unemployment, Interest and Assets,** Harvard University Press, Cambridge, Mass., 1994*

*Reviewed by **Martin Parkinson***

The diversity in the unemployment experience of OECD countries since the mid-1970s has become one of the most perplexing issues confronting economists. Whereas in some countries (especially the United States) unemployment has risen as activity has slowed and fallen during recovery, in much of OECD Europe unemployment has been persistently high and apparently intractable even in times of rapid economic growth. Moreover, each economic slowdown since the first OPEC oil shock in 1974 has resulted in higher unemployment that is not fully unwound when activity recovers.

Unemployment is often divided into two components. 'Cyclical' unemployment reflects short-term variations in activity. The 'natural' level of unemployment, which tends to be more permanent, is the level that would appear in the absence of outside interference: it reflects the economy's existing industry structure, education and skill level, wage-fixing arrangements, government spending and tax structures, and so on. (The 'natural' level of unemployment is closely related, but not identical, to the concept of the 'non-accelerating inflation rate of unemployment', or NAIRU, but for most purposes the two can be used interchangeably.) It is often suggested that whereas unemployment in the US consists predominantly of cyclical variations around a stable natural rate, in Europe the natural rate itself has ratcheted up over time.

Two kinds of explanation that use this framework have been advanced. The first assumes that the natural rate and cyclical unemployment evolve independently and that increases in the natural rate reflect structural factors such as excessive real wages, minimum wage laws, legislative restrictions on dismissal and high levels of unemployment benefits. The other explanation — the 'hysteresis' hypothesis[1] — holds that the two types of unemployment are interrelated and that an increase in cyclical unemployment (due to, say, a temporary slowdown in growth) may lead to an increase in the natural rate. The mechanisms that effect this are varied but basically involve either unemployment that leads to an erosion of skills and so a reduction in the employability of the long-term unemployed, or a failure of wage-bargaining institutions to take into account the interests of the unemployed.

Both classes of explanation virtually always find the cause of unemployment in the labour market. In *Structural Slumps,* however, Edmund Phelps, McVickar Professor of Political Economy at Columbia University, has shown how

[1] 'Hysteresis' means, loosely speaking, that where you get to is determined by how you get there. More formally, a variable exhibiting hysteresis is path dependent.

real factors outside the labour market can cause the natural rate to move. This lays the foundations of a coherent theory of how the natural rate is disturbed by real demand and supply shocks and how the adjustment process works.

Central to Phelps's approach is the argument that hiring and firing workers is costly and that firms attempt to reduce their employees' incentive to quit (or shirk) by paying above-market clearing wages. The novelty of his approach, though, comes from marrying this process with a capital market where interest rates are disturbed by non-monetary forces such as changes in productivity, saving, the rate of technological progress and population growth. So because training a new worker is costly, a decision to increase employment has some affinity with an investment decision. Other authors have shown how increases in firing costs (for example, increased redundancy entitlements) or higher wages affect this decision. Phelps's contribution is to show that changes in interest rates can also affect employment, because they change the potential profits that can be derived from an employee's output.

In the standard Keynesian model, a fiscal stimulus (and the associated increase in government debt) is inflationary but leads to an increase in employment by driving down the real wage. In Phelps's models, in contrast, a fiscal stimulus that results in increased (government or private) consumption reduces employment because the resulting rise in the rate of interest discourages firms from training new workers (that is to say, the marginal cost of training rises). Not only are no new workers hired, but existing workers are laid off because higher interest rates also reduce the value of the potential profits they can generate. This delivers what Phelps calls 'the paradox of demand': higher demand leads to higher unemployment.

However, even if we accept this conclusion, a number of points can be made. First, Phelps's result arises only when the economy reaches equilibrium. This may take a very long time; meanwhile, the fiscal stimulus may lead to an expansion through the traditional Keynesian channel. Second, Phelps's models show that increased government demand for capital goods (unlike an increase in demand for consumption goods) yields an increase in employment and a reduction in the rate of interest: an apparently Keynesian outcome. This arises because increased capital goods purchases by government crowd out not only some private investment but also some consumption-goods production; since consumption goods are assumed to be more capital-intensive than investment goods, interest rates fall, resulting in higher employment through the mechanism outlined above.

The theory leads to the testable proposition that high unemployment in Europe should be accompanied by high real interest rates. Phelps provides some evidence that seems to support this claim. Applying the model to Australia, he finds that increases in world interest rates (which are influenced by world public debt per worker, world public-sector expenditure, the transitory component of real oil prices, and world inflation — none of which can be influenced by Australian policymakers) result in increases in Australian unemployment. Increases in world oil prices (not just the transitory component), the proportion of youth in our population, and direct taxes as a share of household income also raise Australia's unemployment rate.

These results appear to support Phelps's hypothesis. But they should be treated with caution. For example, his empirical results do not justify his rejection of the hypothesis that a fiscal stimulus through public consumption has the same effects as a stimulus through investment. As well, his results show that Australian unemployment is highly correlated with world unemployment, which suggests that Australian unemployment is heavily influenced by overseas developments. This is hardly surprising: unemployment rates have to a large extent moved contemporaneously across OECD member countries, although individual, nation-specific shocks and unequal responses to common shocks are capable of differentiating unemployment performance. Indeed, it is this diversity in experience which is so interesting and which Phelps's empirical work does not adequately explain.

While the jury will remain out for some time on Phelps's claims, the ideas are challenging and the policy implications intriguing, particularly the suggestion that it is the composition rather than the amount of government outlays that matters. In Australia, the federal government has already embraced the hysteresis view in its *Working Nation* program, which aims to improve the job readiness of the unemployed and rebuild their attachment to the labour force without additional Keynesian fiscal stimulus or widespread nominal wage reductions. By improving the ability of the long-term unemployed to compete effectively for jobs, such programs can lower the natural unemployment rate for a given level of inflation.

Taken literally, Phelps's book implies that while raising skill levels will help reduce unemployment (by reducing the cost of training), Australia should be urging other countries to adopt fiscal consolidation programs in order to help reduce world interest rates. However, I suspect that even an adherent to Phelps's views would acknowledge that although the Australian government has committed itself to a deficit-reduction program, world public debt levels are unlikely to fall in the near future. Realists would also acknowledge that measures to improve the skill level of the unemployed and to increase the flexibility of the labour market will remain the main options for lowering unemployment in the foreseeable future. And while Phelps suggests that other factors may be important in addressing the unemployment problem, he is careful not to make excessive claims. He acknowledges that variables crucial to his explanations are important also in other theories; indeed, he submits that it would be naive to believe that he has found the one 'true' model of employment determination.

That said, this is an important book, presenting an alternative to the neoclassical and Keynesian paradigms. All theories tell us something about the effects of different shocks over some time-frame. Phelps's theory clearly adds to our understanding, even if it is unlikely to replace all other theories.

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Planning in One City

J. Brian McLoughlin, Shaping Melbourne's Future: Town Planning, the State and Civil Society, Cambridge University Press, Melbourne, 1992

*Reviewed by **Tony Sorensen***

This is an important book for urban planners and public policy analysts alike. The late Brian McLoughlin, who was Professor of Town and Regional Planning at the University of Melbourne, provides us with one of the few detailed evaluations of urban planning's achievements and the reasons behind its successes and failures. The author examines how and why planners' goals and objectives, ideas and knowledge, *modus operandi* and legal sanctions have influenced Melbourne's changing physical, economic and social structure over the last 50 years.

Despite the focus on just one city, this task is ambitious. Cities are shaped by a vast number of dynamic and often elusive forces whose complex web of interrelationships is barely understood. Such factors as technological innovation, changing lifestyle preferences, fluctuating attitudes towards environmental conservation, and the ageing of the population are largely independent of government *fiat*. Yet governments do strongly influence the form and structure of urban development, though their role is far from monolithic. Numerous departments within and across all tiers are directly interested in various aspects of urban form (planning, housing, environment, transport, health, education), as are a range of infrastructure-supplying agencies concerned with such matters as power, telecommunications, transit, ports and airports, sewerage, and water. Indirectly, just about everything that government does affects the structure of cities. Not surprisingly, government has great difficulty in coordinating its urban management activities.

On top of all this, urban development is also the artefact of countless private investment decisions made by vast numbers of individuals and organisations. Private strategies often conflict with each other and with third parties. Thus cities become a battleground over which powerful interest groups fight for privilege, the *status quo*, or economic and social gain. Urban planning sets up legal mechanisms that interest groups try to capture for their own benefit. Hence the so-called 'Not In My Back Yard' (NIMBY) syndrome.

The situation is complicated even further by two somewhat contradictory circumstances. On the one hand, urban form often serves cultural, aesthetic, political, historical and sentimental ends; part of the urban planning task is therefore conservative and backward looking. On the other hand, it is about inventing the future over some of the longest time horizons confronting government: 20 years or more. Perhaps, then, town planning is the ultimate 'wicked problem' in which a constellation of often unbridled forces and conflicting requirements tends to dominate the relatively feeble efforts of town planners. Changing urban form thus reflects primarily the balance of political power between a mass of conflicting protagonists.

McLoughlin acknowledges all of this in the first two parts of his book. Part One presents Melbourne's urban history and the other systematically analyses the forces at work. The former is a crucial part of the exercise because it describes and explains the metaphorical stage on which urban development in the post-war period was acted out. Past development exerts considerable influence over present options on account of its comparative longevity and rigidity. Part Two canvasses the wide array of causal factors outlined above.

The final, and perhaps most interesting, part contrasts Melbourne's development with what the planners intended. The author identifies three distinct planning tasks: long-term and synoptic metropolitan development strategy; sub-regional development strategy (or meso-planning); and local environmental planning. The first was the least successful, in McLoughlin's view because of a mixture of factors including the autonomy of infrastructure servicing agencies, the preferences of households, and the power of finance capital, all of whose actions tend to deviate from planners' neat preconceptions. The author rightly explains this behaviour in terms of the superior political and economic power of the quango or private sector *vis-à-vis* the urban planner. But he downplays another more important issue. Very simply, metropolitan planning, which usually takes a long-term perspective, is intrinsically maladaptive, on two main counts. First, we cannot forecast accurately the nature of economy and society over five years, yet alone 20. Second, plan formulation is often a lengthy consultative process. Metropolitan plans will therefore tend to be overtaken rapidly by changing lifestyle preferences or by events in the commercial sector. Paradoxically, however, metropolitan planning has the capacity to save governments millions of dollars through the coordination of public works. It is a pity, then, that the author fails to consider what kind of metropolitan planning might maximise its benefits and minimise its defects.

McLoughlin thinks the relative success of local planning arises from its control by local councils. These bodies are responsive to the needs of local residents, which enables them to fend off unwanted development. This effectively endorses NIMBY attitudes which, though defensible in some respects, create problems that the author underestimates. While the exercise of local democracy should be applauded, it also retards the adaptation of cities to changing development opportunities or may simply transfer problems from one locality to another or from the articulate and well-funded to the less so.

Although Brian McLoughlin fails to consider fully the implications of his findings for the future development of both the ends and the means of land-use planning, his book abounds in richly detailed investigations and perceptive observations of planning's accomplishments, or lack of them, and the reasons for those outcomes. It can be highly recommended.

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An Incomplete Revolution?

*Richard Cockett, **Thinking the Unthinkable: Think-Tanks and the Economic Counter-Revolution, 1931-1983**, HarperCollins, London, 1994*

*Reviewed by **Michael James***

The revival of classical liberalism as a major intellectual force in the last 20 years has been accompanied, and largely achieved, by the rise of the free-market 'think-tanks', private organisations devoted to showing how public policy can be reformed in the light of liberal principles. But although governments have adopted some of their proposals, it remains uncertain how much of this can be attributed to the power of ideas. Would not at least some of the changes have happened anyway under the pressure of events? Some readers may be disappointed that Richard Cockett devotes so little of his book to this intriguing question.

Thinking the Unthinkable is a detailed history of the 'economic counter-revolution' against the collectivism which steadily gained ground from the turn of the 20th century and which received an enormous boost in the 1930s from Keynes's prescriptions for dealing with recessions. It is more of a narrative history than a theoretical one; Cockett is concerned with the individuals, groups and organisations that emerged, from the 1930s on, warning that collectivist policies would eventually come to grief and developing the policies that should replace them. Cockett's fluent style enables him to cover a lot of detail without becoming tedious.

The book is focused very largely on Britain, the home not just of Keynes but also of the Institute of Economic Affairs (IEA), the free-market think-tank that, founded in 1955, eventually became the model for a world-wide movement. One of the most interesting accounts is of an early confrontation between Keynesians and economic liberals on the Economic Advisory Council set up in 1929 to advise Britain's MacDonald Government on the causes of and cures for the depression. The liberals on the Council objected to Keynes's proposals for higher public spending and public-works programs on the grounds that

> what Keynes was proposing was a *political* solution dictated by the apparently politically impossible task of lowering real wages in a recession and of tackling trade union restrictive practices and distortions in the market caused by governmental interference in the economy. To the economic liberals, Keynes was not solving the real problems of the economy, whose existence Keynes fully recognised, but was merely running away from them by proposing solutions that would be *politically* acceptable, but which would be, ultimately, disastrous. (p.38; emphasis in original)

Sounds familiar? As Cockett presents it, the terms of the economic debate did indeed remain essentially unchanged until the liberals were vindicated by the self-destruction of Keynesian policies in the Heath Government's boom of 1972-74 —

though it was not until the early 1980s that the structural rigidities in Britain's economy were at last confronted.

The crucial figure in the continuing opposition to Keynesianism was, of course, F. A. Hayek, who joined the London School of Economics in 1931. Cockett believes that Hayek's decision, five years later, not to respond to Keynes's *General Theory* remains a mystery, and that Hayek's later claim that he thought that Keynes would soon change his mind is unconvincing. But Hayek made his own mark in 1944 with *The Road to Serfdom.* Three years later he set up the Mont Pèlerin Society, a low-profile international group of liberal economists and intellectuals that gradually gained membership and influence to the point where, in 1972, Milton Friedman could suggest that it disband, having achieved its purpose of putting economic liberalism back on the intellectual map. (Perhaps think-tanks do have a natural life-span, shorter than that of their founders.)

The real breakthrough, however, occurred in the mid-1970s. Britain's brush with hyperinflation shattered the collectivist consensus and polarised opinion between a command-cum-siege economy and monetarism-cum-liberalisation, the latter being adopted by Margaret Thatcher, the new Conservative Party leader. (Australia had a somewhat similar experience in the wake of the Whitlam Government's failures, except that both main parties shifted towards monetarism, and it was Labor that started seriously to liberalise the economy.) The think-tank movement now took off and spread to all continents. But although, as noted, it was the IEA that provided the model of the non-partisan, intellectually rigorous policy institute, unconstrained by the 'politically possible', in Britain itself it was the Centre for Policy Studies (CPS) that came to have the most immediate impact on policy. Set up in 1974 by the leading Conservative politician Sir Keith Joseph, the CPS was independent of the Conservative Party but closely associated with it. Through the single-mindedness and rhetorical flair of its Director, Alfred Sherman, the CPS helped the Tory leadership to carry through its industrial-relations reforms in the face of resistance from a defeatist and declinist public service and from consensus-minded backbenchers and ministers. Sherman argued, correctly, that the trade unions were paper tigers, and that public opinion would support their disestablishment. But the CPS fell from grace soon thereafter, when in 1983 it failed to persuade the Thatcher Government to disestablish the public service as well, so that the welfare state could be reformed and power shifted decisively from government to citizens.

In his epilogue Cockett makes some good points. He notes that the think-tanks have laid bare the intellectual paralysis of the official party research organisations and of the universities. He also notes that, at least in Britain, their impact has been limited; most Conservative MPs never espoused economic liberalism, and after her electoral victory in 1983 even Margaret Thatcher lost interest in the 'unthinkable' thoughts of the think-tanks — which themselves lost interest in producing them. But Cockett then suggests that economic liberalism, having become the reigning orthodoxy, is itself ripe for overthrow by a new idea and a new movement; and he thinks that this might have already been started by J. K. Galbraith's claim, in *The*

Culture of Contentment (1992), that modern capitalism marginalises and disenfranchises large swathes of the population.

It's true that the recent recession has deprived economic liberalism of much of the intellectual prestige it enjoyed in the 1980s. It's also true that collectivist thought is already enjoying a revival, with politicians in all parties talking about 'community' — which in this context is code for more public spending on middle-class welfare. But Cockett might have pondered more deeply the failure of the liberal counter-revolution to extend to the welfare state, since it raises doubts about whether economic liberalism really has become an orthodoxy. There is a deep irony in the fact (noted by Cockett) that some think-tanks promoted public choice theory. For whereas the think-tanks adopted as their motto Keynes's famous aphorism about the power of ideas over vested interests, public choice theory teaches that interests do rule after all. The popular critique of economic liberalism does consist largely of sentimental special pleading and aggressive self-righteousness — the authentic trademarks of vested interests.

Future books on the liberal think-tank movement may have to dwell on the issue raised at the start of this review: the extent to which such liberalisation as has occurred has been a response to compelling circumstances rather than to compelling ideas. They could well conclude that, as the size and reach of the welfare-state and thought-controlling bureaucracies continue to expand in all Western countries, the think-tanks have had little effect on the drift towards the 'administrative despotism' that Alexis de Tocqueville, a century before Hayek wrote *The Road to Serfdom*, warned was the likely fate of democracies.

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

Machoeconomics

*Steven E. Landsburg, **The Armchair Economist: Economics and Everyday Life**, The Free Press, New York, 1993*

*Reviewed by **Ross Parish***

As its sub-title suggests, this book seeks to expound economic principles by using them to solve, or clarify, puzzles and problems of everyday life and popular discourse. It is well-written in a lively style and is generally successful in exemplifying the economic way of thinking.

The person best known for employing economic concepts to illuminate all aspects of human behaviour, Gary Becker, has expressed his methodological credo as follows: 'The combined assumptions of maximising behaviour, market equilibrium, and stable preferences, used relentlessly and unflinchingly, form the heart of the economic approach as I see it' (*The Economic Approach to Human Behavior*, Chicago, 1976, p.5). Landsburg's credo is the same. He rejects non-economic explanations for any aspects of human behaviour: 'Our working assumption is that whatever people do, they have excellent reasons for doing. If we as economists can't see their reasons, then it is we who have a new riddle to solve' (p.19).

As a research strategy for economists, Becker's methodology has a lot going for it: after all, he was awarded a Nōbel Prize. It induces one to take economics seriously, and is a useful prophylactic against cop-out 'explanations' involving tradition, habit, or irrationality. And it is true that many aspects of human behaviour, not normally considered to be economic, have been illuminated by the use of economic theory.

However, a research strategy for doing economics is not always the most appropriate way of discovering the truth. To believe that it is, is to assume that other disciplines or modes of inquiry have no explanatory value. Now while one may be sceptical about the claims of, say, sociology or psychology, one would have to be a macho economist indeed to dismiss those disciplines as having no explanatory power at all. Nevertheless, Landsburg gives the impression that he does just this: 'Do not imagine that I am an outwardly crusty but inwardly mellow economist acknowledging that there is more to life than economic models admit. On the contrary . . .' (p.44).

Landsburg concedes that the assumption of rationality 'is not always literally true', but he is unwilling to admit that rationally inexplicable behaviour is irrational. He puts forward a weak rationalisation of 99 cent pricing, but does admit that those economists who attribute this pricing policy to 'a mild form of irrationality in which consumers notice only the first digit of the price' may be right (p.15).

Landsburg insists on the moral neutrality of economics. He believes cost-benefit analysis should treat the gains and losses of criminals on a par with the gains and losses of law-abiding persons. This approach is arguable, but most policy-makers — including, I would suggest, most economists — would in practice discount the gains and losses of criminals. Landsburg draws attention to the silence of the American Civil

Liberties Union on a bill regulating the type of showerhead consumers were permitted to buy, and speculates that the ACLU would not have been silent 'if the bill had specified allowable prayerbooks instead of allowable showerheads'. To make the point that consumer protection or environmental protection is a form of censorship, and subject to much the same sort of criticisms as literary and artistic censorship, is valid enough; indeed I have made the point myself (in 'Industrial Censorship', *Quadrant*, July 1978). Landsburg goes on to say: 'But nothing in the science of economics suggests any fundamental difference between a preference for the Book of Common Prayer and a preference for a powerful shower spray. Quite the contrary; the economic way of thinking forces us to recognise that there *is* no fundamental difference' (p.228). From the economic point of view, true enough: but not necessarily from other points of view, such as the moral or the aesthetic. The moral neutrality of the economic way of thinking does not require economists to be morally neutral, to draw no distinction between economics and morals.

A pedagogic technique used by Landsburg is to produce a startling or counter-intuitive result on the basis of a highly abstract model, and then modify it by introducing more realistic assumptions (sometimes only in footnotes). Thus, he invokes what he calls the Indifference Principle: 'Except when people have unusual tastes or unusual talents, all activities must be equally desirable' (p.32). Knowledge of this principle saves one from worrying about where to live, since 'when all factors are accounted for, all inhabited cities must be equally attractive. If they weren't, nobody would live in any but the best' (p.31). He also argues that the addition of a 'free' amenity to a town will bring no net benefit to the citizens, since the benefit will be entirely dissipated by the activity of queuing for admission.

The principle that the market will adjust prices so as to bring about a net equalisation of the relative advantages of different activities is well established, going back to Adam Smith. But as important as the equalisation of advantages is the notion that this occurs only *on the margin*. For equalisation to occur for all participants, supply and demand curves (depending on the example) must be perfectly elastic. Thus, Landsburg's conclusion in the queuing case requires that all consumers are willing to pay exactly the same (time or money) price for the use of the amenity. Now he recognises this to the extent of saying that everyone in the town 'has pretty much the same preferences and the same opportunities in life' but does not stress how crucial this assumption is for his conclusion. (Landsburg's reference to unusual tastes suggests that he believes that most people do have similar preferences.) Readers would have gained greater economic insight had they been told of equalisation at the margin and the concomitant existence of surpluses for the intramarginal participants. (Elsewhere in the book he does not shy away from the concept of consumer surplus.)

I am sympathetic to the aims of Landsburg's book; and in many respects it is successful. However, readers may be put off by the exaggeration and the intransigent, macho style. But then again, some readers — younger, or less mellow, ones perhaps — may well be attracted by the very features that I find objectionable.

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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)

Policy Contradiction: Australia's Car Export Facilitation Scheme

David Pearce

Government intervention to support particular industries often has unintended and contradictory effects. Attempts to correct these effects with further intervention may lead to additional costs and further unintended effects. Australia' s automotive industry provides an excellent example of this.

The recent export performance of the Australian automotive sector has been impressive. Exports have more than trebled since 1984, and in 1993 were worth about the same as exports of education services (A$1.5 billion). The exports are diverse — including vehicles such as the Mitsubishi Verada, engines and a wide variety of components — and mostly go to the US, Japan and New Zealand.

This boom in automotive exports has been widely reported and some commentators have seen it as proof of Australia's newly found international competitiveness in manufacturing. But rather than being a positive sign, the exports reveal the inherent contradictions in Australia's automotive industry policy. How can exports boom in an industry that is struggling with reductions in border protection? That is, *how is it that an industry, which by its own admission cannot compete with overseas producers on the domestic market, manages to compete with those same producers on the international market?*

The short answer is simple. Just as Australia's automotive industry is protected or subsidised on the domestic market, many of its exports are subsidised on the international market. The subsidy takes place through an export facilitation scheme that has been operating in Australia since 1982.

The Contradiction

Few Australian industries have received as much government support as the automotive industry. Almost since its inception the industry has been projected by a variety of schemes (sometimes changing annually) designed to protect the industry from a changing international environment. Protection steadily increased throughout the 1960s and exploded in the mid-1970s with the introduction of import quotas. Only comparatively recently, as the costs of protection have become unsustainable, has protection begun to decline.

One problem with all this import protection is that it created a bias against exporting. Imagine that the automotive industry has two types of production — for export markets and for the domestic market — that are roughly interchangeable. The actual combination of domestic and export production depends on the relative rewards from each type of production.

Without import tariffs on motor vehicles, both domestic production and exports receive the world price and will be equally attractive. If an import tariff is introduced, production for the domestic market receives the world price plus the rate of the tariff. For example, with a 30 per cent tariff, a car selling on the world market for $10,000 could be sold on the domestic market for $13,000 (excluding sales taxes and other on-road costs). Exports, however, can be sold only at the world price, $10,000. Thus, production for the domestic market becomes relatively more attractive, earning 30 per cent more than production for export markets.

This is where export facilitation comes in. Export facilitation aims to correct the bias against exports created by the protection given to import-competing industries, by providing exporters with the same protection (in this case a 30 per cent subsidy) that producers supplying the domestic market receive. Although its details have varied since its introduction in 1982, the scheme essentially allows producers, in return for exports, to purchase imported vehicles free of duty: that is, the producer has to pay only $10,000 for an imported vehicle. The producer can then sell this vehicle on the domestic market at the duty-inclusive price, making a profit of $3,000. This profit amounts to a subsidy for exporters and equalises the returns from export markets with the returns from production for the domestic market.

The maximum subsidy provided by export facilitation is the rate of tariff on imported vehicles. The actual subsidy depends on how export credits accrue under the scheme. Export credits currently accrue on the basis of value added in exports. If the value added is 20 per cent, then the actual subsidy is 20 per cent times the rate of the tariff.

Following the introduction of export facilitation, production for the domestic market falls, exports increase and imports satisfy the residual domestic demand. But import prices faced by consumers do not fall. Consumers must effectively pay for both the subsidy given to producers supplying the domestic production and the subsidy given to exporters.

The Problem

But that is not the end of the story. The discussion so far assumes that the total resources used in the automotive industry are fixed: that total production does not change in response to the introduction of export facilitation.

A well known effect of protection is that, when a tariff is introduced, the returns to the industry producing the protected good increase relative to the returns to other domestic industries. This means that total production in the protected industry increases at the expense of industries receiving less protection. In the same way, export facilitation increases the returns from exporting motor vehicles relative to the returns from exporting other goods or producing them for the domestic market. Indeed, the implicit subsidy available through the export facilitation scheme is considerably higher than assistance made available to other manufacturing industries. As a result, motor vehicle exports increase because production increases. So the size of the automotive industry increases at the expense of other domestic industries. Just as protecting domestic production is a net cost to the economy, so is subsidising exports.

What It All Means

All this means that we can never be sure that automotive exports actually lead to an increase in welfare. They are more likely to reduce it in exactly the same way that import protection does.

There are two additional problems. First, export facilitation creates a vested interest in continued tariff protection. To the extent that export facilitation provides a net subsidy to some activities, it creates a group of managers and workers whose interests depend on the continuation of export facilitation and subsequently on the maintenance of motor vehicle protection. This has led to pressures to oppose the government' s plans to phase down the level of tariff protection given to the automotive industry.

Second, providing subsidies to exporters runs counter to Australia's usual position in multilateral trade negotiations. Australia has campaigned long and hard against the subsidies provided to US and European farmers. Yet Australia engages in what, in principle, is exactly the same sort of activity: taxing consumers to subsidise exporters.

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The Lysterfield Avenue of Honour

Shaun Patrick Kenaelly

The Lysterfield district extends along a valley between the southern ridge of the Blue Dandenong ranges (East of Melbourne) and the low Lysterfield hills. These fall away toward the industrial city of Dandenong and the very new suburban estates around Endeavour Hills and Rowville. At points the transition is abrupt. The hills were heavily quarried until the 1970s, but the valley itself remains pastoral: a mixture of grazing and intensive market gardening. It sent twelve men to the Great War; two did not come back. We know this thanks to the presence of a war memorial: an avenue of honour down Lysterfield road, from the junction of Wellington road. A local landowner, Gus Powell, acting on his own initiative and working at his own expense, planted the avenue of trees and dedicated it as an Anzac memorial, in September 1919.

Gus Powell chose his trees with an eye to their symbolism. There is a tree for each man. The first two were English Oak (*Quercus robur*), standing for the men who had fallen: G. M. Reid (missing in action, Fleurbaix, July 19, 1916), and Gunner R. W. Moors (died of wounds, July 25, 1916). Moors had enlisted under a false name and was perhaps under age. A brother is represented elsewhere in the avenue. The remainder of the trees were Silky Oak (*Grevillea robusta*), an interesting association of European and Australian trees. Silky Oak is not native to the district, but is a fine plantation tree. There were tree guards bearing the individual names and the first oak also carried a memorial plaque:

ERECTED BY
GUS POWELL
IN HONOR
OF THOSE
WHO SERVED
THE EMPIRE
IN THE
GREAT WAR
1914-1919
LYSTERFIELD, 13TH. SEPT. 1919.

Most places can boast similar memorials. Within five miles of this are — or were — half-a-dozen Anzac avenues. Not all have survived the chances of the years. The Lysterfield avenue is of wider interest because of its subsequent history and because we know what that history was. Unlike the more enduring monuments of stone, the

avenues have not generally enjoyed luck. The trees were planted, grew — and were gradually forgotten. Some were felled in road-widening schemes, others lopped as power-lines were strung above their heads. The Lysterfield avenue earned a brief mention in a volume of Shire history published in 1958, but otherwise grew out of memory and keeping as the years passed by. At the end of the 1970s it lay in neglect. Some of the trees were gone and others missing their names. The plaque was concealed by undergrowth. But it was not entirely forgotten.

In 1978, learning of a plan to widen the road, Mrs Heather Ronald, granddaughter of Gus Powell, rescued the plaque and commenced to lobby for preservation and restoration of the avenue. There was much in the way of letter-writing. She contacted the historical society and the Shire Council. Lt Col R. A. Gordon, of Upwey-Belgrave RSL, joined the campaign and military archives were consulted for the service details of the twelve men. The Shire engineer gave his advice and Council accepted it. All of which sounds easy, but it took six years. A cairn, of local bluestone, was erected and Mrs Ronald provided a new plaque. The wording followed the spirit of the old, but in simpler lines and now including the names, ranks and units of the men. The Lysterfield avenue of honour was re-dedicated, 10 November 1984.

The forgetting was swifter. After ten years, the avenue was again found in a sorry state. The cairn was buried under a tangle of blackberry and bracken. No one had thought to maintain it. Then it was remembered. Returned soldiers approached Council and the local newspaper. The Shire voted to clean up the area and the newspaper editorialised about the value of heritage. All of which was dutifully done and said — and which, presumably, will happen all over again in another decade or so. Here is the problem in a nutshell. Simply, who owns the avenue? Who is to take responsibility for it? Is this a civic, corporate, or private matter?

The press reports were full of howlers (one had Gus Powell as one of the twelve men and Mrs Ronald's great-grandfather), and the Shire did the clearing as a 'gesture to community feeling', thus avoiding direct responsibility: a responsibility, to be fair, it probably did not possess in the first place. Trees and cairn stand on a road reserve, where Council does have an interest; but establishment and renewal were a matter of private initiative. Groups like the RSL and the historical societies do have a legitimate interest, but it is hardly *theirs*. Nor did Gus Powell leave the stewardship to his own posterity. It was a civic and patriotic gesture on his part and a fine one, given to district and nation in the aftermath of a profound historical drama. It follows that if anyone does have title, then it would be the spirit of the nation and not any of its particular agencies at any given historical point.

Gus Powell was not a constitutional lawyer. But he was probably right to trust to the *spirit of the laws*. There is one fixed point in the year where the spirit of the nation is made tangible: on Anzac Day, when in town and country, ceremonies and services are conducted at war memorials, all in the assumption that cenotaph, statue or tree belong to our known past, the unseen future, and to us, very much so, as we stand respectfully in the present. Over the longer term this tangible spirit is likely to arise, at intervals, to remember the Lysterfield avenue of honour at need and to take up its cause before the appropriate authorities. In other words, a Gus Powell or two in every

generation. In so doing, they will undoubtedly appeal to the authority of that spirit, which rests upon tradition, sentiment and usage. It is an authority existing prior to and above the practical question of who is going to cut the grass.

It would be far easier were some single authority take full responsibility for the avenue. But that carries the risk of interference. Without doubt, the best guarantee for the future of the avenue lies in *usage*. Anzac and Armistice Day ceremonies deserve to be conducted there. Once or twice a year, people will be able to check upon the condition of the place, re-establishing possession, as it were. Otherwise, the next chapter in the story seems fairly clear. Suburban pressure is building up on the Lysterfield valley, with conservationists resisting it. What will probably result is a compromise of estate-housing and green belt. At some point (the centenary, 2015?), the new residents will rediscover the Lysterfield avenue of honour and recognise it as the one sure link with the old district and providing the continuity of a historical past. Certain of their title they will claim it as their own.

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