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 Bryce Wilkinson, First NZ Capital  
 Alan Woodfield, University of Canterbury

# **Treating Australia's Health Insurance System: Palliatives or Radical Surgery?**

**Ross H. McLeod**

**I**T seems to be an unfortunate fact of life that getting elected requires political parties to make sweeping promises in relation to any issue on which they feel vulnerable. Such promises then have a strong tendency to stifle debate and creative thinking in areas where these are plainly needed. One such area in Australia is the goods and services tax, so closely associated with the failure of the Liberal-National Coalition to win government in 1993.

This article concerns two of the Coalition's campaign promises at the March 1996 election: to retain community rating in private health insurance, and to retain Medicare in its present form. These promises have led to an absurd state of affairs in which the recommendations of the current inquiry by the Productivity Commission into the seriously ailing private health insurance industry are expressly required to take the promises as given. Constraining the inquiry thus ensures that its recommendations will be nothing more than palliative — although the Commission's draft report (Productivity Commission, 1996) makes some effort to escape from these confines.

Australia's health insurance system comprises both private insurance and public insurance (through Medicare), and should be seen as a whole. In 1983, two-thirds of the population was covered by private health insurance; now only one-third is. The exodus from private insurance is directly attributable to community rating and Medicare. The present government's response, apart from setting up the inquiry, has been to announce that, from July 1997, it will (i) subsidise through tax rebates the purchase of health insurance by those on low incomes; (ii) penalise failure to purchase it by the wealthy through a tax surcharge; and (iii) raise the threshold for the medical expenses income-tax rebate. But these moves are unlikely to reduce budgetary outlays on health significantly, if at all, and more radical surgery is needed. It is important, therefore, to open up debate about the possibility of switching from community rating to actuarial rating and, at the same time, to rethink the role of Medicare.

This article proposes a radically different health insurance system which, while sharing the broad objectives of the present arrangements, promises far greater efficiency, far less reliance on tax revenues, and far wider individual freedom of choice. These ends can be achieved quite easily, by moving to a competitive, market-based insurance system, without turning our backs on the less fortunate members of society.

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*Ross McLeod is an economist in the Research School of Pacific and Asian Studies at The Australian National University.*

### **The Community Rating Principle**

Until the 1970s, health care in Australia was financed mainly by direct payments from patients and from private health insurers operating on the basis of community rating. This principle requires insurers to offer everyone the same contribution rates for a given level of cover. It may be contrasted with actuarial (or experience) rating, under which different premiums are charged that reflect differences in risk. Actuarial rating applies to cars, for example: insurance for expensive cars costs more than insurance for cheap cars (other things equal), since repairing or replacing them likewise costs more. But under community-rated health insurance, the premium for a person aged 25 is the same as that for someone aged 65, even though the latter is likely to incur much larger health care costs within any given period.

Community rating has a good deal of emotional appeal. A propensity to require a high level of health care implies misfortune, and community rating lessens the misfortune by sharing the financial burden among the whole community. High-risk groups thus claim more in benefits from their insurer than they pay in as contributions, while low-risk groups contribute more than they claim. To a large degree, the high-risk groups comprise the old, the chronically ill, and larger families (who pay the same premiums as childless couples); the low-risk groups comprise the young and healthy, and singles and couples without children, who can well afford to contribute in excess of their own treatment costs.

But it is precisely this characteristic that give rise to a major difficulty with community rating: it amounts to a tax on low-risk groups to provide a subsidy to high-risk groups. Human nature being what it is, people have a desire to avoid paying taxes, and to put themselves in the position where they will benefit from any available subsidies. When only community-rated insurance is available, many low-risk people will escape the implicit tax by declining to buy insurance, while high-risk people can be expected to avail themselves of the implicit subsidy by buying insurance — perhaps with a higher level of cover than they would choose in the absence of the subsidy. As a result, the insurer ends up covering disproportionately more of the high risks: those who, as a group, make relatively more and larger claims. As the average cost of claims per member rises, contributions have to be increased if the insurer is to remain financially viable. But the higher the contribution rates, the bigger the implicit tax on low-risk groups, and the fewer the number of persons from these groups who will still want insurance. The larger the number of high-risk persons relative to low-risk persons, the more severe the problem becomes.

For this reason, the long-term viability of community rated insurance is very uncertain in the absence of compulsion. This inherent weakness arguably contributed significantly to the number of persons choosing not to be insured by Australia's community-rated private health funds in the 1960s and early 1970s. The obvious consequences were extreme financial hardship for those who required expensive treatment as a result of unforeseen serious accidents or illnesses but who had taken the risk of not insuring, and a growing financial burden for the public hospital system, which treated such people even when they could not afford to pay.



## **The Budgetary Consequences of Medibank/Medicare**

This, in turn, was the main catalyst for the introduction of universal insurance, in the form of the original Medibank scheme of 1975. This scheme aimed to make health care available to all who needed it, even if they were not privately insured.<sup>1</sup> Paradoxically, however, the existence of what is now known as Medicare makes the problem even worse for private health insurance. All permanent residents have access to Medicare, for which they pay through taxes, and this significantly weakens the incentive to purchase health insurance privately. Indeed, the only reason to purchase insurance is that the quality of cover provided by Medicare is perceived to be inferior. Specifically, Medicare provides for treatment only in shared wards in public hospitals, relying on doctors chosen by those hospitals. As well, there are long waiting lists for admission. If all people thought public hospital treatment was as good as private hospital treatment in all respects, and that choice of doctor was unimportant, there would be no demand at all for private hospital treatment or private health insurance.

The strong disincentive to purchasing costly private insurance serves to compound the effect of the community rating requirement. Rather than being simply the solution to the problem of those who would choose not to insure privately, Medicare has come to be seen as an acceptable alternative form of insurance by large numbers of people who otherwise would have been happy to do so. Thus, although the charming fiction of near-free access to health care for everybody has been sold to voters in numerous election campaigns, time has shown that we are not prepared to be taxed heavily enough to make this possible. The task of governments in reality has been to find an electorally acceptable balance between taxing us to pay for Medicare, and winding back the quality of health treatment available to Medicare users.

## **Tax Rebates to Encourage Opting Out of Medicare**

Medicare is 'free', in the sense that one has to pay income tax whether or not one calls on its resources. Those who desire merely the *increment* in quality of cover that private insurance provides therefore have to be prepared to pay the *full cost* of private insurance. A possible means of offsetting this significant distortion is to provide a tax rebate to people who purchase private insurance (and in so doing implicitly choose not to rely on Medicare). More people can be expected to purchase private insurance if by doing so they are relieved of some or all of the burden of having to contribute to Medicare. This is the approach announced in the Commonwealth Budget for 1996/97.

How big should the rebate be? The amounts announced in the Budget were fairly small, at least for relatively low-income earners: \$100 for singles, \$200 for

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<sup>1</sup> For a brief history of Medibank/Medicare, see Logan et al. (1989:28-30). The paternalistic notion that people *should* be insured, even if they would prefer not to purchase insurance if given the choice, is neither supported nor challenged here, but simply taken as given.

couples, and \$350 for families (plus additional amounts for ancillary cover). This group comprises individuals with annual incomes up to \$35,000, and couples and one-child families with incomes up to \$70,000; the income threshold rises by \$3,000 for each additional child. Much larger rebates are available to relatively high-income earners, for whom the rebate is 1 per cent of taxable income. This group comprises individuals with incomes above \$50,000 and couples and families with incomes above \$100,000. The marginal tax rate for this group was simultaneously increased by 1 per cent (characterised as a 'Medicare Levy Surcharge'), but since they can escape the extra tax by purchasing private insurance, the new arrangements amount to a tax rebate which is proportional to income. For example, a couple or a family with a combined income of \$100,000 would receive a rebate of \$1,000 — roughly equivalent to the full cost of basic private insurance cover with a front-end deductible (or excess) of \$500. People with still higher incomes would actually obtain rebates *in excess of* the cost of private insurance.

The implications of the new arrangements are worth noting. Low-income individuals obtain access to (somewhat inferior) Medicare hospital cover at the cost of the tax rebate forgone, amounting to \$100. High-income individuals obtain access to private insurance — with freedom to choose both hospital and doctor, and to avoid waiting lists — free of charge, or even at negative cost. In the middle, individuals earning \$35,000–\$50,000 get Medicare cover at no cost, but have to pay the full cost of private insurance if that is their preference. Similar implications apply to couples and families.

This strategy may or may not achieve budgetary savings. Among lower-income earners, each couple opting for private cover will cost the government \$200 annually; but if their likely cost of Medicare benefits was, say, \$1,000, there is an implied saving of \$800. On the other hand, the rebate will also flow to those individuals who have already chosen to be privately insured. The strategy thus imposes on the government the fixed cost of giving the rebate to all existing lower-income, privately insured taxpayers. (Middle-income earners are not affected by the changes, while the number of relatively high-income earners — about 110,000 singles and 100,000 couples and families, according to a Department of Health and Family Services press release, 'Private Health Insurance', of 20 August 1996 — appears too small to have any major budgetary impact.)

A delicate balance is involved. If the rebate is too small, not many low-income earners will make the switch, and the cost of paying the rebate to existing privately insured taxpayers may exceed the gains from slightly reducing the numbers of people reliant on Medicare. If the rebate is large relative to the average cost imposed by individuals in Medicare, many could be expected to switch to private insurance; but the net gain from each person who leaves will be small and the fixed cost of the rebate to those already privately insured will be even larger than in the first case, thus again resulting in a net increase in the government's overall health budget. It is possible that there is *no* rebate capable of yielding a budgetary gain; and even if there is, the gain may be small. Indeed, the government itself has stated, in a Department of Health and Family Services press release of 20 August 1996, 'Financial

Incentives to Boost Private Health Insurance', that its primary aim is merely 'to arrest the decline' in private fund membership. This is not to say that the changes will be devoid of benefit: presumably the government is also motivated, to some extent, by a desire to mitigate the inequity involved in forcing those who are privately insured to contribute to the insurance of those who are not.

### **Actuarial Rating for Private Health Insurance**

A more promising approach to reforming Australia's health insurance industry is to combine withdrawal of the community-rating requirement with a subsidy scheme for the purchase of health insurance.

Under actuarial rating,<sup>2</sup> insurers would be free to set different premiums for different sections of the population. People would be classified by various criteria such as age, sex, occupation, previous health experience — indeed, any criterion at all believed by the insurer to give some indication of the degree of health risk — and their premium levels determined accordingly.

Among existing members of private health funds, actuarial rating would raise premiums for high-risk groups and lower them for low-risk groups. Some members of the high-risk group could be expected to drop their existing cover, and rely instead on Medicare; this would *increase* the cost to taxpayers of Medicare. At the same time, some members of the low-risk group not presently insured would now choose to purchase private insurance, thus *reducing* the cost of Medicare. The net effect on the budget would depend on the relative numbers of 'movers' and differences in relative costs.

It seems quite likely that the costs of adding high-cost individuals to Medicare would outweigh the savings from shifting low-cost individuals to private insurance. High-risk individuals would have a strong incentive to drop private insurance, but low-risk individuals would have only a weak incentive to take it up, because unevenness in the distribution of risk means that the small high-risk group would see a large rise in their premiums, while the large low-risk group would see a relatively small fall in theirs. This is probably the major explanation for successive governments' reluctance to remove the community rating requirement. It would also help to explain support for this principle from the private health funds themselves: without it, they would lose market share to Medicare.

### **Targeting Health Insurance Subsidies**

Supporters of community-rated insurance are troubled by the fact that, under actuarial rating, high-risk groups pay more than low-risk groups. Yet actuarial rating is not incompatible with the widely accepted view that high-risk groups should have their costs subsidised by low-risk groups. Actuarial rating can be combined with *direct subsidies to the high-risk groups*, sufficient to make health insurance readily affordable. Pre-

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<sup>2</sup> For brevity's sake, the discussion that follows focuses mainly on hospital, as distinct from medical, cover. At present, the private funds are primarily concerned with the former.

sumably, however, low-risk individuals with low incomes should not be called on to subsidise high-risk, but high-income individuals. Any subsidies for gaining access to health insurance should be directed so as to benefit those who are both high health risks *and* relatively poor, and paid for by those who are both low health risks *and* relatively well off. Suppose, then, a subsidy were provided in the form of a tax rebate which increased both as the premium increased (to assist those with higher health risks) and as taxable income decreased (to assist those with low incomes). Much less tax revenue would be required to subsidise health care for those in real need than to subsidise everyone, as Medicare attempts to do.

Of course, even with the subsidy, there would still be the distorting influence of the option of staying in Medicare at the small cost of forgoing the tax rebate that would be available to those who opted out. To remove this distortion, Medicare would start charging for membership, in the same manner as private insurers, to cover actuarially estimated costs plus a margin of profit (that is, without relying on tax revenue). People who elected to stay with Medicare, of course, would receive the same subsidies, through tax rebates, as those who shifted to private insurers.

The financial details of a model of the proposed subsidy scheme are shown in Figures 1a and 1b.<sup>3</sup> The model is intended to illustrate the general principles only, and would need to be adjusted in the light of the full range of premiums determined by insurers, together with political judgments about a tolerable total outlay on the subsidy. Each curve in the diagrams shows the net (subsidised) premium paid for families with a given level of taxable income. Figure 1b is similar to Figure 1a, but focuses on annual premiums up to \$5,000, which would account for a large majority of the population. Some figures are provided by way of illustration in Table 1.

**Table 1**

**Net insurance premiums for selected combinations of family income and family gross insurance premiums (\$ per annum)\***

<i>Gross family premium</i>	<i>Taxable family income</i>				
	<i>12,000</i>	<i>18,000</i>	<i>25,000</i>	<i>35,000</i>	<i>50,000</i>
300	265	280	288	293	296
900	654	749	804	841	866
1,500	939	1132	1255	1345	1409
3,000	1,433	1,863	2,184	2,453	2,661
6,000	2,026	2,835	3,535	4,213	4,815
7,500	2,233	3,192	4,059	4,938	5,756
12,000	2,687	3,999	5,286	6,714	8,184

\*Single individuals are treated as one-person 'families'.

<sup>3</sup> This is a more sophisticated version of a scheme initially proposed in McLeod (1987:45-50).

Figure 1a

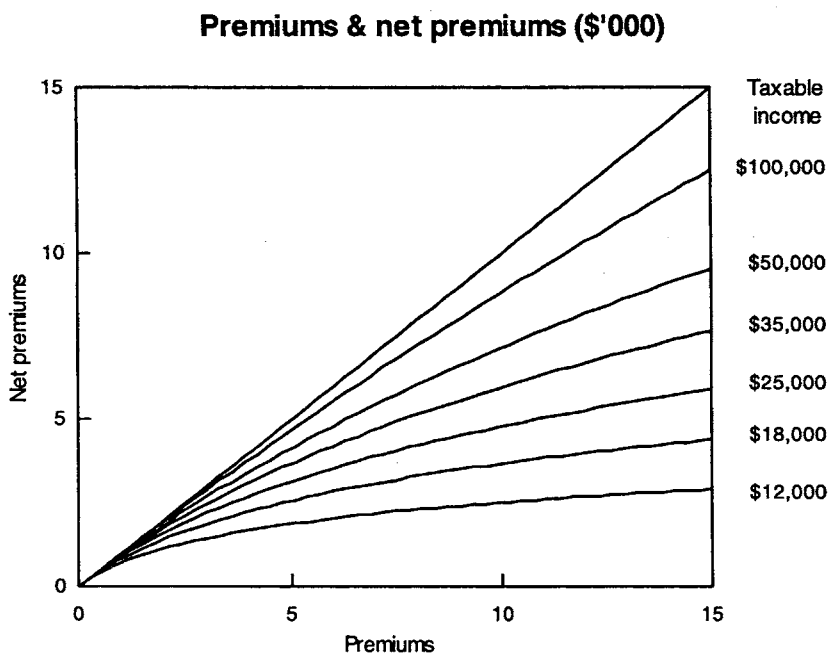
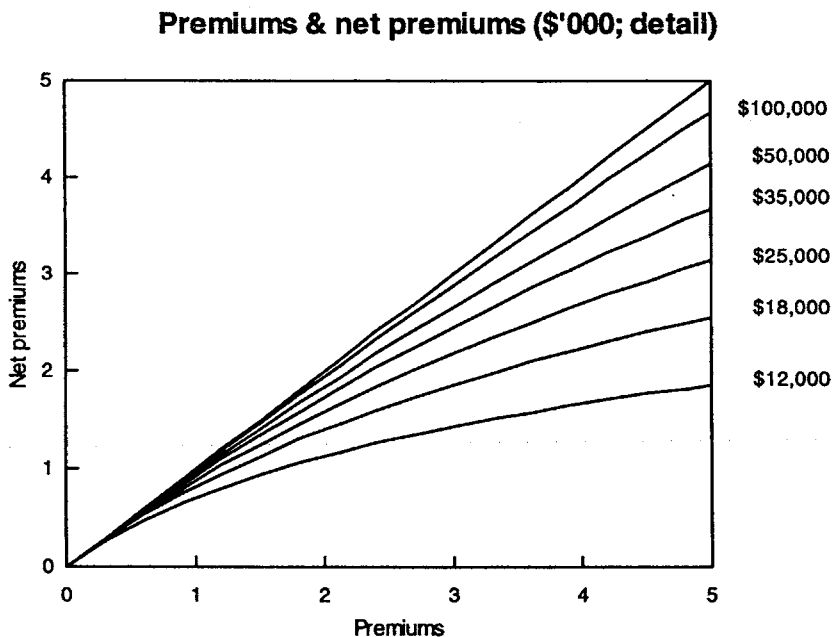


Figure 1b



The important characteristics of the model are as follows:

- The subsidy increases with increases in the premium (for a given income); people who are higher health risks receive higher subsidies. (The subsidy is the vertical distance between the curve and the diagonal line, along which the subsidy is zero.)
- The slope of each curve is always positive, indicating that the individual always has to pay at least some portion of any increase in the gross premium. This is important, in order to ensure that people have an incentive to shop around for the cheapest insurer and, conversely, that insurers have an incentive to keep their costs as low as possible.
- The subsidy decreases with increasing income (for a given premium); people with higher incomes receive lower subsidies.
- Although it is not apparent in the diagrams, the mathematical formulation of the subsidy is designed to ensure that the rate of decline of the subsidy as income increases is not so rapid as to remove or seriously diminish the incentive to earn additional income.<sup>4</sup> The disincentive effect of high marginal rates of income taxation, under which only a small proportion of each additional dollar of income earned is retained as disposable income, is well known. A problem with the present proposal (which is unavoidable, if the subsidy is to decline as income increases) is that it tends to increase the effective marginal rate of taxation: reducing the rate of subsidy as income increases has the same effect as increasing the marginal tax rate. But the addition to the marginal tax rate has been kept small, except for a very small proportion of the population who have very high health risks and very low incomes.

The subsidy scheme has been designed so that the net premium in no case exceeds an arbitrary limit of 25 per cent of taxable income. A lower or higher ceiling could be imposed, resulting in higher or lower tax revenue requirements; it would be sensible to adjust the ceiling in the light of experience with operating the scheme. It might also be necessary to set up different arrangements altogether for those who are both very poor and chronically ill, since insurance is not really the appropriate mechanism for financing health care in this circumstance. (It may be objected that everybody receives at least some subsidy, no matter how well off they may be. But the subsidy is paid for by taxation, and the wealthy pay far more tax than the poor. The relevant question, then, is the combined distributional impact of the income

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<sup>4</sup> The net premium is given by

$$N = aY^b \ln \left[ \frac{P}{aY^b} + 1 \right],$$

where  $P$  is the gross insurance premium, and  $Y$  is taxable income. For the purpose of constructing Figures 1a and b,  $a = 0.0002$  and  $b = 1.65$ .

tax and subsidy scheme taken together, not the impact of the subsidy scheme alone.)

### Administrative Details

Payment of the health insurance subsidy would be administered through the existing income tax system. The subsidy takes the form of a tax rebate that either increases the end-of-year tax refund or reduces any additional tax payable. Alternatively, individuals could submit information to their employers regarding their outlays on basic insurance cover (as they do already in relation to dependants' allowances), and have the relevant subsidy amount credited against their normal PAYE deductions. Individuals who failed to produce evidence of insurance cover in their income tax returns would have to make an additional tax payment. The government would use the amounts collected to purchase insurance for the individuals concerned from Medicare or from private insurers, but the additional payment would be high enough to cover this expense as well as to impose a penalty that would provide an incentive to individuals to purchase insurance of their own accord.

The meaning of 'basic insurance cover' requires elaboration. Hospitals are in many respects akin to hotels: with both, individuals' preferences differ in relation to accommodation. Many are happy to be placed in a shared ward, others prefer a private ward using a shared bathroom, yet others would prefer their own room with extra thick carpet and *en suite* facilities. Profit-oriented hospitals can be expected to make available all standards of accommodation for which there is a demand at a price which will cover the cost of provision. But as the cost of different standards of accommodation ranges widely, health insurers would need to offer different levels of insurance cover appropriate to their contributors' diverse preferences for accommodation. The health insurance subsidy, however, like Medicare at present, is directed to the provision of a basic level of hospital accommodation consistent with effective treatment, but without non-essential frills.

Table 2

### Hypothetical insurance premiums (\$ per annum)

Risk category	Premiums			
	Basic rate	One star	Two star	Three star
Low	800	960	1,200	1,800
m1	1,500	1,900	2,200	3,000
m2	3,000	3,600	4,600	6,000
High	6,000	7,000	9,000	12,000

Many people, then, would want to purchase higher levels of cover. Their rebate would not be based on their actual insurance premium, however, but on what their premium would be if they were insuring at the basic level. This makes it necessary to require each insurer to inform the tax office of its schedule of charges, for each distinct risk group that it identifies, and for all levels of cover, including the basic level (a simplified hypothetical example is shown in Table 2). It would then periodically certify in respect of each of its contributors the risk category to which he or she belonged, the level of cover, and the actual premium paid. Thus, a contributor in risk category m2 would face a basic cover premium of \$3,000 a year, but might choose 'two star' cover for \$4,600. Nevertheless, her insurance subsidy would be based on the \$3,000 figure (in combination with her taxable income).

Insurers could be expected to explore ways of increasing the size of the subsidy to their contributors, thereby attracting more business to themselves. One way would be to overstate the charge for basic cover. This could be detected by observing the level of demand for basic cover insurance (through an audit procedure): if there was little or none, the insurer could be considered to be not playing by the rules, and could be subjected to sanctions of some kind. It would not be feasible to falsely assign contributors to higher-risk categories, because the actual premiums paid and the level of cover purchased would have been certified and would be subject to audit checking.

### **The Proposals Summarised**

Under these proposals, hospital insurance would be provided on a profit-oriented basis by the government, through Medicare, competing on equal terms with private insurers.<sup>5</sup> Both Medicare and private insurers would provide the basic standard of insurance plus higher levels of cover (for private ward accommodation, for example), in accordance with the demands of their contributors. But Medicare would be financed not from general tax revenue (as it is now), but from the flow of premium payments from its members.

Health insurance would be compulsory and therefore universal, but people would pay for it directly. The poor and those with high health risks would be protected by a safety net consisting of carefully targeted subsidies in the form of tax rebates. These subsidies would be administered not through Medicare but through the income tax system.

These proposals would make possible a significant reduction in both taxation and government expenditure. Commonwealth government outlays on health attributable to the Medicare system are of the order of \$15 billion annually,<sup>6</sup> which suggests the size of potential tax savings from taking Medicare insurance (including

<sup>5</sup> Extension of the arguments above suggest that there is no reason why private insurers should not also compete for the medical insurance component of Medicare.

<sup>6</sup> This sum comprises \$6.1 billion in medical benefits, \$4.8 billion in Medicare Agreement financing to the States for public hospitals, and \$3.9 billion in other hospital funding grants. These costs do not come close to being covered by the Medicare levy, which generates only about \$4 billion annually.



the funding of public hospitals) out of the budget. If this amount were distributed over, say, 10m taxpayers, the cut in each individual's income tax could be around \$1,500 (before allowing for the subsidy). Since people would now pay for health insurance directly, rather than indirectly through taxes, they could strongly influence the types and levels of insurance cover offered by virtue of their decisions as to what they bought, and from whom.

Under the proposed arrangements, Medicare would not be restricted to providing cover for treatment only at public hospitals. The public hospitals would be made to compete for patients by making them dependent for revenue on demand for their services that was no longer artificially boosted. There would then be no need for any distinction between public and private hospitals. On the contrary, the aim would be to get all hospitals to compete on equal terms, as in the case of Medicare and the private insurers. The impact on Telstra of forcing it to compete with Optus suggests that, in both cases, these would provide a significant stimulus to improvement.

The only health insurance burden on the taxpayer would be that needed to finance the subsidies to the relatively small proportion of the population who were both high health risks and poor. The government would still be in the business of operating hospitals and providing health insurance, but it would no longer have the competitive advantage of being able to offer something 'free' to the public by virtue of taxpayer support. If experience showed that it could not compete on a level playing field, of course, the next logical step would be privatisation.

### **Broken Promises?**

If the present government were to implement these proposals, it would be accused of breaking its election promises to retain Medicare and community rating. It could justify breaking these promises, however, by arguing that it had retained the *essence* of Medicare, even though the system was being radically altered.

What then is the essence of Medicare, and how would the reform proposals preserve it?

- *Medicare ensures universal health cover. Everyone is assured of having access to medical and hospital care as needed, without facing the prospect of potentially crippling expenses.* The new scheme would be more genuinely universal, because it would get rid of waiting lists, and permit patient choice of doctor. It would be more efficient, because it would make use of all hospitals rather than only public hospitals, permitting greater patient freedom of choice in this respect also.
- *It provides free medical and hospital insurance, paid for out of general tax revenues.* Under the new scheme, individuals choose among Medicare and private insurers, and have to pay for the insurance cover chosen. In return, the income tax schedule (including the existing Medicare levy) is modified so as to generate significant tax reductions for all taxpayers.

- *It provides non-transparent cross-subsidies from the majority of the population who have low health risks to the minority who have high health risks, without regard to individual income levels.* The new scheme would also subsidise high health-risk individuals at the expense of low-risk individuals but, at the same time, would make the subsidies transparent, and modify them in accordance with differences in ability to pay.

## Conclusion

Steadfast adherence to the inherently flawed community rating principle in health insurance has been responsible for an unending stream of policy interventions under successive governments, all intended to patch up the problems community rating causes. These have created a highly distorted and inefficient system of health care in Australia. The underlying aim may well have been to protect less fortunate members of the community, but this concern has not been matched by clear or creative thinking as to how best to achieve this objective. The most obvious symptom is the coexistence of long waiting lists for admission to public hospitals and excess capacity in private hospitals, but the recent proposal that newly trained doctors will not be given Medicare provider numbers will have the effect of causing an unconscionable wastage of these human resources to match the underutilisation of private sector infrastructure.

It is possible to design a system of health insurance subsidies which protects the least fortunate, but which at the same time minimises the need for tax revenues and an extensive health bureaucracy, and gives individuals freedom of choice in relation to levels of insurance, insurers, doctors and hospitals. Such a system, the broad outlines of which have been presented here, would be far more effective in providing the quality of health care people want, rather than what governments think they should have, and in bringing about considerable improvements in efficiency.

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# **Prudential Regulation of the Financial System: A Functional Approach**

**Warren P. Hogan and Ian G. Sharpe**

**I**N announcing the Financial Systems Inquiry on 30 May 1996, Australia's Commonwealth Treasurer (1996) referred to the need for specific recommendations on a number of topics, including the establishment of 'a consistent regulatory framework for similar financial functions, products or services . . .'. This reference reflects a very strong current interest in the 'functional' approach to regulation, which Merton (1995) defines as the similar regulatory treatment of economically equivalent transactions.

Several factors have contributed to this interest, including an emerging view that technological developments and financial innovation have stripped banks of their pivotal position in the financial system. Indeed, banks currently do little that is not also done either by financial markets or non-bank financial institutions (NBFIs). Moreover, with the development of financial derivatives, such as options and swap contracts, traditional institutional categories are becoming quite arbitrary.

Financial innovations have also increased competition in financial markets. In the mortgage market, improvements in communications and information technology, along with the development of securitisation, have made it possible for loans to be generated and serviced by institutions different from those that fund them. In Australia, this has resulted in a loss of business for, and pressure on the profitability of, banks and building societies, the traditional mortgage lenders.

The erosion of the distinctions between various participants in Australian financial markets<sup>1</sup> has been accelerated by the introduction of compulsory superannuation payments for all the workforce. The effect has been to restrict the supply of retail deposits to banks and to increase banks' demand for wholesale deposits where pricing and quantity supplied reflect asset allocations by funds managers. Segmentation of the market for retail funding reflects the previous prohibition, now to be relaxed, on banks bidding directly for superannuation funds by offering special retirement savings accounts. The prohibition encouraged banks to expand their activities into insurance and funds management through subsidiaries. At the same time, insurance companies have expanded into traditional banking activities: for example, Colonial Mutual Group

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<sup>1</sup> With the increasing integration of world capital markets, these recent developments in financial markets are not unique to Australia. See for example Edwards and Mishkin (1995).

*Warren Hogan is Professor of Economics at The University of Sydney. Ian Sharpe is Professor of Finance at The University of New South Wales.*

has acquired the State Bank of New South Wales, and AMP has developed its Priority One banking offshoot, which currently offers home-mortgage financing and term-deposit facilities. Thus, financial conglomerates have become increasingly important: approximately two-thirds of the total assets of the Australian financial system are controlled by the 30 largest groups.

These developments, in conjunction with several spectacular failures (and near failures) of financial institutions and other firms active in the new markets, have contributed to a lively debate on whether the changes have affected the stability of the financial system and whether existing financial-sector prudential regulation, which is largely institutionally based, is appropriate to the changed environment. In Australia, the Reserve Bank of Australia (RBA) has responsibility for banks and authorised short-term money market dealers, the Australian Financial Institutions Commission (AFIC) and State Supervisory Authorities for building societies and credit unions, and the Insurance and Superannuation Commission (ISC) for life insurance companies and superannuation and approved deposit funds. Moreover, economists are increasingly concerned that regulation designed to stabilise the financial system and the macroeconomy by preventing runs on financial firms may have had perverse effects.

These concerns have led to proposals to replace the institutionally based system of prudential regulation with a functional approach. The proposals seek to limit the coverage of prudential regulation to key economic functions. Here, we evaluate the purposes and consequences of prudential regulation<sup>2</sup> and then place that analysis in the context of the new functional approach.

### Arguments for Prudential Regulation

The primary economic arguments for prudential regulation, as in other areas of economic regulation, stem from the presence of externalities and/or asymmetric information (Hogan & Sharpe, 1987, 1990). Positive externalities arise from the acceptance of bank deposits as a medium of exchange and a store of value, but these could be eroded by a bank failure. Moreover, negative externalities would be associated with bank runs if contagion (the effects of shocks on one or more firms spilling over on to others) were to result in solvent banks being impaired and if the real economy were adversely affected. As bank loans are generally risky and difficult to assess or value without careful monitoring, then, in the presence of asymmetric information, depositors may question the value of bank loans in periods of bad economic news. Consequently, deposits could be withdrawn from both solvent and insolvent banks, thereby producing a banking panic. Theoretical justification for this view is provided by Diamond and Dybvig's (1983) model of bank runs, which supports the existence of a

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<sup>2</sup> Space limitations preclude an analysis of alternative reforms to prudential regulation that have been proposed, such as *laissez-faire* banking.

regulatory safety net, like deposit insurance or depositor protection. However, the assumptions underpinning the model detract from its applicability.<sup>3</sup>

## Systemic Risk

Controversy surrounds the issue of whether the financial system exhibits instability and, if so, its causes. At one extreme, proponents of *laissez-faire* banking argue that, in the absence of prudential regulation, market discipline from the bank's owners and creditors would limit the risk assumed by the bank. At the other extreme are those who believe that the financial system is inherently unstable and subject to destabilising financial cycles and crises, and that market forces aggravate recessions (Randall, 1993). They advocate comprehensive regulation of financial institutions so as to prevent excessive risk taking.

The payments clearing system is frequently viewed as an important channel in the spread of financial contagion; since the clearing institutions are closely interconnected, a default by one institution could quickly spread to others. With banks at the centre of the payments system, and given the possibility that financial crises could severely impinge on the efficient operation of the monetary system, the regulatory safety net has traditionally focused on banking activities. However, the introduction of new arrangements for payments between banks later in 1997 will see requirements for the instantaneous payment of obligations due to other banks. These provisions have the potential to reduce significantly the payments-related credit risk exposures of individual banks, with a consequent reduction in systemic risk (see RBA, 1995).

Kaufman (1994) concludes that the costs of bank failures are relatively small and that bank runs are largely firm-specific and a rational response to relevant information. Furthermore, systemic risk (the risk of widespread contagion) is significantly reduced when monetary authorities act to restore *aggregate* banking system reserves that would otherwise be reduced in a flight to currency. The Australian experience of the 1987 stock market crash lends support to this view.

Nevertheless, most countries have introduced regulatory safety nets such as lender-of-last-resort arrangements, deposit insurance schemes and, in Australia, a combination of government guarantees, the depositor protection provisions of the Banking Act, prudential arrangements for building societies and credit unions under the AFIC, and supervision of insurance and superannuation under the ISC. The objectives of the safety nets are to reduce systemic risk, to protect depositors/investors deemed to be disadvantaged in their ability to protect themselves in the presence of asymmetric information, and possibly to provide economies of centralised risk monitoring. An alternative view is that the best protection against systemic risk is stable

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<sup>3</sup> Schwartz (1995) notes that Diamond and Dybvig's bank is a monopoly bank with no capital and that there is no central bank in the model. In the absence of a regulatory safety net, rational banks will structure their operations so as to limit the probability of a run on deposits by holding capital to reassure depositors of the safety of their deposits. Moreover, in a multi-bank system a withdrawal from one bank is likely to be redeposited in another rather than being taken in cash, while flights to currency could be limited by open-market operations of the central bank.

macroeconomic policies. However, Kaufman (1996) argues that because central banks are unlikely to deliver such policies successfully, a back-up prudential safety net is desirable.

### Moral Hazard and Principal-Agent Problems

When they are unfunded, or financed by an implicit or explicit fixed risk-insensitive charge (or deposit insurance premium), safety nets introduce new problems. The most important of these is *moral hazard*. Assuming the safety net is credible, banks have an incentive to increase shareholder value by increasing risk (for example, with a more risky asset portfolio and/or a lower capital ratio) because they no longer have to pay a risk premium on their deposits and the risk of a run of those deposits is significantly reduced. In effect, the risk is shifted from depositors to the deposit insurer/protector, and ultimately to general taxpayers. Thus, the safety net provides a taxpayer-funded subsidy to bank-equity holders for increased risk taking.<sup>4</sup>

To overcome the moral hazard problem and thereby limit the taxpayer-funded subsidy of excessive bank risk taking, governments implement various types of prudential regulations and controls through central banks or other regulatory agencies. These regulations replace the forgone market discipline with regulatory discipline. However, there is little evidence supporting the view that governments or their regulatory agencies are more efficient than market participants in assessing changes in risk in a timely manner and in taking appropriate disciplinary actions (Benston, 1993:69-73; Hogan & Sharpe, 1991).

Another problem introduced by regulation is the *principal-agent* problem, where regulators acting as agents for taxpayers may pursue their self-interest rather than the public interest. Prudential supervision is a *discretionary* form of regulation that relies on judgment and ambiguity to eliminate perverse moral hazard incentives. Boot and Thakor (1993) note that supervisors perform two roles: (i) monitoring and supervising bank risk or asset choice where the supervisor's ability is uncertain; and (ii) deciding whether a problem bank should be closed. They show that regulators acting in their self-interest have an incentive to delay closing problem banks because the closure damages the regulator's prestige and reputation as an efficient supervisor of bank risk. Furthermore, because regulators are criticised for bank failures and do not get the full benefit of bank risk taking, they have an incentive to adopt an overly conservative policy toward bank risk taking. This conservative position is further compounded by their lack of confidence in the ability of monetary policy to counter systemic risk through appropriate open-market operations.

Prudential policy must attempt to balance two objectives: systemic stability, and minimising taxpayer-funded losses of failed banks arising from the moral hazard problem for banks and the principal-agent problem for regulators. However, the two

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<sup>4</sup> The view that moral hazard underlies increased risk taking in banking has not gone unchallenged. Gorton and Rosen (1995) note that the increased risk has emanated from loan portfolios where shareholders rely on managers' lending decisions and where asymmetric information makes the monitoring of these decisions costly.

objectives are *time-inconsistent* in, for example, the decision of whether to bail out a troubled bank. While a bailout may have a positive immediate benefit in preventing a single bank default from having systemic consequences, it does so at a longer-run cost of increasing moral hazard for banks because the bailout reduces both the incentive of creditors to monitor the risk of banks and the incentive of banks to maintain solvency (see Lane, 1993).

### **Market Discipline and Credibility**

Effective market discipline of risk taking by banks and NBFIs requires that:

1. financial markets are competitive;
2. timely and reliable information on the institution's prudential condition is available for shareholders, creditors and/or private risk-rating agencies;
3. shareholders and creditors believe that the institution will not be bailed out if it is insolvent; and
4. financial markets correctly signal changes in risk exposures and shareholders and creditors respond appropriately to those signals.

In Australia, the first condition for market discipline does not appear to be a problem, though mergers between the major banking groups and/or major insurance groups would require a reassessment. Discussions relating to the information condition have suggested three potential improvements to information flows: (i) making supervisor's on-site examination reports publicly available; (ii) the use of market value accounting; and (iii) risk accounting techniques which Merton (1995:26) describes as measures to indicate 'how individual balance sheet values are likely to change in response to changes in the underlying financial-economic environment'. An improvement in the quality of information reduces asymmetric information and systemic risk as market participants would be better able to differentiate between the risk attributes of individual borrowers.

However, improved information is of little benefit to market participants if they do not believe their investments are at risk. Hence the third condition for market discipline, the no-bailout condition, is critical. Here the issue is one of *credibility*, for it is not enough<sup>5</sup> for a regulator or government to promise there will be no bailout: it must be credible.

A regulatory promise to close insolvent institutions in a timely and efficient manner with shareholders and creditors at risk is generally thought to be less credible when the depositors/creditors are viewed as being relatively unsophisticated small in-

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<sup>5</sup> Lane (1993) notes that the source of the credibility problem is time inconsistency in competing policy objectives. However, the principal-agent problem for regulators is also of some relevance.

vestors, when the institution plays a key role in the operation of the payments system so that systemic risk is of greater concern, and/or when it is perceived as being so big that regulators would not allow it to fail. The latter possibility, commonly referred to as 'too big to fail' (TBTF), is particularly serious as it introduces *regulatory inequity*.<sup>6</sup> That is, large institutions are granted a competitive advantage in accessing funds in financial markets, while smaller institutions have to pay higher risk premiums on those borrowings because they are not underwritten or subsidised by the TBTF policy.

The fourth condition for market discipline relates to the ability of markets to signal changes in risk exposures and whether bank management take prudent actions as a consequence. There is now strong evidence<sup>7</sup> to show that bank share prices reflect bank risk and that yields on bank-subordinated debt and certificates of deposit incorporate risk premiums.<sup>8</sup> However, the evidence is less clear that bank management responds to those signals by reducing risk without regulatory supervision.

This analysis suggests that there would be considerable scope for utilising market discipline to limit the moral hazard and principal-agent problems without significantly compromising the objective of systemic stability. The recent reforms to banking supervision in New Zealand involve a very significant shift towards a reliance on private sector market-based discipline to supervise bank risk taking (see Grimes, 1996).

### The Financial Sector's Six Functions

The functional approach to the analysis of the activities pursued within the financial sector draws its inspiration from the stability in the services offered over time by its various participants. This feature contrasts with the institutional arrangements within the financial sector whereby legal entities can take on new functions while possibly discarding old ones. This distinction between the stability of functions and the flexibility of the participating institutions in the financial sector is important in assessing where regulatory monitoring and supervision might help secure optimal outcomes.

The main purpose of the financial services sector is to support the allocation of real goods and services within and between economies. Within this primary purpose, it is possible to distinguish six basic functions undertaken within the financial sector (Merton & Bodie, 1995).

*Clearing and settlement.* The main feature of this function is the payments system whereby the exchange of goods, services, assets and liabilities is completed. This payments or clearing system may be treated at different levels. Conventionally, the dominant characteristic has been the electronic and paper transfers between banks

<sup>6</sup> A referee has commented that large institutions may secure economies of scale in risk management. However, a recent review of US bank economies of scale studies by Berger et al. (1993) concluded that medium-sized banks were slightly more scale-efficient than either very large or very small banks. For Australian evidence, see Esho and Sharpe (1995).

<sup>7</sup> For Australian evidence, see Dennis, Sharpe and Sim (1996), and, for the US, Gilbert (1990), Ellis and Flannery (1992) and Cook and Spellman (1994).

<sup>8</sup> Information may not be absorbed promptly or accurately by market participants on all occasions; but such a reservation applies equally to regulatory and rating-agency responses to information.



through settlement accounts at the Reserve Bank of Australia. The efficient use of this mechanism has called forth a number of financial techniques, including collateral provisions, daylight overdrafts and interbank funding. Furthermore, clearing and settlements come in other guises, such as clearing houses for exchange-traded derivative financial instruments.

*Pooling and divisibility.* The financial sector provides the means for bringing together funds held by households and firms, thus allowing the pooling of individual sums to support an array of productive activities. Mechanisms for pooling resources and subdividing shares may be found in intermediation and securitisation.

*Resource transfers.* This function relates to the transfer of economic resources in time and location. This means life-cycle allocations by households and optimal allocation of capital resources in efficient locations of plant and equipment. The great bulk of financial intermediaries and agents participate in these activities.

*Risk management.* This function is about managing uncertainty and controlling risk. It is a comparatively new development as a separate function, allowing distinctions to be made between real investment and risk bearing. The growth of financial derivatives has extended greatly the scope for hedging risk and at the same time provided further means of separating savings functions from risk-avoidance measures.

*Information.* With the main purpose of financial markets to foster transactions in financial instruments, the information on which to base decisions for market participation is generated by both price and the volume of trades taking place. At issue is the extent to which such information helps assessments about future prices and their volatility. The scope for drawing inferences of this nature has been extended by the rapid growth of new financial instruments over the past two decades, most notably with derivatives and swaps.

*Incentives, contracting and completion.* An effective financial system provides the means to minimise incentive problems between parties to contracts. This means that parties have as much common information as possible so that each may observe and recognise the action of others. The result is to reduce, if not eliminate, enforcement costs.

## **Functions and Prudential Regulation**

At issue is the breadth of the canvas for the conduct of prudential regulation and what that regulation should embrace. Present arrangements differ from country to country, but most reflect some formal measure of depositor protection. In Australia, the Banking Act provides for the RBA to be 'the guardian, not the guarantor of depositors' interests' (Johnston, 1985:571). Thus, for prudential purposes, the main focus of monitoring and supervision is the protection of depositors.

There is one function on which the other five depend for the completion of all financing activities: clearing and settlement. This function is becoming increasingly dominant, reflecting the extension of clearing from the banking institutional setting in a variety of ways. Households are linked to payments clearing directly rather than indirectly through the historic paper settlement and clearing. The range of institutional clearers has been extended by inauguration of exchange-traded clearing, particularly for derivative financial instruments. This capacity to complete financial transactions with certainty stands as the most important feature of the financial services sector. It is essential to the efficient performance of the real sectors in the economy. By the same token, households and business entities wish to ensure certainty in the completion of agreements or contracts to buy those goods and services. Accordingly, there are firm grounds for adapting institutions to meet this need for safety and certainty in clearing and settlement.

There are two possible ways of implementing the functional approach. The more radical way is to define banks as those institutions offering only transactions accounts and payment services backed by safe assets (Pierce, 1993). Many financial institutions, other than those now defined as banks, might be enticed or persuaded to become banks under this regime. This radical proposal to confine banking to transactions services for clearing and settlement would be based on liabilities other than shareholders' funds being held in short-term liquid assets, mainly federal or State government bonds and treasury bills. More important would be the holding of foreign governments' short-term bonds and treasury bills to ensure liquidity in international clearing. Liabilities would comprise the transaction deposits of the financial system. Any individual or entity wishing to participate in clearing and settlements would have to hold a deposit account with a transactions bank. To secure funds to meet a payment when insufficient sums were lodged in the deposit account, the user would have to borrow from a non-bank financial intermediary to ensure availability of funds for completion. The bank, in its turn, would have to manage its asset portfolio to ensure the availability of funds to meet claims in the clearing and settlements system. Provision would be needed to permit borrowing from outside transactions banking to ensure liquidity and thus capacity to meet the needs of clearing and settlement. Thus, any transactions bank would be able to borrow from, but never lend to, other non-bank financial institutions.

In exchange for the limitations on access to the payments system for clearing and settlement, what sort of guarantee would depositors enjoy for the safety and certainty of their accounts? Pierce (1993) argues for specific guarantees of all transaction bank deposits: all those wanting fully guaranteed deposits would lodge their funds in transactions accounts matched by government paper. This guarantee by government, through the central bank as the supervisor, would not apply to any other type of deposit or its equivalent. The effect of this arrangement is to distinguish the transactions role of demand deposits from the other five functions, which are a reflection of investment activity.

To prevent moral hazard, Pierce (1993) would heavily regulate the transactions banks with asset restrictions, risk-based capital standards, and strong prudential regu-

lation and supervision. In contrast, the financial institutions not classified as transactions banks would not be recipients of deposit guarantees and hence would not be subject to prudential regulation. Instead, they would be subject to companies law and disclosure requirements.

An alternative proposal for implementing this functional approach would be to require all institutions wishing to engage in clearing and settlement, whether they be banks (as now defined by the Banking Act), building societies, credit unions or other financial entities, to account separately for transactions services activities within the structure of their corporate accounts (see Merton & Bodie, 1993). The same structures would apply as with the radical approach, namely, the matching of demand deposits with short-dated bonds and treasury bills from domestic governments and, possibly, foreign-government paper with similar maturities and liquidity. However, somewhat watered-down proposals have been advanced that would allow transaction banks to include top-quality business paper and loans as collateral on transactions deposits.

### **Evaluation of Transactions Banking**

*Regulatory equity.* The crux of the functional approach is the distinction between transactions banking business and all other financial activities. The former is geared up to supervision and monitoring in light of the commitment to guarantee transactions deposits. The latter group, heterogeneous as it is in its institutional complexity, is not subject to any guarantees or prudential protection. In short, there is a heavy stress on the role of market discipline in all financial activities other than transactions banking. The explanation for this sharp distinction is straightforward. Once the remaining five functions of the financial services sector are analysed, it is hard to discern any specific qualities in the assets and liabilities of any one set of financial institutions which are separable from those exhibited by other sets. There are many other deposit-taking intermediaries besides banks, while the growth of trusts and investment funds has brought many different ways of mobilising savings. Moreover, finance companies and money market corporations play significant roles in business lending. In these circumstances, there is no ready justification for continuing traditional distinctions between banks and other financial intermediaries in order to limit deposit guarantees, other than in their transactions role.

Because the functional approach applies regulation to economic activities, it achieves regulatory equity within functions. Thus, transactions banking proposals would eliminate many of the distortions and inefficiencies emanating from existing institutionally based regulation.<sup>10</sup>

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<sup>9</sup> Pierce (1993) would also allow for some insurance regulation to continue.

<sup>10</sup> Alternatively, equity could be achieved by extending existing guarantees and prudential regulation so as to encompass all forms of financing and financial institutions. However, the further extension of such guarantees calls into question the potential costs of support and its implications for taxpayers.

*Systemic risk.* The traditional argument for some type of guarantee for all bank deposits is that banks typically convert short-term liabilities into illiquid long-term assets. At any one time, there is the risk of not being able to re-finance an asset portfolio while at the same time not being able to run down quickly a loan portfolio so as to match the claims for repayment. This possibility opens up not just the prospect of illiquidity leading into failure, but also the potential for contagion as closure of one bank may bring runs on the liquidity of other banks.

Being withdrawable on demand, transactions deposits are much more susceptible to runs than time or fixed deposits. Thus, provided non-transactions banks are precluded from paying out their fixed deposits prior to maturity, the functional regulatory proposals focus the government guarantee on those depositors with the greatest capacity to withdraw funds at a time of crisis. Those insured depositors include the relatively less well-informed depositors who traditionally hold transactions deposits in banks, building societies and credit unions. Moreover, the guarantee is buttressed by asset allocation restrictions and prudential regulation and supervision which would severely limit risk taking in transactions banks. With these protections, there is little prospect of default on deposits, or of runs and illiquidity crises, within the transactions banking area. Furthermore, the development of real-time payments settlement systems has the potential to reduce significantly credit risk arising from non-instantaneous settlement between participants in the payments system.

Nevertheless, there remains a concern, particularly among regulators, that systemic risk and contagion may develop in the non-transactions banking area. But Kaufman's (1994:132) survey of US studies finds little evidence of contagion among money market funds, finance companies or security brokerage firms surrounding the failure of a firm in the industry. The extension of the safety net beyond transaction banking is, therefore, unlikely to reduce significantly systemic risk in the financial system.

*Credibility and moral hazard.* The functional regulatory proposals offer scope for a significant reduction in regulation-induced moral hazard within the financial system by focusing regulation on transaction banking while enhancing market discipline in the non-transactions sphere. But would prudential regulation reflecting this distinction be credible?

At issue is whether creditors or investors in the non-transaction sector believe that regulatory authorities would not, under any circumstance, support a financial intermediary experiencing difficulties when that institution is not an authorised transaction bank. Three circumstances could result in regulatory intervention and a bailout of depositors: where the institution is considered to be so big that the authorities fear the ramifications of its failure on financial markets; where the institution has many small and relatively unsophisticated depositors capable of exerting political pressure; and where the troubled institution is part of a major financial group in which there is also a transaction bank.

While one can never be certain that the authorities would not implement a TBTF policy, the fact that the payments system would be insulated from runs could reduce

regulatory fears of systemic dangers. Moreover, the functional approach would fully protect the transactions balances of small unsophisticated depositors who currently conduct their payments transactions through banks, building societies and credit unions. The third circumstance questions the effectiveness of the so-called Chinese walls that would have to be established between the transaction bank and subsidiaries in the non-transaction sector. But this issue is not new, having been addressed in a related way in the RBA's Prudential Statement No. C2 on funds management and securitisation (RBA, 1994). Apart from legal obligations, the non-banking activity must be held separate from that of the bank within the group and investors must be made fully aware that their investments are subject to investment risk, and do not represent deposits or other liabilities of the banking group.

A related issue is how the transaction bank should be organised in a group of legal entities. There are grounds for thinking that the radical transactions banking proposal must imply a holding company structure with the transactions bank a subsidiary. It could not be the parent company of the group, as is presently the case for most Australian banks.

*Other considerations.* The restriction preventing transactions banks from engaging in personal and business lending has created some concern that the supply of these loans may be reduced. Given the trend toward securitisation of large business loans and home mortgage loans, there is little need for concern in these two areas. Of more concern is the potential effect on small to medium business lending; but even then it must be noted that finance companies and money market corporations lend actively in this area and do so without government guarantees. Hence there is every reason to expect that banking groups would continue providing lending services to small businesses, but through a non-banking subsidiary.<sup>11</sup>

The transactions banking proposal is also attractive for its affinity to trends in financial markets. With the unbundling of services and gradual removal of cross-subsidisation of banking services, transactions banking has become a profit centre within banks. Hence the separation of transactions banking from other services could be viewed as a natural evolution of current banking trends. Where it breaks new ground is in the restriction of asset choice to protect the transaction deposits. Moreover, securitisation in the mortgage market is breaking down the traditional practice of funding mortgages with short-term liquid demand deposits. It is inevitable that corporate lending will also move in this direction. The functional banking proposals appear to offer the prospect of accelerating the elimination of existing cross-subsidies in transactions banking.

When assessing the practicality of the transactions banking proposal in its various guises, one should examine just what banks now do in the payments system. Trans-

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<sup>11</sup> A colleague has suggested that funding loans with non-transaction deposits could increase interest rates on those loans. However, this need not be the case as borrowers presently cross-subsidise some transaction banking activities. In the narrow banking model these cross-subsidies would be eliminated, allowing some reduction in existing borrowing rates.

actions-related items in a major bank's balance sheet show items due to and from other banks. For example, in 1995 National Australia Bank had about 4.9 per cent of its assets in the 'Due from' category and 9.5 per cent as 'Due to'. There is a substantial commitment to short-term credit in support of the payments system. Moreover, within any one bank group there are substantial proportions of assets and liabilities in the bank related to intragroup transactions; 10.5 per cent and 6.3 per cent respectively for the National Australia Bank in 1995. Much of this would have to be taken outside transactions banking under any functional proposal. However, as noted earlier, with the introduction of real-time payments settlement, these proportions of balance sheet business should be reduced.

### Conclusion

Prudential regulation involves a trade-off between the policy objectives of ensuring systemic stability and of minimising the taxpayer-funded subsidy of bank risk that arises from the moral hazard and principal-agent problems. Recently, more stable monetary policy techniques have reduced systemic risk concerns, while regulatory failures in the US and elsewhere have highlighted the costs generated by the moral hazard and principal-agent problems. Consequently, numerous reform proposals have been advanced with the objective of reducing the agency costs by replacing regulatory discipline with market-based discipline.

We have provided an economic analysis of one of those proposals: functional regulation. Within this proposal, concerns for systemic risk underlie the provision of a guarantee for deposits in transactions banks and the associated prudential regulation of those deposits. Moreover, by restricting the regulatory safety net to transactions banking, moral hazard is confined to these activities, while allowing market discipline, supported by adequate disclosure requirements, to constrain risk taking in the remainder of the financial system.

Our economic analysis of this functional approach suggests that it could have considerable merit. But this would require market discipline to operate effectively in the non-regulated sector of the financial system. This requirement is dependent on two conditions. First, there must be a policy whereby the government and/or central bank does not bail out those financial institutions beyond transactions banking, should they experience financial difficulties. Second, this policy must have credibility with market participants.

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# **Patriotism and Politics in the Marketplace**

**Rod Falvey**

CAMPAIGNS designed to persuade consumers to take account of a product's country of origin when making their purchases are not new, but seem to be increasing in prominence. Such campaigns can be directed either at encouraging or at discouraging purchases from particular 'target' countries. In Australia, the most obvious example of positive discrimination is the current Buy Australian campaign, which targets Australian-made products. Another example is Community Aid Abroad's promotion of goods made in Cuba and Mozambique. Negative discrimination, meanwhile, is usually directed at the products of countries whose governments are in political disfavour, such as South Africa (for its erstwhile apartheid policies) or France (for its nuclear testing in the Pacific).

The ostensible aim of campaigns of positive discrimination is to benefit the residents of the target country. Since this is to be achieved by purchasing more of the country's products than otherwise, any benefits are likely to accrue to 'producers' (employees and owners) in the first instance, before spreading more widely within the community. Thus, Buy Australian is directed at assisting Australian import-competing producers, but the increased domestic output, or reduction in imports, is supposed to bring a range of benefits (such as jobs or a reduced current account deficit) to the whole nation. The ostensible aim of campaigns of negative discrimination is to change government policy by punishing producers in the target country in the hope that they will then exert pressure on their government to drop the policy in disfavour.

Shifting consumption patterns away from strict 'value for money' comes at a cost to the consumer. Although this cost is undertaken voluntarily, it may be incurred in the mistaken belief that certain social benefits will follow. As noted, consumer campaigns have quite ambitious ostensible objectives, which are unlikely to be achieved, especially in the Australian context. But beside these objectives, such campaigns may often serve simply to provide guidance to individuals who have an underlying desire to make 'patriotic' or 'politically correct' consumption decisions. This is clearly a more attainable objective, but even here there are significant difficulties. Thus, depending on the extent of the individual consumer's commitment, adhering to consumer campaigns is likely to generate a sense of frustration and failure when its objectives are not achieved. It is therefore important that consumers have realistic expectations in order that failure does generate political pressure for more costly and coercive policies.

## **Buy Australian**

Of these campaigns, those that discriminate in favour of domestic products are the most common and have been the most extensively analysed. Our discussion of them can therefore be brief, focussing on the Buy Australian campaign, because that is the most familiar.<sup>1</sup> Buy Australian has much in common with the group of strategies or policies referred to as 'protectionist' (examples include import tariffs and quotas). The immediate aim of protectionist strategies is also to divert spending from imports to domestic output, though the stated reasons for adopting such a strategy can vary.

Whatever their purposes, protectionist policies impose costs on an economy by distorting production, consumption and trading patterns away from those that result from direct competition between producers on the basis of relative costs. If all countries export those goods and services that they are relatively most efficient at producing (those in which they have a 'comparative advantage') and import those goods and services that other countries are relatively most efficient at producing, then world output is allocated efficiently and all countries participate in the resulting gains from trade. Protectionist strategies induce consumers to purchase from relatively higher-cost domestic suppliers rather than from lower-cost foreign exporters. The domestic import-competing sector is therefore larger than otherwise and the foreign exporting sector is smaller. At least some of this promotion of domestic import-competing industries comes at the expense of relatively low-cost domestic export industries. Abroad, the shift is in the same direction: a contraction of foreign export industries in favour of their relatively high-cost import-competing industries. The result is a misallocation of resources, both internally and externally, since neither country is able to take full advantage of its comparative advantage. Some of the potential gains from trade are sacrificed by both parties as a consequence.

Given that the costs of protectionist policies are now widely recognised, they must be shown to offer offsetting advantages if their adoption is to be justified. Why might it be socially desirable for consumers to purchase an Australian-made product rather than an otherwise better-value-for-money import? Some of the reasons offered will sound familiar to those acquainted with the Buy Australian campaign: reducing unemployment and excessive foreign debt in particular. Though even the extent to which these are problems can be disputed, the focus of most of the criticism of protectionism has been on exposing the very dubious nature of the solutions that protectionist policies might provide. There is no need to review this debate in detail here, but it is useful to consider two arguments to illustrate the misconceptions and fallacies that can arise.

Protectionists, like Buy Australian proponents, claim the preservation of Australian jobs as one of the major benefits of buying domestic products. Few would

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<sup>1</sup> See Black (1995) for a recent analysis of the Buy Australian campaign. Campaigns similar to the current Buy Australian campaign have been tried in Australia in the past and elsewhere. Slogans such as 'Be American, Buy American; The Job You Save May Be Your Own' and 'When You Shop Canadian You Buy Jobs For Canada', should sound familiar to Australian readers.

doubt that unemployment involves real social costs. More contentious are the appropriateness and efficacy of protectionist strategies as a solution to unemployment. These strategies are attractive because the jobs so 'protected' are held by definite, identifiable people (voters). It is specific jobs, rather than employment in general, that are being protected. Yet the individuals that hold, or might hold, the jobs that are believed to be threatened will generally find jobs elsewhere. Experience indicates that the use of protectionist policies does not increase overall employment in the long run, but instead influences the way this employment is distributed among activities in the economy. In the long run, it is not in the nation's interest to reallocate employment away from its comparative advantage and into import-competing activities. Protectionist economies have been characterised by significantly lower growth rates rather than significantly lower unemployment rates.

A further argument commonly used to justify protectionist interventions is that consumers, out of ignorance, systematically undervalue domestic products; they are 'biased' in favour of imports. It is interesting that this was an early theme of the Buy Australian campaign. Consumers were urged to compare locally produced with imported products and then to purchase whichever represented the better value for money. From this perspective, the Buy Australian campaign could be viewed as simply an instrument for assisting consumers to make more informed and rational choices. This theme appears to have been dropped, however, and I am unaware of any evidence that suggests Australian consumers do systematically undervalue locally-made products. Even if they do, a consumer bias in favour of imports may not be as irrational as it seems. The international market is very competitive, and the fact that a product can survive in that market (without government assistance) is an indicator that it is likely to represent value for money. Ironically, the Buy Australian campaign itself has played on this bias in television commercials drawing attention to the fact that Australian-made products are exported as an indicator of their quality. This may very well be true, but to then argue that Australian consumers should therefore buy Australian made products in preference to imports in general seems inconsistent. How is it that Australian exports are an indicator of quality, but other countries' exports (Australia's imports) are not?

All that said, although Buy Australian may share the purposes and tactics of protectionist policies, there are fundamental differences between them. Buy Australian uses 'moral suasion', through an advertising campaign that argues the merits of purchasing domestic products, rather than 'coercing' consumers through price-increasing taxes or quantitative controls. Consumers persuaded by the Buy Australian argument can make the switch. Those unpersuaded can continue to purchase imports at world prices. To the extent that the Buy Australian campaign is successful, consumers will make some purchases other than from the least-cost producer

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<sup>2</sup> Horridge et al. (1987) use the ORANI model of the Australian economy to simulate the short-run effects of switching expenditure from imports to domestic output. They find that the consequences for employment are ambiguous, even in the short run, depending on the way in which the diverted expenditure is distributed across domestic activities. Krueger (1978) provides evidence on the relationships between a country's trade regime and its unemployment and growth performance.

and which therefore do not represent the best value for money. Australia will end up producing goods and services in which it is not internationally competitive. Consumers will incur avoidable costs in the mistaken belief that they are reducing aggregate unemployment or reducing the foreign debt. But at least it is the consumer's choice, and a voluntary (albeit tax-funded) campaign of this sort will not incur the full costs of distortionary trade policies. If, for political reasons, governments feel compelled to be active in this area, Buy Australian is far less distortionary than some other approaches.

### Rules of Origin

This line of argument might be taken to suggest that, if nothing else, the Buy Australian campaign has performed the useful task of identifying Australian-made products so that patriotic consumers can exercise their preferences.<sup>3</sup> Yet even this task is not as straightforward as it seems. The time when most products were wholly manufactured in a single country is long past. Modern manufactures, whether domestically produced or imported, are likely to contain components from a variety of sources, both domestic and foreign. Governments establish 'rules of origin' that legally determine which country shall be deemed the country of origin of a particular import. Such rules play a role in the application of marking, labelling, and advertising laws and regulations. For the Buy Australian campaign to meet its ostensible objectives, a similar determination is required for products that claim to be 'Australian'. There would seem to be no point in diverting consumer demand from an 'import' which had a very high Australian content but received its final processing overseas, to a 'domestic product' which had a very high foreign content but received its final processing in Australia. To exercise the choices suggested by the Buy Australian campaign, consumers need to be informed of a product's 'Australian content' in at least some dimension. Take, for example, the objective of promoting 'Australian jobs'. A dollar's worth of added value will represent different numbers of jobs in different Australian manufacturing activities. A consumer really concerned about 'jobs' would presumably want to target those domestic industries with a high labour content. But how are these to be identified? And how could we prevent firms from responding by adopting more labour-intensive, but less efficient, production methods?

The complications of attempting such labelling are already becoming apparent. Labelling rules for food products have been the subject of negotiations between the federal government, the ACTU, the National Farmers' Federation, the Australian Consumers' Association and the Australian Food Council. As reported in *The Canberra Times* (8 October 1995), agreement has been reached on what partici-

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<sup>3</sup> Free-rider problems may inhibit Australian producers from financing their own campaign, although the Australian Owned Companies are sufficiently well organised for their Association to publish the Ausbuy Guide which 'informs' consumers of which brand names are foreign and which are Australian-owned.

pants described as a 'simple' three-tiered system of labelling. The categories are as follows:

- *Product of Australia*, where all ingredients (except minor components) are Australian and processing takes place in Australia;
- *Made in Australia*, where the food obtains its essential character in Australia. Any imported ingredients must be declared on the label, unless the ingredients are not available in Australia. 'Made in Australia from local and imported ingredients' means more than 50 per cent of the ingredients are local; and
- *Packed, Blended, Cured, or Smoked in Australia from imported ingredients*, where the food has some Australian input. The Australian character or process must be declared, as well as the nature of the imported ingredients: for example, 'squeezed in Australia from USA oranges'.

This categorisation appears to be targeted at 'import content' rather than 'jobs' or 'foreign ownership', and conforming and monitoring will be costly exercises. The labelling might prove informative for some consumers, but one is not optimistic that the patriotic consumer's trips to the supermarket would be quick ones.

Buying Australian involves clear costs in terms of forgone gains from trade, while its ability to deliver 'benefits' in terms of reduced unemployment or foreign debt are dubious at best. If taken seriously, Buy Australian requires the elaborate labelling of products to indicate the extent of their Australian content. Logically, this labelling would vary with the objective of the campaign: jobs, import content or foreign ownership. Furthermore, such labelling would need to adjust to changes in production technology and exchange rates (as these affect the employment and import contents), and transfers of ownership between domestic and foreign residents. Surely, few commentators would seriously advocate the public funding of such a costly exercise with such dubious and uncertain social benefits. Nevertheless, the Australian Democrats' 'Getting to Work' Plan unveiled in the 1993 election campaign came close to proposing such labelling.

### **Consumer Boycotts**

Consumer discrimination against imports from a target country (a consumer boycott<sup>4</sup>) is likely to sacrifice fewer of the gains from trade than discrimination against imports in general, except in those cases where all foreign suppliers are involved.

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<sup>4</sup> The term 'boycott' originates in the ostracism of Captain Boycott, an Irish land agent, in the 1880s, though clearly the practice precedes that date. Consumer boycotts have been organised to protest the 'policies' or actions of both governments and private companies. Friedman (1985) and Smith (1990: Appendix B) list examples. These boycotts have a diverse range of objectives, including: promoting animal welfare, environmental protection, health, the rights of minorities and labour organisations, and opposing pornography.

The diverted demand is spread over both domestic production and imports from other sources. Yet costs are incurred, since purchases are being made according to a criterion other than value for money. Any compensating 'benefits' depends on the objective and likely effectiveness of the campaign. Three possible objectives are publicity, punishment and policy change. If the objective is simply to allow consumers to avoid purchasing the products of a target country, as a way of demonstrating their opposition to a particular policy of its government, then identifying these products will be sufficient for the campaign to be effective. If the objective is to 'punish' the target country for its government policy, then success requires that the concerted actions of Australian consumers inflict significant economic harm in the target country. If the objective is to induce the target government to change its policy, then both the harm and the conditions for an appropriate target government response are required.

The first question that arises is why consumer boycotts need to be organised at all. If individual consumers object to the policies of some foreign government (like nuclear testing, suppression of minorities, change of government by coup rather than election, and so on) they are free not to purchase products from that country. Consumers are not required to take vacations in its resorts, fly on its national airline or purchase products sold under brand names associated with its producers. It is true, however, that individual consumers are unlikely to be fully informed about the origins of all the products they purchase. Individual boycotts will therefore target only the more obvious candidates. Were consumers to be fully informed, they could generate a more comprehensive boycott. Yet full information could be a mixed blessing. It is true that a more comprehensive boycott would inflict greater economic damage in the target country, but only if participating domestic consumers incurred higher economic costs themselves. Perhaps one should take the view that some ignorance is bliss, but, if not, there is a case for a coordinated campaign to identify the relevant products. A coordinated advertising campaign may also be necessary to inform the target government of the reasons for the boycott.

Where public outrage over some foreign government policy is sufficiently strong and widespread that a mere 'private protest' is deemed insufficient, boycotts can be expanded and coordinated by governments. The objective would now be to signal displeasure and to punish, and even to change target government policy by reducing the economic benefits that country obtains from its trading relations with Australia. Unfortunately, the reciprocal nature of the gains from trade means that Australian benefits from this trade would be reduced also. Government trade sanctions impose economic costs on *all* parties in order to achieve political ends. In general, sanctions that inflict heavy costs on the target country are more likely to succeed, although they can sometimes have the perverse effect of inducing its residents to rally in support of their government. Sanctions that generate heavy costs in the imposing country are more likely to fail. To be most effective, sanctions should be able to target all transactions — revenue from the sales of goods and services, profits from foreign investment, remittances from migrants, and so on — which a government can do but private consumers cannot. Indeed, government sanctions

are likely to concentrate, in the first instance, on financial and bureaucratic matters (freezing bank accounts, restricting official travel, cancelling entry visas, and the like), which might be thought to impose maximum inconvenience on the target regime at minimum local costs.

### **Do Consumer Boycotts Work?**

Yet, despite their potential to apply maximum coverage, government-imposed sanctions have not proved successful in achieving political ends. In a recent and quite comprehensive study, Hufbauer et al. (1990) find few cases where sanctions inflict economic costs equivalent to even 1 per cent of a target country's GNP. Certainly, the extensive use of international economic sanctions by the League of Nations between the world wars is generally regarded as a failure. Once one recognises the limited success that government sanctions have had, even where there has been strong multilateral support, and that 'voluntary' consumer boycotts are a much diluted version, since they are less comprehensive in coverage and lack legal enforcement powers, one cannot but be pessimistic about the success that consumer boycotts will have in influencing foreign government behaviour.

Hufbauer et al. (1990) note that government sanctions tend to restrict both imports and exports, and that, when trade in only one direction is restrained, export controls are almost always<sup>5</sup> chosen in preference to import controls. Depriving the target country of one's own exports is deemed to be a more effective punishment than attempting to block the inflow of its exports. The reasons underlying this preference are clear. For many products, target countries find it relatively easy to find alternative markets for their exports, or to arrange triangular arbitrage to circumvent import controls. It is difficult to identify the country of origin of bulk products in particular. Sanctions generate strong incentives for evasion and the development of imaginative new trading arrangements because it is so difficult to trace the origin and destination of traded goods. For example, during the period of international sanctions against South Africa, a comparison of trade flows recorded in South African statistics with those recorded by its trading partners revealed that over 50 per cent of South Africa's trade had been 'lost'.

Consumer boycotts are, by their very nature, limited to imports. For homogeneous bulk products, which have many alternative sources, a less than universal import boycott is unlikely to have more than a very short-term effect. The medium-term outcome will be a rearrangement of trading patterns, probably involving some increase in transport and transactions costs. But, since these products are primarily intermediate inputs, they will not be the target of any but a very sophisticated consumer boycott (one that extends to looking at the origin of a product's major inputs). Given that attempting to include such products will do little to increase the boycott's effectiveness, it is probably just as well that they are omitted, since this is

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<sup>5</sup> Interestingly, one of the few examples of the use of import controls alone involves Australia. In 1954 the USSR imposed an embargo on wool imports from Australia in an (unsuccessful) attempt to force the return of a defector.

likely to reduce significantly the local costs of the boycott. Producers are then left free to obtain intermediate inputs from the lowest-cost source, so that their international competitiveness is not impaired.

Instead, consumer boycotts will typically focus on manufactures, and even here they are likely to be less than comprehensive given incomplete information about the origins of products. The initial focus will be on a few high-profile consumer goods and services, such as national airlines, motor vehicles and wines. Interestingly, these are the types of firms and products on which a boycott is likely to have its greatest impact (Friedman, 1991). Since their production involves high fixed costs and low marginal costs, their profitability is heavily dependent on maintaining sales volume. They are also sold in markets with relatively high degrees of product differentiation and limited product substitutability, so that producers cannot maintain sales volume by diverting products to other boycott-free markets without taking significant cuts in price. The targeted products are easy for consumers to identify, and consumer 'violations' of the boycott are particularly visible. The producers are often image conscious and can wield significant political influence with their home governments.<sup>6</sup>

But while the producers and products may be right, the impact of the boycott will be considerably muted by the small scale of the Australian market. Consumer boycotts will have their greatest impact where Australia is the major market or where sales cannot be diverted — that is, where the goods or services are not traded — since then Australia is 'the market'. But Australia is a major export market for very few foreign countries or foreign products. Targeting nontradables requires a shift in the focus of the boycott, since the product's country of origin is likely to be Australia (otherwise it would be tradable). Now the focus must be on the nationality of the producer. Where a product is produced by a wholly foreign-owned firm, there is some chance that it can be identified with the nationality of its producer. But ownership is no more a discrete variable than is country of origin. Should the boycott also apply to all products whose producers are at least 50 per cent owned in the target country? If the criterion is to be target country control, then this can be achieved by ownership levels considerably less than 50 per cent, depending on how the remainder of the ownership is distributed. But pursuing this approach would again impose enormous reporting and labelling requirements. It also brings the issue of unintended victims and beneficiaries of the boycott to the fore.

To be effective in changing target government policy, consumer boycotts must 'harm' target producers by reducing the demand for their products and forcing down their market prices. The costs then fall on the boycotters, who end up purchasing a less preferred product, and the boycottees, who end up selling less at a lower price. The latter group invariably includes a range of 'innocent' parties: those selling inputs to target producers, foreign investors in the target country, do-

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<sup>6</sup> One should recognise that not all residents of the target country necessarily support their government in its pursuit of the policy under attack. It is possible that a misdirected boycott could in fact reduce the resources available to opponents of the policy in the target country, thereby weakening their opposition to the very policy whose overturn is sought.



mestic investors in and employees of importing firms (such as investors and workers in dealerships selling target country products), investors in and employees of domestic joint ventures with target country firms, and even investors in and employees of wholly domestically-owned firms whose output happens to be identified with the target country (like 'French' restaurants). Accompanying them will be (often unforeseen) beneficiaries located where the expenditure is diverted.

But the main direct beneficiaries are likely to be nonparticipating consumers who now pay lower prices for the boycotted products.<sup>7</sup> How the participants respond to this free-riding behaviour by nonparticipants is important. If participants accept that, in the Australian context, boycotts play essentially a protest role, then their solidarity will ultimately be so undermined by free riding that the boycott peters out. But there will be a natural tendency for some participants to blame free riders for the failure of the boycott, and to seek to strengthen it through political action. Such action could involve pressure for local, State and federal governments to honour the boycott in their own purchases, and could even extend to pressure for the adoption of more coercive policies (such as government trade sanctions) that constrain all consumers. In the circumstances, these strategies are unlikely to increase significantly the chances that the target government will change its policy. What is certain is that they will significantly increase the local costs of the boycott.

## Conclusions

The small size of the Australian market precludes consumer boycotts or consumer promotions<sup>8</sup> from having a significant impact on target countries, except in a very few cases. The main role of these campaigns would appear to be to facilitate the actions of individual consumers who derive a psychic satisfaction from supporting or opposing particular policies or governments with their purchases. Consumer discrimination in favour of domestic products can potentially have a significant impact in expanding the production of importables, but only at the expense of exportables in the long run, with a consequent sacrifice of the gains from trade, and with no logical expectation that the ultimate objectives (lower unemployment and foreign debt) will be any nearer to achievement.

In a liberal-democratic society, individuals, firms and pressure groups are free to influence consumer spending patterns. Commercial advertising typically promotes a product as better value for money than its competitors. Consumer campaigns, in contrast, generally ask the consumer to sacrifice value for money in support of social objectives. As long as consumers recognise and accept that the behaviour exhorted by these campaigns consists largely of 'protest' or 'feel good' actions,

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<sup>7</sup> Indeed, were all consumers to cut back some of their purchases rather than just some consumers eliminating all their purchases, consumers effectively would be acting as a 'buyers' cartel', and all would reap the benefits of the lower prices.

<sup>8</sup> In the US, these are sometimes referred to as 'buycotts', and an example is the Buy New Zealand campaign announced by antinuclear groups to reward that country for its government's policy of remaining free of nuclear weapons.

then they appear harmless enough. The danger emerges when a majority of participants take this rhetoric too seriously, and expect 'results'. When these are not forthcoming, their activity may shift to domestic political action demanding more coercive measures (government trade sanctions or protectionist trade policies). These, while not significantly improving the chances of achieving the objectives, will significantly increase the local costs of the action and the likelihood of foreign retaliation. It is therefore important that consumers be aware of the limitations of consumer campaigns targeted at broad objectives, both for the sake of their own well-being and in the interests of sensible policy-making.

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# Measuring Poverty and Income Inequality in Australia

**Peter Whiteford**

**O**VER the past 20 years the number of income distribution and poverty studies in Australia has increased enormously. Surveys undertaken by the Australian Bureau of Statistics (ABS), particularly the Income Distribution Surveys (IDS) and the Household Expenditure Surveys (HES), contain detailed information on the economic circumstances of households and families.

Yet the literature provides a bewildering array of contradictory results and trends. We hear that there is an ever-rising tide of poverty, that the rich are getting richer and the poor poorer, that the gap between rich and poor is wider than at any time since the 1940s, that the middle class is shrinking or disappearing (or that there is a 'new middle class'), and that there is an emerging underclass. From supposedly being the wealthiest country in the world at the end of the 19th century, as well as one of the least unequal, Australia is said to be slipping in the national income stakes and to be one of the most unequal developed countries. But we are also told that average incomes and living standards are at a higher level than at any previous time in Australia's history, that the real value of benefits for the poor has increased substantially over time, and that government spending on health, education and other community services<sup>1</sup> also significantly reduces inequality.

There is no unanimity on either the trend or level of inequality and poverty in Australia. Some authorities conclude that poverty increased by around 60 per cent over the 1980s (Saunders, 1994); others claim that it fell by more than 20 per cent (Harding & Mitchell, 1992). Often, individual researchers have simply focused on different aspects of income and used differing methods of analysis. Such technical choices can change the direction of measured social trends: for example, some of the technical judgements made in research using the 'Henderson poverty line' are problematic and internally contradictory, thus producing poverty estimates that are potentially misleading.

This article identifies and discusses some of the main technical factors affecting both poverty measurement and distributional analysis.

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<sup>1</sup> Sometimes called the 'social wage' (Harding, 1982).

*Peter Whiteford works in the Strategic Planning Division of the Department of Social Security, Canberra. The views expressed are his own and should not be attributed to the Department of Social Security.*

## **The Concept of Living Standards**

Most distributional studies are concerned with material living standards rather than broader welfare concepts, such as satisfaction with life, levels of security, social isolation, or feelings of stress. But material living standards may rise while many households subjectively feel worse-off. Individuals may work longer hours to produce higher incomes, but feel under pressure. The increased labour-force participation of women may produce higher measured family income, but some individuals may prefer to spend more time with their children.

Some negative factors may not be given a monetary value, such as declining environmental quality. Other positive contributions to material well-being, such as unpaid work in the home, are often ignored. But it is possible to give many factors a monetary value (Travers & Richardson, 1993).

## **The Measure of Resources**

The concentration on material living standards reflects the quantitative preferences of researchers. The measure of material resources is probably the most important issue to be considered in any distributional study; yet it often attracts the least discussion.

Consider the differences between the distribution of income and the distribution of expenditures or consumption. According to the 1993-94 HES, the average gross income of the highest income quintile was around eleven times that of the lowest income quintile, but the ratio of the average expenditure of these groups was around 3.3 to 1. Several factors explain this large difference. High-income groups pay more income tax than low-income groups and save more of their income. Low-income individuals may run down their savings or go into debt to maintain expenditure levels, while some self-employed have low current incomes or are experiencing business losses. But the difference shows that an appraisal of the level of inequality is highly dependent on the choice of the measure of resources.

Figure 1 sets out the income accounting framework used in most Australian and overseas studies. Most studies treat material standards of living as synonymous with cash incomes. By definition, the more comprehensive the definition of income, the more accurate is the measure of material resources. But no study can be said to use a fully comprehensive definition of income. Some well-known studies concentrate on wage and salary income (Gregory, 1993); others use gross incomes before tax (Gregory & Hunter, 1995). But the most common measure is after-tax disposable income (Saunders, 1994). Recent work by the National Centre for Social and Economic Planning (NATSEM) (Harding, 1995) includes the value of other social spending on services, but excludes the effects of indirect taxes. Yates (1991) shows the impact of owner-occupied housing on income distribution. The most comprehensive studies are those undertaken by the ABS (1987, 1992, 1996a), which analyse the impact of community services and indirect taxes; but even they do not include private housing wealth, capital gains or fringe benefits.

Figure 1

**The income-accounting framework**

Wages and salaries plus self-employment income plus property income	<b>factor income</b>
plus occupational and private pensions	<b>market income</b>
plus social security cash benefits (universal, income-related, contributory)	
plus private transfers plus other cash income	<b>gross income</b>
minus income tax (and employee social security contributions)	
	<b>cash disposable income</b>
times equivalence scales	<b>equivalent cash disposable income</b>
Possible additional components: the social wage, indirect taxes, imputed income from owner-occupied housing, fringe benefits, capital gains	

Many studies deal with only part of total income distribution, legitimately concentrating on specific trends in wage and salary or cash disposable income, for example. But it follows that it is necessary to be cautious about the conclusions drawn from incomplete studies.

The ABS (1996b) has recently published a conceptual framework for statistics on household income, consumption, saving and wealth. Under this framework, economic well-being can be described from a disbursements perspective as the sum of consumption, changes in net worth, and a notional wealth annuity. From a receipts perspective, this is equivalent to net disposable income minus saving, plus the change in net worth and a notional wealth annuity.

It is also notable that virtually all studies that broaden the measure of resources produce lower estimates of poverty and inequality than those that use cash disposable income (Harding, 1995; Smeeding et al., 1992).

**The Period of Assessment**

Since individuals may accumulate or withdraw savings, their current living standards are not identical to their current incomes. Their circumstances may change significantly over their lifetime and also within a single year. The pattern of income changes with the family life-cycle. This pattern has changed over the 20th century and government programs now redistribute resources from times of relative affluence to relative need; but important features of the family life-cycle remain pertinent. This pattern coexists with inequality between classes, but should not be confounded with it.

Individuals also change their family status and therefore their incomes perhaps more frequently than in the past. Still, more people experience a relatively short period of lone parenthood than remain lone parents for five or more years, say. For these and other reasons, differences in the period used in analysis may affect measured income inequality. For example, using the 1990 IDS, it can be estimated that the Gini coefficient for wage and salary income is 0.300 for current income

data,<sup>2</sup> but 0.352 for the annual data, a very substantial difference of around 17 per cent.

The time horizon used may be particularly significant when measuring the impact of public policy. Creedy (1994) notes that as transfers have an insurance element and a redistributive element, their redistributive element cannot be examined using only annual information. This point is of crucial importance in international comparisons of redistribution, since the mix of self-insurance and actual redistribution differs between countries. Falkingham and Harding (1996), for example, compare the redistributive impact of the UK and Australian social security systems. In the targeted Australian system, 38 per cent of lifetime benefits received by individuals are paid for at another stage in their life (that is, they are equivalent to self-insurance); the remaining 62 per cent consists of redistribution between income groups. In the UK, in contrast, only 38 per cent of benefits is accounted for redistribution between different income groups. By spending less overall on social security than nearly any other developed country, Australia appears to provide less by way of redistribution between income groups. But this reflects the fact that, in a single year accounting period, it is implicitly assumed that all measured transfer spending consists of redistribution between income groups, when in fact much of it is self-insurance.<sup>3</sup>

One means of correcting this bias is to undertake lifetime incidence studies of income distribution and redistribution (Harding, 1993). An alternative is to bring all public and private redistribution within the compass of a single year's accounting period. This would involve developing a comprehensive measure of income, covering the benefits of all forms of government activity, including imputed wealth in the form of public pension rights, as well as the costs and benefits of private provision, such as imputed income from owner-occupied housing (Yates, 1991).

### **The Income Sharing Unit**

While we are all individuals, we also live in households that may contain other people with whom we may share income or expenses. We are also members of families who may share resources even when we do not live in the same households, and we provide gifts and other voluntary transfers to other households. On the other hand, young adults may live at home, but have a degree of independence in managing their incomes.

Most studies assume that couples completely share their incomes between themselves and their dependent children. Actual income sharing is unmeasured, however, and the equal-sharing assumption has been questioned. Even where patterns of income sharing differ, household members who share may face lower

<sup>2</sup> The Gini coefficient ranges between 0 and 1 with a higher Gini implying greater inequality.

<sup>3</sup> For example, assume that Australia spent 10 per cent of GDP on transfers, while the UK spent 15 per cent of GDP. If we separate out the redistributive and self-insurance components, then Australian redistribution would be 6.2 per cent of GDP, while UK redistribution is 5.7 per cent of GDP. So, contrary to the standard approach, actual redistribution would be greater in Australia than in the UK.

housing and related costs than they would if living separately. Consequently, studies must decide whether income is measured for individuals alone, for the nuclear family, for the extended family or for the household. Results will differ depending on the choice made, which must be arbitrary to the extent that the actual degree of income sharing within households and between related individuals is unknown. In general terms, the wider is the unit assumed to share resources, the lower will be the level of measured inequality or poverty.

### **Equivalence Scales**

Equivalence scales seek to quantify the relative incomes needed by different types of families to attain similar living standards. They are usually expressed as a set of numbers with some family type chosen as the base. Fixing the scale for a single person at 60 per cent of that of a couple without children implies that a single person with an income of \$12,000 is as well off as a couple without children and an income of \$20,000.

Given a set of scales, researchers adjust actual income by the scale to produce a measure of 'equivalent income'. This re-ranks households, so that smaller households have their income adjusted upwards and larger households have their incomes adjusted downwards to reflect the estimated relationship between needs and income.

No consensus exists on the appropriate method of estimation; and empirical estimates of scales vary widely (Whiteford, 1985). However, the social security system contains a set of implicit equivalence scales that strongly affect the relative incomes of households (mainly age pensioners and sole parents) where many people rely entirely on benefits. This concentration of households around statutory benefit levels means that slight variations in the scales used may result in either a very high or a very low proportion of these populations estimated to be in poverty. The use of different equivalence scales may therefore have a substantial impact on estimates of the extent of inequality and low income for these population groups.

Equivalence scales need to take account of changes in household characteristics over time. Over the past 15 years, the number of single-person and sole-parent households increased from 22 per cent to 29 per cent of all households, and the average number of children per family fell. As the average number of people in households falls, average household incomes also tend to fall. If average household size falls more for low-income groups than for high-income groups, then disparities between their incomes will apparently widen. Take HES data for average household income. Real household income fell by 7.8 per cent between 1975-76 and 1984, and rose by 0.7 per cent between 1984 and 1988-89. At the same time, average household size fell from 3.09 in 1975-76 to 2.84 in 1984 and 2.78 in 1988-89. In fact, adjusting for these changes in household size implies there was no change in real household income per person between the mid-1970s and the mid-1980s, while real household income per person rose by about 2.5 per cent in the second period. Thus, taking account of changes in household size reverses the apparent direction of change.

### The Poverty Standard

In defining poverty and a 'poverty line', it is common to distinguish between 'absolute' and 'relative' poverty, with absolute poverty lines usually defined as the cost of a minimally adequate basket of goods and services. Most researchers now agree that value judgments necessarily affect the definition of adequacy, and the composition of a minimally adequate basket of goods and services cannot be separated from the social environment in which people live. Consequently, most research is now based on some measure of relative poverty.

As noted by Sen (1983), the common view of poverty is that it has an irreducibly 'absolute' component, which gives the goal of poverty alleviation its moral imperative. But a relative poverty line denotes relative low income, or the lower tail of the income distribution. The constraints imposed by relative low income may or may not be 'acceptable' to the majority in the community (especially if they do not have to experience it). Yet virtually no modern study of poverty tells us whether people living below the poverty line have an unacceptably low standard of living. This does not mean that relative poverty in rich communities is not real, but rather that we need different sorts of research to link demonstrated problems with living standards and the statistical measures of low income commonly used as proxies for poverty.

The use of a relative poverty line implies that the living standards of the poor should keep pace with general community standards (Saunders & Whiteford, 1989).<sup>4</sup> This raises the problem of defining average living standards and measuring trends in these standards. In international comparisons, it is common to use fractions (usually 50 per cent) of mean or median survey income as the poverty line. In Australia, the 'Henderson poverty line' used since the late 1960s is a relative poverty measure, although it is not based on either mean or median survey income. When originally developed, the Henderson measure was a form of 'absolute' poverty line, since it was defined as the basic wage plus child endowment for a couple with two children. This arbitrary definition was justified on the grounds that it produced a standard 'so austere as, we believe, to make it unchallengeable. No one can seriously argue that those we define as poor are not so' (Henderson, Harcourt & Harper, 1970, quoted in Saunders, 1994).

The Henderson poverty line was again used by the Commission of Inquiry into Poverty in the early 1970s, and subsequently by researchers and welfare organisations. This required a means of updating it over time. Initially, the line was adjusted according to movements in average weekly earnings, but since the early 1980s it has been updated in line with Household Disposable Income Per Capita (HDIPC) from the National Accounts. Since the Poverty Inquiry Survey in 1973, HDIPC has grown in real terms by around 30 per cent. This means that the statement that the 'poor have got poorer' when based on incomes compared with the

<sup>4</sup> It has been argued that the use of a relative poverty line makes it impossible to abolish poverty, since there will always be income inequality. But if relative poverty is defined as some percentage of community incomes, then it is technically possible to raise all incomes above such a line.



Henderson line is simply not correct. In fact, the absolute living standards of those at the poverty line have risen quite substantially.

The Henderson line has the additional complication that household disposable income measured in income surveys does not coincide with HDIPC measured in the National Accounts. The IDS does not include imputed income from owner-occupied housing or the undistributed earnings of superannuation funds. These are included in the National Accounts, and they have risen more rapidly than other income components. As a result, the Henderson poverty line has actually risen faster than either mean or median survey incomes. Thus, the finding that there has been an 'ever-rising tide' of poverty over the 1980s inevitably reflects the fact that the Henderson poverty line has increased in relative as well as absolute terms. Studies that use a poverty line adjusted only in line with prices (Bradbury & Doyle, 1992) or one set at 50 per cent of median income (Harding & Mitchell, 1992) show declining poverty rates over the 1980s.<sup>5</sup>

Discussion of poverty usually focuses on the number of people or families with incomes below the poverty line, often referred to as the 'poverty headcount'. But the headcount does not tell us whether families are \$100 or \$2,000 a year under the poverty line. Moreover, if a government introduced a new payment that increased the incomes of all the poor from \$2,000 a year below the poverty line to \$100 a year below the poverty line, then a headcount measure may register no change in poverty rates. One way of dealing with this is to use more than one poverty line. Some researchers have used 80 per cent, 100 per cent and 120 per cent of the Henderson line as measures of people being either 'extremely poor', 'rather poor', or 'near poor'. International research often defines poverty lines as 40 per cent, 50 per cent or 60 per cent of median income. A further option is to calculate the 'poverty gap', either the aggregate difference (as a percentage of GDP) or average difference (in dollars) between families' actual incomes and their respective poverty lines. As well, indices may be used that weight individuals by their distance below the poverty line. This raises a potential problem with those who have artificially low or negative business incomes. Nevertheless, an index of this sort may provide a superior measure, since the poverty gap and the poverty headcount may move in opposite directions.

The choice of a definition of poverty reflects a set of value judgments, some of which unavoidably have arbitrary elements. There appear to be major problems, however, with the Henderson poverty line commonly used in Australia, since it does not provide consistent measures of trends in the number of people with relative low incomes. As noted by Saunders (1991:26): 'The time is perhaps right to consider once again how the poverty line should be set and how the extent of poverty is best measured'.

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<sup>5</sup> This is in contrast to the US, where the official poverty line is adjusted in line with prices, and the proportion of the population below the line is as it was in the 1970s. In the UK and New Zealand, the extent of poverty has risen compared with a constant real poverty line (UK Department of Social Security, 1994; Stephens, 1995).

## Changes Over Time and International Comparisons

Much academic and public interest in distributional issues is explicitly comparative. We want to know how our current situation compares with the past, and how we compare with other countries. Such comparisons are often used in assessing specific government policies and decisions.

Determining the impact of government is not straightforward. Measured trends in income may be substantially affected by the beginning and end points of any analysis. For example, in analysing trends in income distribution under Australia's Labor government of 1983-96, it is common to start with the 1981-82 IDS, which is the survey closest in time to Labor's accession to office. But that survey was conducted about six months before the election, during which time unemployment increased by around 50 per cent. Using this survey as the base therefore makes the Hawke Government responsible for the rise in unemployment, and also gives it credit for tax cuts and benefit increases introduced by the previous government. The following year may have been a better starting point; but the ABS did not conduct a survey in 1983. Microsimulation data create further problems. The year 1982-83 was an exceptionally bad one for farmers.<sup>6</sup> This has a substantial impact on trends in median incomes, and on poverty rates calculated by reference to median incomes. In addition, policy changes may have an effect on income distribution only in the very long run, such as the expansion of superannuation coverage and increased school participation rates over the 1980s.

All the problems discussed above may arise with international comparisons. For example, the United Nations *Human Development Report* (1996) has recently attracted considerable attention, particularly its estimate that Australia has one of the widest dispersions of income of any developed country. But this finding arises because the figures quoted for Australia make no adjustment for household size, while those for many other countries do use equivalence scales. Similarly, Peter Singer (1995) argues that Australia should adopt specific features of the Japanese model on the assumption that Japan is one of the most equal of developed countries. However, Bauer and Mason (1992) show, that the surveys used to assess the distribution of income in Japan exclude all single-person households, and do not include income data for the non-agricultural self-employed sector, which accounts for about 30 per cent of the total population. Other studies in Japan have concluded that its income distribution was much like the US and relatively unequal in the OECD.

To overcome the formidable problems of data and methodological comparability, the Luxembourg Income Study (LIS) database has been established, offering the opportunity to apply the same approach in nearly all analytical areas (O'Higgins et al., 1990). Although it provides the best source of data for international comparisons, it is not perfect. In some countries, the operation of government policies makes precise comparability impossible. For example, in the UK, mortgage tax

<sup>6</sup> Income from unincorporated farm enterprises increased in real terms by 766 per cent between 1982-83 and 1989-90. Using a three-year average as the starting point gives a small real fall of around 4 per cent in farm incomes.

relief for home purchasers is paid as a direct subsidy to lending institutions, and does not appear in the data set. Again, in the UK and other countries, assistance to low-income renters is provided through measured cash subsidies, while indirect subsidies effected through reduced rents, as they are in Australia, are excluded.

The fundamental problem with international comparisons is that measured income means different things in different countries.<sup>7</sup> This reflects the fact that most analysis is restricted to cash disposable income, as defined in Figure 1. In a single year accounting period, taxes and social security contributions, which are much higher in most developed countries than in Australia, are treated as a 'burden'. Middle-income families in larger welfare states are apparently worse-off than similar families in smaller welfare states, because their measured tax liabilities are higher, while the benefits accruing to middle-income households in large welfare states are not counted because they mainly arise as future entitlements. Thus, using a relative measure of poverty will result in lower poverty in large welfare states, not because the poor are absolutely worse-off, but because the median is artificially lowered.

In Australia, in contrast, the processes of redistribution between income groups (targeting) and redistribution across the life-cycle have been substantially separated. More of the redistribution across the life-cycle in Australia is effected through private means, including endowment insurance, home purchase, superannuation and other forms of savings. The costs of these forms of savings are not included in the standard framework summarised in Figure 1, because they are arranged privately. In contrast, the costs of savings (redistribution across the life-cycle) associated with state pensions are included in the standard approach, because they are financed from taxes and social security contributions. Similarly, the exclusion of imputed income from owner-occupied housing from most international comparisons reinforces the impression of higher inequality in small welfare states. The standard framework systematically makes high-taxing welfare states look more equal than low-taxing countries, such as Australia.

## Conclusion

For many of these issues, there is no single technically correct answer. The choice of the unit assumed to share income, the choice of equivalence scales, and the choice of low-income standard are ultimately arbitrary in the sense that there can be good reasons for making different choices.<sup>8</sup> In contrast, the comprehensiveness of the income measure is of fundamental importance. Choice of a different measures can be justified by reference to the objectives of specific studies, but it is important to qualify the conclusions drawn from incomplete measures.

Research results will differ significantly depending on the technical choices made. For example, Whiteford and Kennedy (1995) estimate that the proportion of older Australians (over age-pension age) with relatively low cash disposable in-

<sup>7</sup> See Whiteford (1995) and Ståhlberg (1985) for more detailed discussion.

<sup>8</sup> This does not mean that all choices are equally valid: there are specific equivalence scales, for example, that differ markedly from the consensus of this research.

comes varied between 5.5 per cent and 58.8 per cent, depending on the choice of income standards (40 per cent, 50 per cent or 60 per cent of the mean) and equivalence scales. If the one income standard (50 per cent of the mean) is used, then relative low income could still vary between 14 per cent and 37 per cent in line with differing equivalence scales, with the 'baseline' equivalence scale used giving an estimate of 30 per cent. Using the same equivalence scales and standard (50 per cent of mean final income), but broadening the income concept to incorporate non-cash health, education and housing benefits and imputed income from owner-occupied housing, would reduce the extent of relative low income from 30 per cent to 4.9 per cent. If the poverty line used had been based on percentages of the median, then all these estimates would fall. Moreover, Australia's international ranking changes enormously depending on the measure of resources used. On the basis of cash disposable income, relative poverty among older Australians is three times higher than in Germany; adding government services and imputed income from owner-occupied housing reduces the Australian poverty rate to about 80 per cent of the (also reduced) German poverty level (Whiteford & Kennedy, 1995).

**Table 1**  
**Comparison of measures of inequality in Australia, 1993-94**  
Ratio of share of richest quintile to poorest quintile (Q5/Q1)

<i>Measure of Resources</i>	<i>Q5/Q1</i>	<i>Q5/Q1 per person</i>
1. Private income	117.7	58.9
2. Gross income	10.6	5.3
3. Disposable income	8.0	4.0
4. Disposable income plus indirect benefits	5.1	2.5
5. Final income	5.3	2.64
6. Expenditure	3.3	1.62
7. 'Final expenditure'	2.6	1.32

Note: Private income is from market sources; gross income is private income plus cash benefits; disposable income is gross income minus direct taxes; the next concept adds government spending on health, education and other services; final income then subtracts indirect taxes; expenditure is current spending on commodities and services; final expenditure is current expenditure plus indirect benefits and minus indirect taxes.

Source: Calculated from ABS (1996a).

Similarly, Table 1 shows the effects of using differing measures of resources on estimated inequality. The inequality measure is the ratio of the average income (or share) of the richest 20 per cent of the population to the average income of the poorest quintile. Moving from private or market income to take account of government cash benefits, then direct taxes, then non-cash benefits and indirect taxes, narrows the ratio appreciably. Taking account of household size halves the inequality measure, and has a more significant impact than any form of government policy

except the provision of social security benefits. Moving from income- to expenditure-based measures of living standards further reduces this measure of inequality.<sup>9</sup>

Most public understanding of the nature of poverty and income inequality in contemporary Australia is highly dependent on technical choices made in analysing statistics on income distribution. The variability of research results suggests that considerable caution should be exercised in reaching firm conclusions about income distribution issues. This does not mean that it is impossible to reach firm conclusions. If studies undertake detailed analysis of the sensitivity of results to technical choices, underlying similarities in trends or differences may be identified. If the direction of change or the direction of difference remains the same under all possible technical choices, then it is highly probable that the trend or difference is real. This suggests, however, that we may have to be content with broad or general conclusions, rather than the implausibly precise claims that are usually made.

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<sup>9</sup> The measure of 'final expenditure' should be regarded as illustrative, as it simply involves adding government-provided consumption (non-cash benefits minus indirect taxes) to private expenditure on commodities and services. It should also be noted that the adjustment for household size does not take account of economies of scale or the lower needs of children, thus tending to overstate the level of equality of consumption and income.

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# **The Environment, Information and the Precautionary Principle**

**Ian Wills**

**O**N 9 April 1996, it was reported in *The Australian* that the New South Wales government had cancelled plans for a \$180m gold mine, even though an independent inquiry had recommended that the mine be approved. The report continued:

The NSW Minister for Urban Affairs and Planning, Mr Knowles, said the Government had always maintained it would 'only support mining at Lake Cowal if there was clear evidence that the mining could take place without any threat to the wetlands or the wildlife species'. 'While the commission could recommend conditions to mitigate or minimise environmental risk, they were unable to guarantee that there would be no threat to the wetlands or downstream impact on species', Mr Knowles told *The Australian*.

In view of scientific uncertainty about the impacts of projects on the environment, is it reasonable to require that developers guarantee the absence of environmental damage? After all, absolute certainty is unattainable in modern science. Would not the demand for such a guarantee before projects proceeded put a stop to all developments that affect the environment (Brunton, 1994)?

## **The Precautionary Approach to Environmental Change**

The precautionary approach in environmental management emerged in the preparation of clean air legislation in West Germany in 1970. 'Precaution' embodied the ideas that damage to the natural world should be avoided in advance, and that, when irreversibility is feared, there should be action before scientific proof of damage is available (Boehmer-Christiansen, 1994:35-8). More recently, policy statements incorporating these ideas have been included in international agreements, including the European Union's 1991 Treaty of Maastricht and the 1992 Framework Convention on Climate Change.

Precaution was proposed as a guiding principle of Australian environmental policy in the nationwide Ecologically Sustainable Development discussions undertaken between 1990 and 1992. The first clear statement of the precautionary principle as a rule for environmental management in Australia was included in the In-

tergovernmental Agreement on the Environment (IGAE) signed by Paul Keating (then Prime Minister), State premiers, chief ministers and a local government representative in May 1992 (Harding & Fisher, 1994).

The precautionary principle is one of four guiding principles cited in the IGAE (1992, para 3.5.1):

Where there are threats of serious or irreversible environmental damage, lack of full scientific certainty should not be used as a reason for postponing measures to prevent environmental degradation.

In the application of the precautionary principle, public and private decisions should be guided by:

- (i) careful evaluation to avoid, wherever practicable, serious or irreversible damage to the environment; and
- (ii) an assessment of the risk-weighted consequences of various options.

To many, this formulation would seem uncontroversial. Advocates of the precautionary principle argue that, faced with the possibility of environmental changes which threaten humanity's life-support systems, a risk-averse society needs to institutionalise caution by placing the burden of proof on those who wish to change the environmental status quo (O'Riordan & Cameron, 1994). Thus, in the absence of scientific certainty about the consequences of natural resource use, a logger or miner or resort developer should be required to provide appropriate proof either that the proposed development will not result in some defined level of environmental damage, or that environmental damage will be minimised. Alternatively, the developer could be required to show that the possible environmental loss is less than the likely benefits of the project to the community.

Interpreted as a demand for proof of zero environmental damage, the precautionary principle would have required the aboriginal immigrants of 50,000-60,000 years ago to leave Australia to the giant kangaroos, marsupial lions and diprotodonts (Flannery, 1994). The principle therefore requires qualifications such as (i) and (ii) in the formulation above. But the qualified principle raises major social choice and definitional problems. Who is to decide what constitutes 'serious environmental damage', what is 'irreversible', and on what evidence? How are 'risk-weighted consequences' to be assessed? The implied degree of discretion on the part of decision-makers would not seem to make for certain or stable environmental management rules. Nor is it clear why the IGAE specified 'serious or irreversible environmental damage' (emphasis added). Young (1993:14) defines 'serious' as 'could have extremely adverse implications for future generations', and 'irreversible' as 'no known substitutes exist for the resource being used'. Precautionary principle advocates give no reasons why we should worry about 'serious' environmental damage which can be reversed, or irreversible damage that is not 'serious'.

In its non-absolute form, the essence of the precautionary approach is not a rejection of scientific and economic analyses, but the reversal of the burden of



proof. While the principle stems from the inadequacy of scientific knowledge, its qualified application sensibly requires the use of the best available science and economics to establish the appropriate standards of proof that would-be developers must meet. However, interpretations of the precautionary principle differ according to beliefs and ethical stances. Decision-makers who are optimistic about the ability of human technology to replace or repair damaged environmental assets will require lower standards of proof about environmental damage than technology pessimists. 'Deep greens', meanwhile, who believe that non-human species have rights independent of human interests, will require developers to meet the highest standards.

Some advocates of the precautionary principle reject the privileged position for science and scientists implied in the preceding paragraph. According to Hunt (1994:121), the precautionary literature encompasses two distinct approaches to the problem of scientific uncertainty. One approach, expressed above, renders the implementation of the precautionary principle dependent on the use of science and economics to establish and assess standards of proof. The alternative, more radical, approach, expressed in Hunt (1994) and Harding and Fisher (1994), is based on the view that scientific (and economic) knowledge, and the concomitant uncertainty, are malleable social constructs. Those adopting this perspective believe that what is known and what is uncertain scientifically depends substantially on culture and who is making the claim, as well as on established scientific testing procedures. They therefore see the present social construction of scientific (and economic) concepts as impeding a full understanding of the consequences of environmental changes. For these people, precautionary policy involves as much cultural and political change as science; they advocate a decision process that puts decisions on 'how much' precaution into the hands of a wider set of stakeholders than at present (Harding & Fisher, 1994:259).

### **Uncertainty about Economic-Environmental Systems**

The economy and the natural environment interact in four ways. The environment is a source of inputs into production. It serves as a receptacle or sink for production and consumption wastes. It provides amenities which directly affect human well-being. Finally, the environment provides human life support, the result of the combined functioning of the climate, chemical element cycling, water cycling and living organisms.

The interactions between the economy and the different services of the environment are sometimes so complex that we are uncertain about the consequences of human actions affecting the natural environment. Such uncertainty arises primarily as a result of:

- environmental complexity due to biological diversity and variations in the physical environment, leading to imperfect scientific understanding of the functioning of the natural world and of ecosystems in particular;

- economic complexity due to the numbers of human agents and goods, the diversity of technologies, preferences and institutions, and the ability of people to learn from experience and to change their preferences and institutions; and
- consequences which extend far into the future. Thus, current decision-makers are ignorant of the identity and personal preferences of future people affected by current actions, and of the future technologies and resource costs which, together with future generations' preferences, will determine their happiness or unhappiness with the world we bequeath to them.

With so many possible interactions within and between the economy and the environment over space and time, it is simply impossible to know all the future consequences of current use of the environment.

What sort of uncertainty is involved? Common (1995:173) distinguishes two types. What we will term 'ordinary uncertainty' applies when the range of possible outcomes is known but their probabilities are not known. 'Radical uncertainty' applies when the possible outcomes of actions cannot all be identified. Young (1993:17) cites an example of radical uncertainty: the use of chlorofluorocarbons (CFCs) as refrigerants and propellants. CFCs were adopted because of their chemical inertness and stability, which were thought at the time to create minimal ecological risks. *Ex post*, scientists realised that these very properties allowed CFCs to reach the stratospheric ozone layer. Another example is the impact of proposed bans on tropical timber imports from Southeast Asia. There are likely to be unforeseen environmental and economic outcomes in both exporting countries (like Malaysia) and importing ones (like Australia), as timber producers and consumers adjust. Unforeseen changes are also likely due to the commercial responses to the ban (such as illegal trade through third countries) and political responses (such as retaliation by the timber exporters).

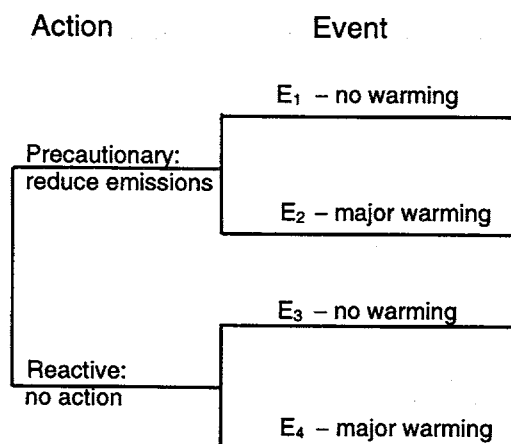
A decision tree can be used to depict the distinction between ordinary and radical uncertainty. Figure 1 depicts the actions available to the decision-maker, the uncontrollable events that can occur, and the relationship between actions and events. In the simplistic greenhouse policy decision tree depicted in Figure 1, the decision-maker has just two present options: to act now to reduce human emissions of greenhouse gases which may lead to major global warming within a few decades, or to postpone action, which avoids present costs. Each option is followed by one of two possible climatic events: either major warming will occur or it will not. In the future, the decision-maker will choose an action tailored to whichever of the specific climatic events,  $E_1$ - $E_4$ , has occurred.

The decision tree in Figure 1 would be correctly structured if it included all the possible actions and all possible action-event scenarios. This is the situation for ordinary uncertainty. However, in the case of greenhouse gas emissions, this is not the case. Uncertainty about greenhouse science, future technologies and people's future responses to climate change means that the event branches and corresponding climatic and economic outcomes on the right hand side of Figure 1 are not all

known. Thus, the greenhouse policy problem involves radical uncertainty: the decision-maker cannot identify all the possible action-event scenarios, let alone their probabilities.

**Figure 1**

**Greenhouse policy decision tree**



Given that uncertainty results from environmental and economic complexity and from long-lived consequences, one would predict that the degree of radical uncertainty increases with the extent and diversity of the ecosystems and economic systems impacted by environmental changes, with the numbers of people involved (both as actors and as sufferers), and with the duration of the consequences. These are in fact the characteristics of the most important global environmental problems, such as CFC and greenhouse gas emissions, major forest clearing and marine pollution. At the other end of the scale, activities that are highly localised in space and time and affect very few people, such as noise pollution between neighbours, are likely to be subject to relatively minor uncertainty.

The most important environmental problems, and hence the greatest uncertainty, commonly result from accumulation of the small-scale activities of large numbers of individuals, such as consumers, drivers, farmers and loggers. The fact that the individual actors are small makes the problem more, not less, serious, since smallness in relation to the overall magnitude of the problem encourages free-riding by both actors and sufferers. For example, any effort that I make to control my car's emissions makes no discernible difference to city pollution or global CO<sub>2</sub> levels. As well, since my car's contribution to these problems is not identifiable, I will suffer no penalty for not acting and obtain no reward if I act to reduce my emissions. So the benefit I expect, either as a sufferer from pollution or as a controller

of pollution, is zero. • Since reducing my car's emissions is costly, I am better off doing nothing.

Uncertainty is most troubling when the possible outcomes of current actions may involve serious *and* irreversible damage to ourselves or to the community. Decisions to undergo risky major surgery have this character for individuals. Major decisions on our use of the natural environment may have serious and irreversible consequences for whole communities if an irreplaceable natural resource or ecological life support system is irreversibly altered. The construction and operation of the Chernobyl nuclear plant in Ukraine is one example. The decline of civilisations whose irrigated agriculture succumbed to increasing salinity appears to be another.

The functioning of the economic system is dependent on social institutions such as moral codes and property rights. Given the interdependence between the economy and the environment, it follows that humanity's future is dependent on both the maintenance of environmental assets which provide human life support and the maintenance and enhancement of social institutions. It is much more difficult to envisage serious and irreversible environmental damage in a society where social institutions are inclusive and effective in signalling people's concerns to others and in motivating people to respond positively to those concerns. Such societies have institutions designed to identify major threats to the society, to inform members of those threats, and to motivate people to alter their behaviour in response to those threats. So, to sustain itself in the long term, a society needs to maintain and enhance both its environmental capital and its social capital: the two are complementary.

The precautionary principle is a proposed addition to our stock of social institutions. Can a set of social institutions including the precautionary principle do a better job of informing people about possible consequences of their use of the environment, and of motivating them to respond appropriately, than our current set of social institutions? In the search for an answer, we need to compare the information requirements of precautionary policies with our knowledge of economic-environmental systems.

### **The Information Requirements of Precautionary Policy**

Consider the policy options for dealing with greenhouse gas emissions. It is feared that major global warming is occurring due to increasing atmospheric concentrations of greenhouse gases resulting from human activity. The serious, possibly life-threatening, consequences contemplated include expansion of the tropical cyclone belts to higher latitudes, extension of deserts due to changes in rainfall patterns, and substantial rises in the global sea level. The uncertainty about greenhouse imposes an unavoidable choice between doing something now to avert possible damage, and postponing action until evidence appears of how the climate is changing. A precautionary approach would involve taking the former option: action to reduce human greenhouse gas emissions now, despite uncertainty about global warming due to those emissions, and about the costs of any global warming which does occur. The

latter, 'reactive', option would involve reacting to climatic changes if and when they occur.

At first glance, if we believe that people are risk averse, the precautionary option seems sensible: better to act now to avert possible future disasters that may cause irreversible damage to society. But a precautionary policy makes little or no sense if the decision-maker is faced with radical uncertainty regardless of the option chosen. With radical uncertainty about the outcomes of precautionary policy, it is impossible to estimate the impact of precautionary measures upon future global warming. Yet choosing precaution over reaction implies that the decision-maker knows something about events and outcomes, namely, that a precautionary policy of (say) reducing greenhouse gas emissions now will eliminate or greatly reduce the possibility of severe future damages due to global warming. If the decision-maker does not know that a precautionary policy will be effective, then it is possible that the precautionary approach leads to the worst of both worlds: society incurs the present costs of precautionary actions, but still suffers the future costs of unanticipated (given precautionary measures) disasters (Chisholm & Clarke, 1992). To put it another way: if the chances of very costly climatic changes, such as substantial rises in sea level, are little affected by costly reductions in current emissions, why incur such costs now? The adoption of precautionary policy is not consistent with radical uncertainty about its outcomes.

If precautionary measures are subject to ordinary, rather than radical, uncertainty, precautionary policy may be justified by considering its impact on the range of possible events and outcomes. Consider the case of a mining project such as the proposed gold mine at Lake Cowal. Suppose that the possible consequences of a ban on mining are well understood, but the environmental impacts of the mine are highly uncertain. The decision-maker faces a clearer choice than before: between a well-defined range of consequences of a ban on mining, and a wide and ill-defined range of mining outcomes. In such circumstances, precautionary policy might be implemented by requiring convincing evidence that (say) environmental protection measures will greatly reduce the extent of environmental damage regardless of future events.

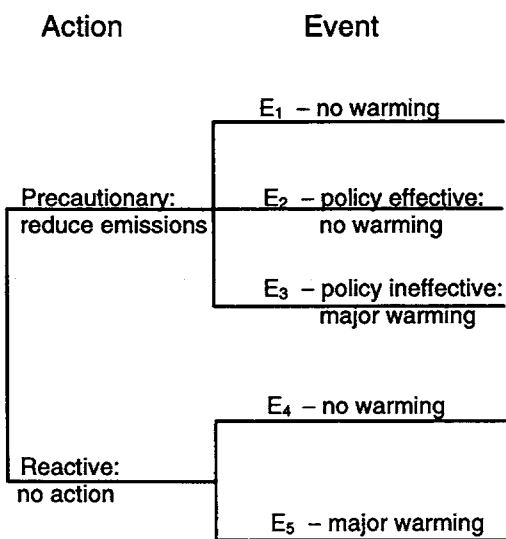
Figure 2 illustrates the possibility of ineffective precautionary policy. It incorporates the same climatic outcomes as Figure 1, and adds the possibility that precautionary emissions reductions may be either effective or ineffective in reducing global warming.

To choose between precautionary and reactive policy, the decision-maker needs information about, first, the magnitude of the present costs of precautionary measures, and second, the future consequences, costs and benefits of precautionary and reactive policies. In the greenhouse policy choice depicted in Figure 2, both are subject to radical uncertainty. In the case of current actions to control emissions, the uncertainty about cost is due to the major economic and social dislocation which could attend severe restrictions on the production of greenhouse gases, in particular CO<sub>2</sub>. In the case of future consequences, limited scientific understanding

of global climate change, and ignorance of future technologies and human responses to climate change, cause major uncertainties.

**Figure 2**

**Greenhouse policy decision tree when policy may be ineffective**



Thus, in the case of greenhouse, a risk-averse society could make matters worse by adopting precautionary policy.

This is an important point. It is commonly believed that precautionary policy, involving the minimisation of currently observable environmental damage, is sensible if people are risk averse. This is almost certainly the case with relatively well-understood environmental systems, such as municipal sewage disposal or local air pollution. Such situations involve mostly ordinary uncertainty; the chances of very costly surprise outcomes of precautionary policy are negligible. On the other hand, with the radical uncertainty characteristic of extensive and complex economic-environmental systems, precautionary policy can be ineffective, can lead to unpleasant surprises, and therefore can be more damaging than reactive policy.

**Planners' Preferences, Judgements and Incentives**

Radical uncertainty about greenhouse means that there is no 'right' choice between precautionary and reactive policies. Decisions, precautionary or reactive, will often turn out to be incorrect with the wisdom of hindsight. The correct *ex ante* policy choice depends heavily on the responsible decision-maker's preferences and subjective evaluation of possible alternatives.

Consider the greenhouse policy choice depicted in Figure 2. Assume that the decision-maker knows the possible events, but not their probabilities or the associated costs and benefits. Under what circumstances will the precautionary option make sense? It depends on the decision-maker's degree of risk aversion and beliefs about the efficacy of precautionary measures. Assume that she is so risk averse that she cares only about the worst possible outcomes of the precautionary and reactive policies: she will choose whichever policy minimises the maximum possible total cost. For the precautionary option of reducing current greenhouse emissions to minimise the maximum possible cost, she must believe that the worst of the possible outcomes of precautionary policy,  $E_3$ , will cost less than the worst of the possible outcomes of reactive policy,  $E_5$ . Yet precautionary policy involves the additional costs of current precautionary measures. Thus, if there is a perceived slight chance that precautionary policy may be ineffective, an extremely risk-averse decision-maker may choose reactive policy. A less risk-averse decision-maker will also give some weight to the other possible events and their costs and benefits. He is willing to accept a perceived low chance of the high costs of ineffective precautionary policy in return for a perceived higher chance of effective policy which avoids the high costs of global warming: he will prefer precautionary policy.

Policy choices will depend on decision-makers' perceptions of the probabilities and consequences of global warming. A decision-maker who is pessimistic about climate change and its consequences, but optimistic about the effectiveness of precautionary emissions reductions, is likely to choose precautionary policy. Conversely, a decision-maker who is optimistic about climate change, but pessimistic about the effectiveness of emissions reductions, will prefer reactive policy. The greater the degree of radical uncertainty, the smaller is the scientific and economic basis for the precautionary-reactive policy choice, and the greater must be the reliance on the preferences and subjective judgement of the person responsible for the choice. This is not a concern when the chooser also bears all or most of the important consequences of the choice; an individual contemplating risky heart surgery has strong incentives to consider all the possible outcomes of both the precautionary and reactive options. However, the subjectivity of decisions made under radical uncertainty increases the degree of discretion enjoyed by political and bureaucratic environmental planners, who do not personally bear all the consequences of their decisions. Because current citizen-voters will have extraordinary difficulty in establishing the possible long-term consequences of precautionary-reactive policy choices, politicians and bureaucrats will have more than their usual scope for pursuing personal goals inconsistent with democratic preferences.

### **A Democratic Bias towards Precautionary Policy?**

Aaron Wildavsky (1988:223-7) argues that planning in Western democracies is biased towards precautionary policies. The possible disasters that we recognise loom much larger in our imaginations than disasters that we cannot imagine or the everyday harms to which we have grown accustomed. It is reported that lay persons overestimate the probabilities of events that are widely publicised and thus easily

imagined, such as nuclear accidents and dramatic climate changes due to greenhouse warming; conversely, the probabilities of unspectacular and rarely-reported events such as strokes and domestic accidents are underestimated (Slovic et al., 1990). This leads to demands for precautionary policies to avert the recognisable disasters, with inadequate recognition that those policies may reduce society's ability to respond to the unforeseen and to reduce the incidence of the mundane. In the case of greenhouse, many people may perceive the possibility of serious and irreversible damage due to climate changes and rises in sea level, and demand emissions reductions as a result. They are less likely to recognise that the resulting reduction in community income and wealth can reduce expenditures on other ways of saving people's lives and property, and on the research and development which equips society to handle the unforeseen. For example, the search for a cure for the unforeseen disaster of AIDS is underpinned by research in molecular biology, which occurred before AIDS revealed itself.

When a politician or a public servant is making a decision on environmental policy, most citizens' information gathering and signalling will be influenced by free-rider logic: since we do not expect our vote to make any difference to the planner's decision, there is little incentive to collect information beyond that which is to hand, and a considerable likelihood that votes will express beliefs rather than judgments based on facts. Since the public is likely to be more aware of the possible costs of not acting on greenhouse than of the costs of acting and getting it wrong, environmental planners' self-interest encourages them to act now. It takes a strong politician or bureaucrat, dependent on the public's votes and its tax dollars, to resist demands to 'do something' by way of precautionary action in response to well-publicised environmental dangers.

Harding and Fisher (1994), advocates of the precautionary principle, are also concerned about the self-interest of environmental planners. They fear that, left to the usual policy participants, adoption of a precautionary approach to environmental policy will make little difference to environmental management in practice; the precautionary approach 'requires no changes to environmental practice and decision-making since we are already operating cautiously' (1994:259).

There is evidence that the implementation of precautionary policy is not immune to planners' self-interest. In Germany, where the precautionary principle originated, it commonly involves the development and promotion of cleaner technologies through the adoption of 'best available technology not entailing excessive costs' (BATNEEC). Boehmer-Christiansen (1994:50-2) attributes Germany's technology-led precautionary policy to the dominance of the German advisory and legal processes by the engineering profession rather than by natural scientists.

### **The Roles of Experts and Citizens**

Recall that some advocates of the precautionary principle see environmental problems as, in part, socially constructed (Hunt, 1994; Harding & Fisher, 1994). For these critics of the present approach to environmental problems, part of the solution lies in opening up the decision-making process to hitherto underrepresented



stakeholders. This raises the difficult question of the respective roles of scientific experts and citizens in the process of determining environmental policies and standards of proof. Remember that people are likely to pay more attention to the spectacular than to the mundane. Further, the costs of stress based on people's fears of unknown and unfavourable outcomes, stress which occurs whether or not such outcomes eventuate, may be substantial.<sup>1</sup> Faced with such fears and stresses related to our use of the natural environment, how much weight does a planner attach to expert opinion, and how much to citizens' perceptions?

Politically sensitive environmental planning requires two-way communication between the judgments of experts (meteorologists, biologists, economists, and the like) and the concerns and values of affected citizens. This emphatically does not mean downgrading rigorous science, but rather more systematic assessments of the limitations of science in the face of radical uncertainty. The new field of 'risk communication' emphasises the need to communicate what is 'culturally rational', in terms of fitting in with acceptable standards of morality, decency and due process, as well as what is 'technically rational' as perceived by technical experts (Plough & Krimsky, 1990).

### **Concluding Comments**

The precautionary principle developed in response to uncertainty about the consequences of environmental changes. However, if the degree of uncertainty about the outcomes of precautionary policy is the same as for the outcomes of reactive policy, it is possible that a risk-averse society could make matters worse by such 'blind' adoption of precautionary policy. Its successful application actually requires considerable scientific and economic information, in particular information about the degrees of uncertainty associated with different policies, the costs of precautionary measures, and their effectiveness in reducing future environmental damage and adjustment costs.

The regional or global environmental problems where the precautionary approach is particularly appealing because of perceived threats to human life support, such as greenhouse warming and tropical deforestation, involve large and complex economic-environmental systems where the consequences of environmental change extend far into the future. The functioning of these systems is subject to so much scientific and behavioural uncertainty that the effectiveness of precautionary policies is uncertain. Unfortunately, precautionary policy is likely to be more effective where decision-makers are less in need of guidance, such as in the case of less complex and relatively well understood economic-environmental systems.

Given radical uncertainty about economic-environmental systems, democratic choices between precautionary and reactive environmental policies must take account of both expert knowledge and citizen perceptions. Improved communication about technical and cultural concepts of 'risk' is a prerequisite for any serious at-

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<sup>1</sup> For a discussion of concern about the outcomes of technologies which pose hazards for people, see Fischhoff et al. (1990).

tempt to implement precautionary policies. In an age of environmental disaster scenarios, perhaps we need an independent body analogous to the Productivity Commission to facilitate honest communication between the parties.

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# **Export-led Industrialisation, Employment and Equity: The Malaysian Case**

**Prema-Chandra Athukorala and Jayant Menon**

**T**HE rapid and sustained growth of newly industrialising countries (NICs) in East Asia since the late 1960s has been accompanied by a more equal income distribution than in other countries at a comparable stage of development. Mainstream (neoclassical) economists attribute this achievement to export-led industrialisation, which, given the right policies, can be replicated in other developing countries. The argument is that, as the comparative advantage of developing countries in international production is in relatively labour-intensive production, the expansion of manufactured exports translates into higher employment. As labour is the most widely distributed factor of production in the economy, employment expansion and the subsequent increase in real wages reduce poverty and income inequality (Krueger, 1995; Balassa & Williamson, 1987; Fei et al., 1979).

Revisionist (structuralist) economists, however, doubt whether the NIC experience can be replicated in other developing countries (Amsden & van der Hoeven, 1996; Helleiner, 1994; Taylor, 1991). These economists argue that 'growth with equity' was brought about largely by favourable initial conditions of these countries and highly accommodating world markets at the formative stage of their economic transformations. The NICs had higher educational standards, more even distribution of income, and broader-based wealth ownership than other developing countries, which helped establish a virtuous circle of high growth and low inequality. As well, the rapidly expanding markets in developed countries in the 1960s and early 1970s facilitated rapid expansion of labour-intensive manufactured exports without requiring real-wage restraint. If the NIC firms had been forced to operate in a depressed world market, so the revisionists argue, they would have been obliged to cut costs rather than to raise prices, leading to real wage stagnation and a massive shift of income from labour to capital (Amsden & van der Hoeven, 1996).

This article seeks to shed light on this debate by examining the case of Malaysia, a country which has achieved impressively high growth through export-led industrialisation since the mid-1980s. Malaysia's initial conditions and structural characteristics had more in common with the many other developing countries in the region than with the East Asian NICs. Thus, the lessons from the Malaysian experi-

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*Prema-Chandra Athukorala is Senior Fellow in the Research School of Pacific and Asian Studies at The Australian National University. Jayant Menon is Senior Research Fellow at the Centre of Policy Studies and Impact Project at Monash University.*

ence would be relevant to the debate on trade and industrial policy reforms in developing countries.

### **Post-Independence Economic Policy**

At independence (Merdeka) in 1957, economic conditions in Malaysia (then the Federation of Malaya) appeared favourable. But the country had to face the challenge of a plural society inherited from the colonial past. At the time, the native Malays, who accounted for 52 per cent of the population, dominated politics, but were relatively poor, being involved mostly in low-productive agricultural activities.<sup>1</sup> The ethnic Chinese (37 per cent of the population) enjoyed greater economic power and dominated most of the modern-sector activities, but lacked the ethnic solidarity or political power of the Malays. Economic policy-making in post-independence Malaysia therefore became a continuing struggle to promote development while preserving communal harmony and political stability.

During the first decade of independence, the government continued the colonial open-door policy stance to trade and industry, while attempting to redress ethnic and regional economic imbalances through rural development schemes and the provision of social and physical infrastructure. Like many other developing countries at this time, Malaysia sought industrialisation through import-substitution policies. However, unlike other countries, Malaysia eschewed forced industrialisation through high tariffs and quantitative import restrictions and the establishment of state-owned industrial enterprises (Lim, 1992). Foreign investment was welcomed during this period. But its impact on the economy was limited for two reasons: (i) in the absence of binding import restrictions, there was no compelling reason for foreign producers to establish import-substituting plants in Malaysia; and (ii) the internationalisation of production within vertically integrated global industries had not yet begun.

By the late 1960s, it was clear that future industrial development depended upon the expansion of export-oriented industries. Incentives offered to export-oriented ventures under the Industrial Incentives Act 1968 included exemptions from company tax and duty on imported inputs, relief from payroll tax, investment tax credits and accelerated depreciation allowances on investment.

Economic expansion during 1957-69, though respectable, failed to make a substantial contribution towards solving the 'special' problems of the Malays. On the other hand, with urban unemployment rising and education and language again looming as issues, non-Malays began to question the extent to which their interests were being safeguarded in the new Malaysia. The bloody communal riots of May 1969 resulted in a clear shift from policy-making based purely on economic considerations and towards a policy of affirmative action based on ethnicity. This New Economic Policy (NEP) formed the basis of the Second Malaysia Plan (1971-75).

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<sup>1</sup> In 1957-58, 34.9 per cent of households had incomes of less than RM120 (A\$48) a month (the official cut-off point for measuring poverty). More than half of these households were Malay, and more than two-thirds were rural (Snodgrass, 1980).

## **The New Economic Policy**

The objective of the NEP was to maintain national unity by eradicating poverty through employment generation and by restructuring society so as to eliminate the identification of race with economic function. To achieve the first objective, development strategy focused on export-oriented industrialisation and an ambitious rural and urban development program. The Free Trade Zone (FTZ) Act 1971 enticed export-oriented foreign direct investment with incentives such as duty-free imports of raw material and capital equipment, streamlined customs formalities, subsidised infrastructure facilities and company income-tax incentives. For the second objective, long-term targets were established for *Bumiputra* (ethnic Malay) ownership of share capital in limited companies, and for the proportion of Malays employed in manufacturing and occupying managerial positions. The NEP aimed to increase the Malay share in corporate assets from 2 per cent in 1970 to 30 per cent in 1990, and to make employment patterns in the urban sector reflect the racial composition of the country. Malay participation in business was promoted in two ways. First, the public sector, where Malays held most of the key positions, was expanded, by setting up new ventures and by the purchase of foreign-owned businesses. Second, Malays were granted privileged access to share ownership and business opportunities in the private sector. The Industrial Coordination Act (ICA) 1975 strengthened measures to implement NEP norms on *Bumiputra* participation at the enterprise level. Under the ICA, the conduct of medium- and large-scale enterprises was subject to licensing with the aim of improving the relative position of the Malays in the modern sector of the economy.

The promotion of heavy industries was a key element in the Fourth Five-Year Plan (1981-85). The Heavy Industries Corporation of Malaysia (HICOM), a public-sector holding company, was formed in 1980 to go into partnership with foreign companies in setting up industries in areas such as petrochemicals; iron and steel; cement; paper and paper products; machinery and equipment; general engineering; transport equipment; and building materials. These industries were expected to 'strengthen the foundation of the manufacturing sector . . . [by providing] strong forward and backward linkages for the development of other industries' (Government of Malaysia, 1984:271). Even though the new selective industrialisation push was often rationalised as an attempt to emulate Japan and Korea (hence the 'look East' policy, a term coined by Mahathir Mohamed in 1981), in practice the selection of new projects was based largely on traditional import-substitution criteria. These projects were supported with subsidised credit, government procurement provisions and heavy tariff protection, without subjecting them to any market-based performance norms. By 1987, Malaysia had 867 corporate public enterprises, more than a third of which were in manufacturing.

The blow-out in public expenditure caused largely by the heavy industries policy led to widening budget and current account deficits, and an increase in external debt from about 1981. As well, the world economic recession in the mid-1980s caused a significant fall in the prices of tin and palm oil and depressed demand for fledgling manufactured exports (in particular electronics) (Corden, 1993:35). The required cuts in government expenditure had contractionary effects on the domestic econ-

omy. At the same time, the uncertainty in the policy environment was reflected in stagnation in private investment (both local and foreign) in the economy. These factors brought the economic advances of the 1970s to a halt and increased racial tensions. Subsequent policy reforms placed greater emphasis on the role of the private sector and strengthening the conditions for export-oriented growth.

### **The National Development Policy**

In 1986 the government declared the NEP to be 'in abeyance'. The Promotion of Investment Act passed in the same year introduced fresh, more generous incentives for private investors; some of the ethnic requirements of the NEP were relaxed; and up to 100 per cent foreign-equity ownership of export-oriented companies was allowed. Work permit requirements for foreign employees of companies with foreign paid-up capital of US\$2m or more were eased. The NEP was subsequently replaced (in 1990) with the National Development Policy (NDP), which aimed to redress racial imbalances in a more overt manner through initiatives geared to entrepreneurship, managerial expertise and skills development within the Malay community.

Since the mid-1980s, state-owned enterprises have been gradually privatised and restructured; by the early 1990s, state ownership in manufacturing was limited to some politically sensitive ventures in automobile manufacturing and to the petrochemical, iron and steel and cement industries. Tariff protection to domestic manufacturing, which had always been lower than in other developing countries, was further reduced, the effective rate falling from 31 per cent in 1979-80 to 17 per cent by the late 1980s (Salleh & Meyanathan, 1993:12). These reforms were accompanied by a strong focus on macroeconomic stability (including the maintenance of a realistic real exchange rate), and meeting the infrastructure needs of a rapidly expanding economy. The Fifth (1986-90) and Sixth (1991-95) Malaysia Plans saw a significant reduction in overall government expenditure and a shift in government spending away from public-sector enterprises and towards infrastructure projects designed to enhance private-sector development.

In the labour market there was a new emphasis (like that of the East Asian NICs) on job creation rather than the protection of workers' rights through labour legislation. Labour market flexibility was promoted through compulsory arbitration of disputes and bans on the right to strike in 'essential services'. Furthermore, unions were banned in the most important export-oriented industry — electronics — until 1988, after which only 'in-house' unions were allowed at the plant, rather than the industry, level. This policy, despite its many critics, has certainly facilitated the outward-oriented growth process with foreign capital participation.<sup>2</sup>

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<sup>2</sup> For a lucid discussion of Malaysia's political changes as they relate to the industrialisation process, see Crouch (1996:Ch. 12).

## **Growth and Structural Change**

The data on overall economic growth and export orientation of the Malaysian economy are summarised in Table 1. Annual growth during 1965-86 averaged a respectable 5.5 per cent. However, this performance record was uneven, reflecting the impact of primary commodity cycles and changes in government expenditure. Growth of real GNP averaged about 6.5 per cent per annum during the 1970s, but then slowed down in the first half of the 1980s, falling to negative 1 per cent in 1985. With better domestic macroeconomic policies and market-based reforms, the Malaysian economy has picked up again since 1987. Real GDP growth accelerated to over 8 per cent a year on average over the nine years up to 1995. This outstanding economic performance was achieved in a lacklustre world economic environment.

The data point to a close association between growth acceleration and the degree of export orientation of the economy. The export-GDP ratio increased at a modest rate during the 1970s, slowed in the first half of the 1980s and then increased sharply from about 1987. The export-GDP ratio in 1995 (96 per cent) was twice as high as in 1970.

In the 1970s and early 1980s, Malaysian economic growth stemmed largely from the expansion of service industries flowing from public sector activities and growth in primary production. In the primary sector, growth in the 1970s was led by a rapidly expanding palm oil sector, and modestly expanding rubber production. In the deregulated environment since the late 1980s, not only has growth significantly increased, but much of it has come from the expansion of manufacturing through private sector initiatives. In 1989, the manufacturing share in GDP for the first time overtook that of agriculture. Between 1987 and 1995, over 50 per cent of the growth in GDP flowed directly from the manufacturing sector, which expanded by an average annual rate of 14.5 per cent and increased its share of GDP from about 20 per cent to over 33 per cent. In addition, much of the output and expansion in the tertiary (service) sectors in recent years has been closely related to the expansion of the manufacturing sector (Ariff, 1991).

The expansion of manufacturing production has predominantly been export-led. In the early 1970s, the share of manufactures in total merchandise exports was about 10 per cent. But in 1980-95, manufactured exports grew (in current US dollar terms) at an annual compound rate of 35 per cent. In 1994, with a manufacturing share of about 78 per cent, Malaysia was the developing world's sixth largest exporter of manufactures, after the four East Asian NICs and China. The share of exports in gross manufacturing output had grown to over 60 per cent by the early 1990s, up from less than 10 per cent in the early 1970s. In the 1970s, resource-based manufacturing such as food, beverages, tobacco, wood products and basic metals loomed large in the structure of manufactured exports. The transformation of the export structure in line with emerging patterns of the international division of labour gathered momentum in the late 1980s. At first, Malaysia found market niches in simple assembly operations in electronics and electrical goods, and production of diffused-technology

consumer goods. In recent years, the export composition has begun to diversify into mature-technology final products such as radios, televisions, cameras and computers.

**Table 1****Malaysia: growth and export orientation, 1970-95**

Year	GDP		Per-capita GDP		Export orientation
	value* (millions of ringgit)	growth (%)	value* (ringgit)	growth (%)	Exports/ GDP (%)
1965-69	30,149	7.08	2,902	3.97	46.09
1970-74	35,986	9.12	3,257	6.04	42.30
1975-79	51,703	7.22	4,734	4.17	50.44
1980	64,883	7.44	4,736	5.48	57.54
1981	69,387	6.94	4,918	3.83	52.34
1982	73,509	5.94	5,066	3.02	50.89
1983	78,104	6.25	5,245	3.54	51.18
1984	84,116	7.70	5,509	5.02	54.27
1985	83,305	-0.96	5,313	-3.55	54.85
1986	84,179	1.05	5,225	-1.65	56.31
1987	88,717	5.39	5,367	2.71	63.85
1988	96,647	8.94	5,705	6.30	67.61
1989	105,547	9.21	6,083	6.63	73.26
1990	115,828	9.74	6,522	7.21	76.28
1991	125,861	8.66	6,923	6.15	80.84
1992	135,667	7.79	7,290	5.30	77.65
1993	146,987	8.34	7,636	4.74	81.45
1994	159,848	8.75	7,972	4.41	89.82
1995	175,225	9.62	8,506	6.70	95.50

\*Constant (1990) prices.

Source: International Monetary Fund, *International Financial Statistics Yearbook - 1995* (Washington DC) and Malaysian Ministry of Finance, *Economic Report 1995* (for estimates for 1995).

Foreign direct investment (FDI), the engine of manufactured export expansion, has grown remarkably over the past two decades,<sup>3</sup> increasing almost ten-fold between 1987 and 1991. Since the mid-1980s, FDI flows to Malaysia have been increasing at a faster rate than those to the other ASEAN countries, and, since 1991, have exceeded such flows to any of the other ASEAN countries. By the late-1980s, FDI inflows had shifted from production for the domestic market to using Malaysia as a base for

<sup>3</sup> The Malaysian experience with attracting FDI has been discussed in detail elsewhere by Athukorala and Menon (1995).

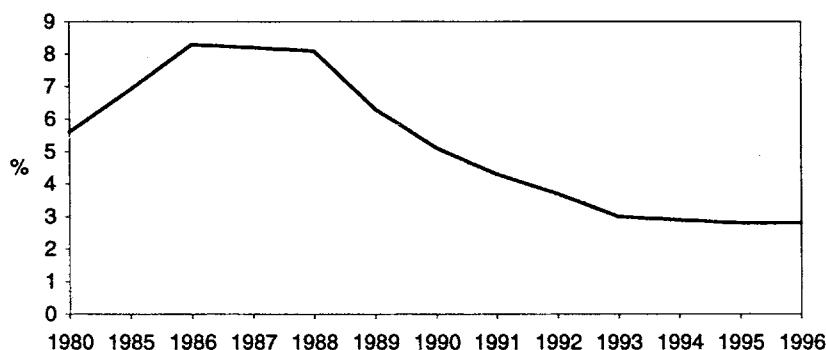


manufacturing for the global market. The share of projects with an export orientation of 50 per cent or more increased from 24 per cent of total approved projects in 1984-85 to about 82 per cent by 1988-89. The proportion of projects with an export orientation of 80 per cent or above increased from one-fifth of the total in 1984 to about three-quarters in 1989. There are no direct estimates of the share of foreign firms in exports. However, a simple comparison of data on export and output shares of foreign firms shows that they provided over three-quarters of total manufactured exports by the mid-1990s (Lall, 1995). There is a close association between the degree of foreign presence in product sectors and their relative contribution to total manufactured exports (Athukorala & Menon, 1996). The electronics industry (which is almost completely foreign-owned) alone contributed over 63 per cent of total exports in 1994. Since the early 1980s, Malaysia has been the largest developing-country exporter (and one of the world's major exporters) of electronic components, particularly integrated circuits.

There is little evidence that either the government leadership in industrial policy in general or the heavy industrialisation push in the early 1980s in particular has affected the export-led industrialisation process. The structure of industry that has evolved over the past two decades closely reflects Malaysia's comparative advantages and changing factor endowment. Most of the industries set up under HICOM were 'born losers' which were artificially spawned with subsidies (Chee, 1994:249). By the late 1980s, HICOM had invested over RM42 billion in various projects which generated fewer than 5,000 jobs directly (RM400,000 per job), and exports from these industries were almost negligible (Chee, 1994:Table 10.5). Doubtless, some employment, some technical and managerial skills and scale economies have been generated, but at considerable expense. Apart from the direct economic cost, inefficient heavy industry projects (mostly in investment and intermediate goods industries) were a burden on downstream industries, which were forced to pay higher prices for the protected products.

### **Employment and Equity**

Unemployment emerged as a public issue in Malaysia only in the early 1960s. In 1963 the unemployment rate in Peninsular Malaysia was estimated at 6 per cent. By the time the NEP was promulgated in 1970, this had increased to 8 per cent, but the Second Malaysia Plan could offer no more than containment at that level (Snodgrass, 1980:59). After dropping to around 5 per cent in the early 1980s, the unemployment rate rose to a peak of 8.3 per cent in the depth of the recession in 1986. Thereafter, it began to decline, falling to only 2.8 per cent by 1995 (see Figure 1). This impressive employment record has been achieved in the context of rising labour force participation of the population, from an average level of 65 per cent in 1980-85 to over 67 per cent by the mid 1990s. This latter increase is a reflection of both the rapid rate of urbanisation and the increased labour-force participation of women, which reached about 47 per cent in the mid-1990s, up from 44 per cent in the early 1980s.

**Figure 1****Unemployment rate, 1980-96**

Note: 1996, forecast.

Source: Malaysian Ministry of Finance, *Economic Report* (various issues).

Most of the new employment has come from the expansion of the manufacturing sector (Table 2). The share of manufacturing in total labour deployment in the economy increased from 14 per cent in the mid-1970s to over 25 per cent by the mid-1990s. The *direct* contribution of manufacturing to total employment increment between 1987 and 1994 was as high as 60 per cent, amounting to an additional 1.2m jobs. In addition, as noted, much of output (and hence employment) expansion in the tertiary (service) sectors in recent years has been closely related to the expansion of the manufacturing sector. The data reported in Athukorala and Menon (1996) point to the important role played by export-oriented foreign investment to manufacturing employment. The percentage of workers employed in foreign firms increased from about 30 per cent in 1983 to 42 per cent in 1992. The increase in the employment share was much faster than the increase in the share of output of these firms (from 41 to 48 per cent), suggesting that, with the rapid expansion of export-oriented manufacturing, the structure of manufacturing production has become more labour-intensive over the years. This pattern was particularly noticeable in non-metallic minerals, basic metal products, fabricated metal products and miscellaneous manufacturing. In the case of electronics, the employment and output shares have remained virtually unchanged at comparable levels as this industry has been highly labour-intensive right from the start.

Real wages in the manufacturing sector declined in the early 1970s (see Table 3). At the time, critics of the export-led industrialisation strategy claimed that the working class was subject to high 'disciplines' (through restrictions on labour unions) and low wages for the benefit of multinationals and local capitalists (Jomo & Osman-Rani, 1984). But this pessimistic view was refuted by subsequent developments.

Table 2

## Employment by sector, 1976-95 (% shares)

Sector	1976	1980	1985	1990	1995
Agriculture, forestry and fishing	43.6	40.6	31.3	29.9	18.9
Industry	20.9	22.7	23.6	24.6	34.9
Manufacturing	14.2	15.8	15.2	17.6	25.5
Services	35.5	36.7	45.1	45.5	46.2
Total	100	100	100	100	100
('000)	4,376	4,817	5,622	6,682	8,060

Source: Malaysian Ministry of Finance, *Economic Report* (various issues).

The decline in real wages in the early 1970s partly reflected the shift in the structure of production away from capital-intensive import substitution activities towards labour-intensive export production. At the same time, real wages were kept low by the availability of a vast pool of surplus labour in the economy, particularly from the rural sector. With the gradual absorption of surplus labour in export-oriented industries, real wages started to rise from the late 1970s, and reached a historical high of 110 in 1992. The significant decline in the unemployment rate suggests that real wages would have continued to increase during the ensuing years. Interestingly, the recent increases in real wages have occurred even though the profitability of manufacturing production (as measured by the price-cost margin) remained virtually unchanged (Table 3). Thus, it appears that with the rapid depletion of surplus labour reserves in the economy, workers have become the major beneficiaries of productivity growth in manufacturing. Higher productivity, rather than lower wages, seems to have borne the burden of creating competitiveness. In the absence of minimum-wage legislation, employment levels have risen first followed by market- and productivity-driven increases in real wage levels.

Growth in real wages in the 1990s would have presumably been much greater but for the influx of migrant workers. As the domestic labour market approached full employment, forcing rapid increases in real wages, a massive inflow of migrant workers occurred from neighbouring labour surplus countries, in particular Indonesia. Official estimates put the number of migrant workers in Malaysia at half a million in 1994. However, there is circumstantial evidence that the number could be as high as 2 million (about 16 per cent of the workforce). By the early 1990s, more than half of the workforce in the construction industry and the plantation sector consisted of foreign workers, by which time they had also begun to enter the manufacturing sector.

The impact of various government programs on reducing poverty and income inequalities during the first three decades of the post-independence period were limited. The ethnic and rural-urban distribution of poverty and income inequality had hardly changed over the period. By the late 1980s, 88 per cent of poor house-

holds were rural, and almost 60 per cent of rural households were poor (Anand, 1983).

**Table 3**

**Employment, profitability and real wages in the manufacturing sector, 1965-94**

	<i>Employment (1990=100)</i>	<i>Price-cost margin (%)</i>	<i>Real value added per worker (1990=100)</i>	<i>Real Wages (1990=100)</i>
1965-69	12.1	17.3	57.1	67.6
1970-74	24.9	21.5	64.0	61.6
1975-79	53.4	20.3	67.5	74.2
1980	na	na	na	na
1981	58.2	17.3	73.6	82.5
1982	61.7	16.6	71.8	86.4
1983	54.8	17.9	82.6	93.0
1984	59.2	19.0	89.9	97.6
1985	56.3	18.6	94.1	105.2
1986	56.8	20.1	102.8	104.1
1987	61.4	18.6	98.6	102.4
1988	71.0	18.1	99.5	98.7
1989	82.7	18.9	104.5	99.4
1990	100	18.6	100	100
1991	115.8	18.9	106.7	104.4
1992	122.5	18.8	107.3	108.3
1993	139.9	na	na	109.7
1994	152.6	na	na	112.9

Sources: Compiled from Malaysian Department of Statistics, *Annual Survey of Manufacturing* and *Monthly Bulletin of Manufacturing Statistics* (for 1993 and 1994).

Since the mid-1980s, Malaysia's record of reducing absolute poverty has been impressive (Table 4). The incidence of poverty among all households (as measured by the percentage of total households below the poverty line) has fallen from 18.4 per cent in 1984 to 9.6 per cent in 1995; this figure is projected to fall to 6.0 per cent by 2000 (see Snodgrass, 1995). A significant decline in poverty is observable for both urban and rural households, even though the incidence of poverty is still relatively high in rural areas. According to the Human Development Index of the United Nations, Malaysia ranked fourth (after Saudi Arabia, South Korea and Mauritius) in the world in terms of improvement in living standards between 1970 and 1990 (Snodgrass, 1995). All ethnic groups have shared in the remarkable improvement in quality of life (Yusof, 1994).

Table 4

**Incidence of poverty and hard-core poverty by region, and Gini coefficients, 1970-1995 and forecast for 2000**

	1970	1984	1990	1993	1995	2000
<i>Incidence of poverty</i>						
Urban	0.255	0.082	0.075	0.053	0.041	0.022
Rural	0.586	0.247	0.218	0.186	0.161	0.110
Total	0.493	0.184	0.171	0.135	0.096	0.060
<i>Incidence of hard-core poverty*</i>						
Urban	0.158	0.024	0.014	0.011	0.009	0.010
Rural	0.446	0.087	0.052	0.043	0.037	0.001
Total	na	0.063	0.040	0.030	0.022	0.005
<i>Gini coefficient</i>	0.537	0.479	0.446	0.459	0.464	na

\* The cut-off income level for the determination of hard-core poverty is set at half of that used in defining poverty, which varies from year to year (refer to source documents listed below).

Sources: Anand (1983); Government of Malaysia (1989, 1991, 1993 and 1996).

Table 5

**Mean monthly household gross incomes by ethnic group, 1957-95**

Group	1957/58	1967/68	1970	1984	1990	1995
All groups*	199	217	264	1,095	1,167	2,007
Malay	144	130	172	852	940	1,600
	(100)	(100)	(100)	(100)	(100)	(100)
Chinese	272	321	394	1,502	1,631	2,895
	(189)	(247)	(229)	(176)	(170)	(181)
Indian	217	253	304	1,094	1,209	2,153
	(151)	(195)	(175)	(128)	(128)	(135)

Notes: Figures in parentheses indicate group incomes as % of Malay incomes. All other figures are in Ringgit. \* Includes minorities and non-citizens.

Sources: For 1957-70: Anand (1983); for 1984: Government of Malaysia (1989); for 1990 and 1995: Government of Malaysia (1996).

The reduction in poverty and increase in overall living standards stem mainly from the growing opportunities for non-agricultural work, particularly in the rapidly expanding export-oriented manufacturing industries. Since unskilled labour is the most widely distributed factor of production, the increase in its real wage has brought about an overall reduction in poverty in the country. In addition, the increase in the number of two-income households has contributed to the increase in

total household income. This is underpinned by the increasing importance of women in the work force.<sup>4</sup> Again, much of this increase is due to the demand for low-skilled labour generated by the rapid expansion of labour-intensive export-oriented manufacturing activities. In sum, employment generation and poverty reduction in Malaysia since the late 1980s compares closely to that of Korea and Taiwan in the late 1970s and 1980s (Fei et al., 1979; Hong, 1990).

Though less so than in reducing absolute poverty, Malaysia has been successful (by the standard of developing countries at the same stage of economic development) in addressing inequality in the size distribution of income. Between 1970 and 1990, the Gini coefficient fell sharply from 0.537 to 0.446 (Table 4). True, it rose slightly to 0.464 in 1995. The overall trend, however, suggests that the benefits of rapid growth in Malaysia have been distributed reasonably widely. The relative position of Malay households improved notably in terms of mean household income between the mid-1960s and 1990 (Table 5). The data for 1995 indicate a slight worsening of the relative position of Malay households. The disaggregated data suggest that this has been due mainly to differential growth rates of incomes in the top 20 per cent and the bottom 40 per cent of households. Within the middle 40 per cent of households the relative position of Malays has remained virtually unchanged (Government of Malaysia, 1996:89).<sup>5</sup> Income inequality, in terms of both size distribution and race, remains an issue in Malaysia. But, because of the remarkable increase in living standards across the board, it is a less politically sensitive issue than it once was.

### Concluding Remarks

Malaysia is undoubtedly a development success story. Its achievements have been especially remarkable since the late 1980s when economic policy decisively adopted an outward orientation. Economic growth during this period has been accompanied by rising living standards and an improvement in the distribution of income, ameliorating the twin problems of poverty and racial income imbalances.

Malaysia's economic success can be attributed to its ability to place itself within a new world economic order that is characterised by increased internationalisation of production. As a small and open economy, Malaysia's economic policy stance has been to respond to developments on the international front as they unfolded. Despite some policy excesses triggered by conflicting objectives in a plural society, the policy-makers have been successful in rectifying policy errors swiftly.

The Malaysian experience of growth with equity is consistent with the mainstream (neoclassical) policy stance relating to export-led industrialisation. The Ma-

<sup>4</sup> The labour force participation rate for women increased from 37.2 per cent in 1970 to 45.8 per cent in 1990 and 47.1 per cent in 1995, while the share of women in employment increased from less than 30 per cent in 1970 to 31.4 per cent in 1990 and 33.7 per cent in 1995 (Government of Malaysia, 1991, 1996).

<sup>5</sup> These compositional shifts do suggest, however, that income distribution *within* the Malay community may have worsened (see Shari & Zin, 1990).

Malaysian experience shows that, in a small and open economy, the task of achieving the apparently conflicting objectives of growth and equity is facilitated by a long-term commitment to an open and liberal trade and investment policy regime. Unlike many other developing countries, Malaysia never resorted to stringent quantitative trade restrictions. Domestic price signals were therefore never insulated from world market conditions, and resource costs arising from rent-seeking activities have always been minimal by developing country standards. Despite the affirmative action policies under the NEP, the private sector was never marginalised and the policy emphasis on export orientation was never compromised. This policy regime, coupled with a stable political climate, has enabled the Malaysian economy to take full advantage of the new opportunities arising from integration with the global economy. There is little doubt that the affirmative action program was instrumental in legitimising government policy and achieving political stability and social harmony. It was an effective and explicit mechanism demonstrating that all would share in future growth. At the same time, the resource cost of these direct redistributive policies was not a serious impediment to growth because of the key role played by FDI flows and rapid export expansion in augmenting the domestic resource base.

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## REVIEW ARTICLES

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### The Media in the Marketplace

Ross Jones

*M. E. Beesley (ed.), Markets and the Media: Competition, Regulation and the Interests of Consumers, Institute of Economic Affairs, London, 1996*

AUSTRALIAN governments have a long history of intervention in media markets. In October 1996 the Commonwealth government announced yet another media review. This review is examining the effectiveness of the current cross-media rules in meeting the stated policy objectives of plurality, diversity and competition in the media industries. Issues of convergence of technologies, services and enterprises are likely to be raised during the review.

Australia is not, of course, unique with regard to government regulation of media industries. Most OECD countries, and many non-OECD countries too, have adopted industry-specific media regulation. Indeed, the deregulatory reforms in many industries in the 1980s and 1990s appear to have left the media untouched. Governments are unwilling to trust media markets, and frequently cite market failure and market imperfections to justify their interventions.

*Markets and the Media*, a new collection from the London-based IEA, questions this stance. The editor, Michael Beesley, has written extensively on deregulation and privatisation in Britain's gas, water, electricity and transport markets. Four papers by different authors examine specific issues in media regulation: copyright, digital technology and its implications, the future of public broadcasting, and concentration and diversity in the media.

#### Barriers to Entry

In his overview, Beesley argues that concerns about media concentration are misplaced and generally unfounded unless there are substantial barriers to entry. Such barriers may occur at a number of levels. At the first level are the copyright holders: persons or entities who develop new ideas and new intellectual products. At the next level are the producers or publishers, who provide newspapers, films, television and radio programs, and sound recordings. The third level, often closely

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*Ross Jones is Senior Lecturer in Economics at the University of Technology, Sydney.*

linked to the second level, consists of the delivery or distribution mechanism: the means by which the output produced at the second level reaches its audience. The fourth level comprises the reception mechanism, which in households would include telephones, television sets, radio sets and encryption devices such as the television-set top boxes for pay TV.

Beesley argues that, to justify the regulation imposed upon the industry, it would be necessary to show that significant barriers to entry existed at one or more levels. If that were the case, vertical integration between the various levels may inhibit competition and so provide grounds for government intervention. Should entry barriers at each of the levels be low, any vertically integrated structures that did emerge would be likely to reflect economies in transactions costs between the different levels. For example, internalisation of transaction costs in the film industry, where each unit of 'product' has unique characteristics, has long been accepted as an explanation for the extent of vertical integration that exists in the industry. Further, even if entry barriers did exist at any of the levels, there could well be factors likely to lead to freer entry in the future. If this is the case, then the removal of existing regulatory barriers may perhaps be justified to enable market forces to shape the future structure of the industry.

### **Copyright Issues**

Dan Goyder examines the effects of copyright. In recent years, copyright protection has undergone a large number of changes in OECD countries. The rapid growth in the volume of intellectual output and the increased opportunities for the commercialisation of such output have led to the extension of copyright protection into new areas, such as computer software and data bases, and to an extension of the term of protection for copyright users.

The international harmonisation of copyright law has been encouraged under the Berne Convention in the 19th century and the Rome Convention in the 1960s. In the recently concluded Uruguay Round of GATT, the US was successful in placing 'trade related aspects of intellectual property' (TRIPS) on to the agenda and ultimately in achieving TRIPS agreements for international enforcement of intellectual property rights. Nevertheless, as Goyder observes, in some situations the aims of competition policy may conflict with the protection of intellectual property rights. He reviews a number of recent copyright cases in the European Union (EU) where the rights of copyright holders have been extended to include 'related rights'. For example, copyright owners of films and sound recordings have been given 'distribution rights' so that they can control, or even prevent, the entry into the EU of products by way of parallel import which they have licensed for sale overseas.

Such action echoes the continuing issue of reforms to the CD industry in Australia. In 1990 the Prices Surveillance Authority recommended changes to the Copyright Act to allow parallel import of legitimate sound recordings. International record companies were practising price discrimination and charging high prices in Australia for CDs by using provisions in the Copyright Act which prevented parallel

imports. Unfortunately for consumers, the government of the day chose to maintain the restrictions on parallel imports, and CD prices have remained high.

Goyder concludes by noting that the rights of copyright holders and the interests of general competition policy are likely to continue to conflict with one another, and suggests that there is a need for 'inventive solutions'. Unfortunately, Goyder does not canvass any such solutions himself.

### **The Digital Revolution**

The second paper, by Malcolm Matson, examines the implications of the technological revolution brought about by digitalisation. Matson believes that much of the regulation imposed on broadcast media is at best misguided and unnecessary, and at worst deliberately anti-competitive and protective of certain existing media interests. He argues that the British government has accepted that competition is the appropriate instrument to achieve technological development and that regulatory regimes that make explicit references to specific technologies militate against innovation and competitiveness.

This approach is in marked contrast with the one adopted by Australian governments. In particular, the Labor government's regulation of pay TV made numerous mistakes by regulating with regard to technology. It forced satellite pay-TV providers to operate in an extremely constrained environment. By restricting individual operators to a maximum of four channels, it severely limited satellite transmission viability at a time when competing delivery mechanisms, such as cable, could provide many more channels at a lower price. The failure in Australia of satellite to emerge as a viable competitor to cable must to some extent be blamed on inappropriate regulatory constraints that reflected the government's view of likely technological development.

A second major theme developed by Matson is that digital technology linked with optical-fibre transmission has made available an enormous capacity for the transmission of communication. The major consequence of this is that communications industries really consist of two separate industries: the supply of infrastructure and the supply of services using that infrastructure. Matson argues that vertically integrating the infrastructure provision with service delivery increases the cost and risk in a competitive market. Such integration could therefore be justified only if the vertically integrated firm had some exclusive government licence which precluded competitive entry.

According to Matson, the capacity of fibre-optic cable is essentially infinite. Given that some countries, such as the UK, the US, and now Australia, are permitting and encouraging the development of competing optic-fibre networks, the market price of carriage will decrease as more capacity is deployed. Should this be the case, then the only way in which a high price for transmission could be maintained is by government regulation. This is not to say that Matson argues for such intervention: on the contrary, he argues that the existence of excess capacity and the inevitable decrease in transmission prices to zero means that government intervention

is unnecessary. In this view of the future, issues of regulatory provision of access and the regulation of the price of access become irrelevant.

Matson supports the general deregulatory approach adopted in the UK. But he notes that, while the British government has been strongly opposed to any supply-side restrictions on telecommunications transmission capacity, many other countries have bowed to the demands of existing (generally publicly owned) monopoly transmission entities, and prevented new entry.

Matson is not entirely uncritical of the UK regulatory regime. He argues that an artificial distinction between the carriage of telecommunications traffic on the one hand and of television signals on the other has divided responsibility for licensing these activities between different regulatory bodies. Such splitting of regulatory responsibility has the potential to result in different regulatory procedures being applied to competing firms. Australia has adopted a similar approach based on method of signal carriage, thus dividing responsibilities between AUSTEL and the Australian Broadcasting Authority, with a more general regulatory responsibility being exercised by the Australian Competition and Consumer Commission. This creates the potential for regulatory conflict as well as the more obvious problem of over-regulation.

Matson rightly concludes that regulatory mechanisms should not be used to protect existing interests. It is his view that digitalisation of information will eliminate any meaningful distinction between television, telecommunications and computing, and any regulatory mechanisms that do operate should apply equally to all media.

### **Public Service Broadcasting**

The third contribution to *Markets and the Media* is by David Sawers, who considers the future of public service broadcasting. Sawers believes that arguments for public service broadcasting (defined generally as broadcasting whose primary objective is the 'improvement' of its audience) are based on invalid market-failure arguments and reflect a strong paternalistic attitude on the part of regulators.

Supporters of publicly funded broadcasting have typically claimed that the market for commercial television services will always contain imperfections that can best be overcome by public broadcasting. In particular, it has been claimed that the external benefits to consumers from consumption of certain programs will be ignored and that consumers will make a less than optimal investment in the consumption of such programs. But even if such arguments were valid, it would not necessarily follow that publicly funded broadcasting would eliminate the market failure. As Sawers notes, supporters of public broadcasting assume that whereas consumers are ignorant of their own best interests, the producers of television programs for the BBC (or the ABC) are not.

The assumption that an intellectual elite should decide what consumers see and hear is hardly consistent with the liberal-democratic tradition. Furthermore, it is difficult to reconcile this view of what public broadcasting should do with what it actually does. Fearful of the consequences of shrinking audiences and low ratings,

public broadcasters in the UK and Australia seek to attract wide audiences. But this duplicates the approach of commercial broadcasters and undermines the market-failure case for public broadcasting.

Sawers argues that there may have been a good argument for the public provision of a universal and impartial broadcasting service in the past, when the number of services was limited by technology and the spectrum had a scarcity value. But now that technology has made possible a vast increase in the number of services (channels) available, and consumers can pay directly for what they want, their demands will be met by the market. The argument that consumers lack perfect information applies in a wide range of information and entertainment services; yet most governments do not provide publicly funded 'quality' newspapers, CDs or cinemas, for example. Sawers concludes that any justification for public broadcasting that ever did exist no longer does so.

### **Convergence and Diversity in the Media**

The final contribution to the collection, by William Shew and Irwin Stelzer, has already attracted much attention in the UK and Australia. Their paper, 'A Policy Framework for the Media Industries', examines the regulatory implications of technological changes leading to convergence. The authors argue that regulations should not impede the development of economically optimal business organisations, while at the same time there is a need to preserve competition and diversity.

One of their major arguments is that past examinations of concentration and market power and of consequent issues of diversity and choice have been distorted by inappropriate market definitions; any analysis of these issues should therefore be based on concentration in the entire media industry. Shew and Stelzer believe that a high degree of competition exists between newspapers, magazines, television and radio for both consumers' attention and advertising dollars, and that such competition justifies a broad definition of the relevant market.

One of the objectives of media regulation is to limit the political and cultural power of media organisations. Shew and Stelzer consider the problems inherent in the measurement of power. While economic power is typically measured by revenue, much of the media industry's revenue comes from advertisers rather than consumers. Since advertising rates reflect advertisers' willingness to pay to reach particular demographics, advertising revenue may not necessarily be a measure of political and cultural influence. For example, the political influence of broadsheet newspapers may be greater than that of their tabloid counterparts; yet the advertising revenue of tabloids may be considerably greater.

Still, it is possible that consumer spending on the media could be a measure of media influence. But it is made more complex by the fact that some influential media are available at no direct cost to consumers. Free-to-air television and radio, both public and private, may exercise considerable influence, but this would not be captured in a consumer-spending measure. In addition, whereas some media rely on advertising as their principal source of revenue, others rely predominantly on subscription revenue. For example, it may be that more 'serious' small-circulation

publications relying largely on subscriber revenue have considerably greater influence than high-circulation advertiser-supported publications.

To avoid such problems, Shew and Stelzer argue that the measure of influence should be the time the public devotes to various media. They claim that the average adult in the UK devotes almost 40 hours a week to the media. Over 60 per cent of this time is spent watching television. Radio accounts for around 28 per cent, newspapers 9 per cent, magazines 2 per cent and cinema less than 1 per cent. The authors conclude that 'the media conglomerates often criticised for their size have inconsequential shares of the national media market' (p. 135). The only significant media group in terms of concentration is the BBC with 44 per cent of the market; News International, by contrast, has only 3.4 per cent.

The authors conclude that concerns over the concentration in the UK media are ill-founded. Further, by treating the media as a whole as the relevant market rather than individual segments of it such as television, newspapers and so on, they conclude that specific cross-media ownership rules are unnecessary in the UK at the present time. This is not to say that no regulation is necessary. They suggest instead that media-specific regulation may be largely unnecessary and that existing general monopoly regulation in the UK, which uses a 25 per cent share of a market as the trigger for an inquiry into whether the monopoly activity is contrary to the public interest, should be applied to the media industry.

Shew and Stelzer's approach has some considerable theoretical appeal. Arbitrary restrictions on cross-media ownership may prevent the realisation of a variety of economies of scale and scope. The degree of substitutability between a variety of media products is such that a high level of concentration in a particular segment of the media market may not produce the market power often associated with ownership concentration. Yet the measurement of market influence poses considerable practical problems. Whatever measure of such influence is adopted — time share, audience share or revenue share — the weightings to be attributed to individual media like newspapers and television will remain controversial. Whereas Shew and Stelzer would claim that a time-share approach eliminates the need for weightings, some observers would argue that some media should still be weighted more heavily than others. For example, if one company owned every national daily newspaper in the UK, its share of the media market would be a mere 3.7 per cent as measured by time share. Such a figure would be unlikely to justify intervention, yet such an outcome would undoubtedly attract criticism of the usefulness of a time-share approach.

Nevertheless, Shaw and Stelzer offer a provocative and partially persuasive argument. Media regulation should not discourage technological development and should be sufficiently flexible to take into account rapid change and the probable convergence of what until recently have been separate industries with their own particular regulatory regimes. As technology lowers entry barriers, it is eliminating many of the grounds for media regulation. Governments need to respond to this in a suitably deregulatory manner.

# A Welfare Ethos for a Free People?

John Savage

*David G. Green, From Welfare State to Civil Society: Towards Welfare that Works in New Zealand, New Zealand Business Roundtable, Wellington, 1996*

IN the run-up to New Zealand's first proportional-representation election on 12 October 1996, the policy debate revolved around the issues of whether the Employment Contracts Act would be 'softened', whether the Reserve Bank's inflation target would be raised, and whether New Zealand could look forward to higher spending or lower taxes. Notably absent was any rigorous discussion of social policy. Such debate as did occur concerned levels of spending. The really hard questions (what the state's social obligations should be, what minimum standards are acceptable, and what weight should be given to equality of opportunity relative to equality of outcomes) were not asked. The publication of *From Welfare State to Civil Society*, a thought-provoking book that squarely confronts these issues, is therefore particularly timely.

The author, David Green, is Director of the Health and Welfare Unit at the London-based Institute of Economic Affairs. Unlike many other social policy specialists, Green takes the debate back to basic principles of political philosophy. This is a real strength of his contribution, although, as I discuss below, there is a difference between grounding the issues in this way and offering a formal framework within which specific problems can be addressed.

Green's basic thesis is that reliance on social welfare cannot be viewed simply as an economic problem, because it is fundamentally a moral problem. It is this moral dimension that is lacking from most analyses of social issues. Green argues that individuals respond to the moral climate that governments create. Specifically, the current welfare environment is one in which not only has persistent reliance on state assistance become acceptable, but access to comprehensive, continuing support by the state has come to be viewed as a 'right' of citizenship. According to Green, before the development of the modern welfare state, responsibility for social support was divided among individuals or families, the community, and the state. Drawing heavily on the philosophy of the late Michael Oakeshott, he introduces a distinction between 'civil association' and 'corporate association'. This distinction is the centrepiece of Green's analysis.

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*John Savage is a Senior Research Associate at the New Zealand Institute of Economic Research.*

### Civil Association vs Corporate Association

Civil association is based on three inseparable assumptions: 'human nature is . . . about assuming personal responsibility for . . . self-improvement and making the world a better place for others; people are . . . united, not under leadership, but in acceptance of conditions which allow [them] to exercise responsibility; and government [upholds] these conditions, . . . the conditions of liberty'. In such a society, support for the needy is driven by an ethos of 'community without politics' (p. vii). Under corporate association, in contrast, it is assumed that society has a common goal that unites individuals. This requires an active government to manage the pursuit of the common goal; individuals are part of the 'grand scheme' and must be directed by government as appropriate.

The analysis in the first part of the book draws strongly on the lessons of history. Green argues that, during the 20th century, the historical tradition of civil association has been replaced by public institutions based on corporate association. This crowding out has been detrimental both morally and practically: the welfare system has become less effective; it has become oriented towards people's weaknesses rather than their strengths; and it has encouraged people to look towards the state for help rather than seeking their own solutions to the problems they, and others in their community, face.

Green is careful to distinguish his view from a simple 'market forces' perspective on welfare. For economists, there is a useful reminder that classical market-oriented analysis is not necessarily based on the ideal that everyone should be left to fend for himself or herself. In fact, as Green and other authors have pointed out (for example, Ormerod, 1994), Adam Smith's analysis of 'the free market' was inseparable from his broader social and moral philosophy. Green notes, for example that while *The Wealth of Nations* is Smith's best known work nowadays, his *Theory of Moral Sentiments* recognised that a good society was one in which individuals took responsibility for improving the lot of the community as a whole. In this sense, Green offers a much richer analysis than many liberal economists.

Indeed, Green criticises those free marketeers who attempt to side-step moral issues or who think purely in terms of individuals as utility maximisers. He is even more scathing of collectivists, noting such problems as private capture of government assistance programs and the 'victim' mentality that paternalistic collectivism tends to encourage. In particular, Green criticises the 'social justice' rationale for collectivism, arguing that relieving poverty is not about enforcing equal outcomes and that such rationales deliberately confuse freedom and power.

The book suggests that New Zealand is repeating the mistakes made in the US in dealing with social problems. This is contributing to even worse social outcomes, in particular rising crime and family breakdown. Green interprets these as the result of a simple, deterministic view of the poor as victims of circumstance who must be assisted by the state without resort to any moral judgments. He also argues that 'resource rights' (effectively, rights of access to the wealth of others) have come to dominate 'protective rights' (designed to enhance people's opportunities).



At the end of the first part of the book, Green draws together his philosophical views and defines a 'welfare ethos for a free people'. This ethos has three components: the depoliticisation of law-making (law-making should return to upholding the conditions of liberty rather than controlling behaviour); the restoration of a sense of personal responsibility among citizens; and a move back towards the provision of welfare by civil society (voluntary associations) rather than the state. The ethos is underpinned by two ideals: 'community without politics' and a sense of 'duty without rights' (in which there is a duty to help others but no presumption of an entitlement to assistance).

The first part of the book has much to recommend it. By taking the debate back to some basic principles of political philosophy, Green introduces a degree of rigour that is often lacking in this area of policy, and he makes explicit the assumptions underlying the rest of the analysis. He recasts the debate so that it is not about a simple choice between the free market and intervention but about the appropriate role and dynamic implications of intervention. Furthermore, Green's historical perspective reminds us of the extent to which our views are shaped by existing institutions that quickly become treated as the norm.

The book also implicitly makes a useful link into some other recent institutional literature and the social policy debate: for example, Epstein's (1995) concern with designing the law around a few simple principles that promote liberty rather than complex rules which attempt to control activity; Putnam's (1993) interest in democracy and civic traditions; and Olson's (1996) reminder that the precise design of social institutions matters in determining economic outcomes. In the past, this sort of broader perspective has been lacking from this debate and it will be interesting to see whether these sorts of links are developed further in the future.

Despite these strengths, an important element is missing from Green's approach. This can be summed up in one question: why did we make the transition from civil association to corporate association? To be fair, Green does address this question to some extent. In particular, he notes the way in which the growth of state intervention undermined many of the institutions of civil society, such as friendly societies and private schools and hospitals. But the more fundamental question is: why did this happen? What dynamics were at play? Did it simply reflect the rise in political power of one group over another? These are important questions, not because of their historical interest, but because they offer a guide to how change might be achieved in the future. From my (admittedly narrow) perspective as an economist, I do not think such questions can be addressed adequately with political theories alone. What is required is a theory to explain the existence of different institutional arrangements and why one institutional type might be preferred to another.

In economics, the so-called comparative institutional literature and the related 'contracting' literature offers some insights. These schools of thought acknowledge that the attainment of either individual or collective goals is always constrained by certain fundamental attributes of human existence. In particular, all social and economic interactions confront the problem of interdependency (there are also often

problems of opportunism and imperfect information). There are costs in overcoming these constraints (such as coordination and contracting costs); and, depending on what outcome is sought, some institutional arrangements are better at reducing those costs than others. The 'optimal' institutional arrangement for delivering a particular outcome will change over time, reflecting changes in preferences, technology and the impact of various 'shocks' that change social, political and economic circumstances.

What does this tell us about the shift from civil to corporate society? It might be that a particular shock (the Great Depression) combined with the emergence of a less homogeneous social structure, led to a 'rational' shift in preferences towards less voluntary provision of welfare and greater state involvement. No doubt Green would, quite rightly, point out that this is a partial view; it needs to be underpinned by a definition of 'optimal' (based on some fundamental values) and it lacks a theory of how individual preferences are translated into political action. Moreover, even if the move was a rational one at the time, there is no reason to believe that the current institutional arrangements continue to be 'optimal'. Nevertheless, this sort of formal framework raises some interesting questions. For example, is it the case that political parties lie along the same institutional spectrum as friendly societies in the sense that both structures represent a coalition of like-minded people who seek to improve their circumstances through collective action? The difference between the institutional forms is that friendly societies are 'inward looking' (they seek to produce their own benefits) while parties are 'outward looking' (seeking to extract benefits from the political process). In that case, the question of interest is: what factors might result in a shift from a one institutional form to another? (Examining the historical development of trade unions might offer some clues.)

### **Welfare Reforms**

In the second part of his book, Green takes the ideal of civil association (and the 'welfare ethos' it engenders) and applies it to four areas of social policy: welfare benefits, health care, education and age pensions. He recommends fundamental reform for the benefit system. Four principles should guide this reform: the system should be consistent with a flexible economy; it should recognise that money transfers alone are not necessarily a solution to poverty; it should encourage self-help rather than narrowing opportunities; and the historical tradition of 'community without politics' (voluntary assistance) needs to be rebuilt.

This analysis leads to several specific recommendations. State grants to the voluntary sector should be reduced in order to encourage private charities to be truly independent; events which can be privately insured, such as sickness or injury, should be; state-provided income support should be seen as a last resort; individuals should be able to opt out of the public welfare system and seek the help of voluntary groups who would focus on individualised 'self-help' approaches; never-married mothers should be required to work as a condition of receiving benefits; and men should be discouraged from fathering children outside marriage and should be made to take responsibility for the children they do father.

On health care, Green's main recommendation is that it should be primarily funded out of private insurance. He sees the 1991 White Paper as offering a viable model: individuals should be able to choose between regional health authorities and alternative health care plans. Regardless of the source of funding, hospitals should be privately owned.

Green favours direct parental payment for education rather than a voucher scheme. This gives parents the strongest incentives to take an interest in their children's education and minimises governmental interference in the education system. Tax credits should be available for low-income families. Control of schools should be handed over to independent educational trusts. For the tertiary sector, Green recommends a phased move to fees covering 100 per cent of costs and a continuation of the student loans scheme. Tertiary institutions should be privatised.

In the chapter on pensions, Green argues that private provision for retirement should be viewed as the primary means of support, with New Zealand Superannuation operating solely as a safety net. He considers that the current level of New Zealand superannuation payments is too high; he recommends that the link to wages should be abandoned, with the invalids benefit viewed as the more relevant comparator. Income and asset tests should apply. Recognising the scale of these changes, Green suggests that they should be phased in over a long period.

### **Getting from Here to There**

I do not propose to debate the merits and defects of these detailed recommendations. They are obviously consistent with the principles Green has previously set out. In this sense, he offers a comprehensive and coherent set of recommendations. Nevertheless, in general, the second part of the book is less satisfying than the first. There are two main reasons for this. First, to many readers, sympathetic or otherwise, there is not much new here and the conclusions drawn are fairly predictable. To a large extent this is unavoidable. However, this effect could have been mitigated by the use of more explicit criteria in assessing different approaches and of more examples to illustrate various successes and failures. For example, Green's general approach is to show how a particular institutional arrangement (say, private education) is consistent with civil association and will therefore deliver better outcomes than the current system. He could more profitably have compared different approaches by reference to standard criteria such as equity and efficiency. This would illustrate how particular arrangements are not only more consistent with some high-level values, such as liberty, but are also superior on more 'practical' grounds. More examples would reinforce this. The book certainly contains elements of this approach, but a more formal and rigorous treatment, underpinned by an institutional framework, might have been more convincing.

The second source of frustration with Green's analysis of specific policy issues has to do with the question of transition paths. In a few areas, Green tackles transition problems directly. However, while civil association might well be preferable to corporate association, it remains unclear how society makes the transition from the latter to the former. It is always tempting to treat transition issues as subsidiary.

But, as many policy-makers have learnt from bitter experience, they can constitute a major hurdle to change. Certainly, for some types of policy reform, the best approach is the 'short sharp shock': signal that the 'world has changed', implement legislation and move on. Many of the policy reforms enacted in New Zealand over the last ten years were of this nature. The approach succeeded where the reform involved changing the general rules of the game (for example, the Reserve Bank Act, the Fiscal Responsibility Act, and the Employment Contracts Act). It was less successful where the reforms involved a lot of detail and required large shifts in attitude as well as rules (for example, the health and education reforms).

Green's reforms are of the latter type: they rely strongly on the ability to shift attitudes and preferences, to 'restore' civil association. This seems to be a very challenging task and may even be founded on some shaky assumptions. For example, as Green repeatedly emphasises, the family unit is absolutely central to civil association. But is the breakdown of the family, about which he is so concerned, simply a reaction to the incentives created by the expansion of the welfare state? Or is it as much to do with increased social diversity (less homogeneous preferences) combined with increased social stresses? Again, a theory about why different institutional arrangements arise would be helpful.

As well, the issue of social preferences is a complex one. In the first place, preferences relate not only to social outcomes (such as whether income equality is desired) but also to the institutions which deliver those outcomes (such as state-run organisations as opposed to charitable organisations). Restoring civil association requires changes in both sets of preferences. In the second place, it may be the case that preferences are 'path-dependent'; existing institutional arrangements become preferred over previous arrangements. In this case it becomes difficult to invoke change in the absence of some sort of shock to the system.

Green has produced a very challenging and provocative book. He boldly tackles one of the most crucial sets of policy issues facing New Zealand. His willingness to ground the debate in some fundamental philosophical principles makes the first part of the book rich and interesting. However, the analysis might have been strengthened by the use of a comparative institutional framework and thus some ideas on dynamics. This would have contributed to our understanding of how and why we came to be where we are today and how we might push forward to achieve a better set of social outcomes.

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## **NOTES AND TOPICS**

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### **How Different Is The New South Africa?**

**Brian Dollery**

VISITORS to apartheid South Africa who had followed Western media accounts of oppressive conditions in that country were invariably surprised at the goodwill characterising everyday relations among South Africans of all colours. More recent travellers to post-apartheid South Africa, conditioned by media reports of the benevolence of the Mandela administration, have been delighted but unsurprised by inter-racial harmony in the new South Africa. At first glance, this may appear to confirm that 'the more things change the more they stay the same'. But, on closer reflection, it becomes a useful metaphorical prism through which to examine the passage of events in contemporary South Africa.

It is widely believed that the poor performance of the South African economy since the early 1970s, exacerbated from the mid-1980s by economic sanctions, played the decisive role in the demise of the old apartheid regime, unquestionably undefeated militarily. This view ignores less tangible evidence on the failure of the 1986 State of Emergency to suppress an urban black revolt, the exhaustion of a government which had been in power since 1948, and the political window of opportunity opened up by the collapse of the Soviet Union, and exaggerates the impact of trade and financial sanctions on the South African economy. But it cannot be disputed that economic growth rates in South Africa had been low and falling for two decades. Just as the poor performance of the South African economy in the 1980s weakened the Botha and De Klerk administrations, so the success of the new democracy may depend crucially on whether the Government of National Unity (GNU) under President Nelson Mandela can deliver substantial increases in material well-being to its predominantly poor black constituency.

#### **South Africa's Enduring Economic Problems**

Table 1 paints a grim picture of the performance of the South African economy and underscores the enduring character of its problems. For example, annual growth in real GDP averaging only 0.9 per cent over the period 1984-95, together with South Africa's high population growth rate, meant a decline in real per capita GDP of almost 15 per cent. At least three factors compound the difficulties in-

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*Brian Dollery is Associate Professor of Economics at the University of New England.*

volved in increasing the rate of economic growth. First, although accurate official estimates do not exist, South Africa has experienced a wave of illegal immigration over the recent past believed to number in the millions. Moreover, migrant flows through South Africa's long and porous borders will very probably increase if economic growth expands economic opportunities for those within its borders. Second, external constraints on South Africa's economy ensure that any domestic economic growth causes a balance-of-payments crisis. Finally, unemployment remains a major problem. Barker (1992) has estimated that around 40 per cent of the labour force cannot obtain employment in the formal economy, half of whom may hold informal sector jobs. Even assuming an economic growth rate of 5 per cent a year, Fallon and de Silva (1994) have calculated that formal sector unemployment will be around 37 per cent by 1998-2001 and 26 per cent by 2002-5. It therefore seems likely that future growth rates will mirror those achieved prior to the political transfer of power, and have the same debilitating political implications.

**Table 1****South Africa's economic performance, 1984-96**

<i>Calendar year</i>	<i>Real GDP (R million)</i>	<i>% change</i>	<i>Real GDP per capita (Rands)</i>	<i>% change</i>
1984	257,292	5.1	7,987	2.5
1985	254,175	-1.2	7,700	3.6
1986	254,221	0.0	7,517	-2.4
1987	259,561	2.1	7,495	-0.3
1988	270,463	4.2	7,631	1.8
1989	276,940	2.4	7,633	0.0
1990	276,060	-0.3	7,434	-2.6
1991	273,249	-1.0	7,192	-3.3
1992	267,257	-2.2	6,879	-4.4
1993	270,181	1.1	6,803	-1.1
1994	276,464	2.3	6,813	0.1
1995	285,587	3.3	6,827	0.2
1996	-	3.2*	-	-
Average 1984-95		0.9		-1.5

\*Estimated.

Sources: South African Department of Finance, *Budget Review*, Pretoria, 1995; South African Reserve Bank *Quarterly Bulletins*, 1995 and 1996.

Just as low rates of economic growth appear to be a continuing feature of contemporary South African society, so too are the causes of this economic malaise, which transcends the colour and ideological composition of successive governments. Various diagnoses have been offered. For example, Mohr (1994) examines

growth patterns in South Africa from 1975 and finds that changes in world economic growth, world trade, technological progress, gold production, import substitution, foreign capital flows, and labour all served to depress South African economic performance. Similarly, Fallon and de Silva (1994) identify five sources of the poor performance of the South African economy since 1965: the ratio of investment to GDP has steadily fallen from a peak of about 16 per cent in 1971-76; an increasing proportion of the capital stock has been invested in the relatively unproductive public sector; macroeconomic policy has encouraged capital-intensive production techniques, a trend which has been amplified by rising real wage rates for black labour; 'skill accumulation has been inadequate, and there has been a growing imbalance between the nation's stocks of physical and human capital' (Fallon & de Silva, 1994:65); and the South African economy has exhibited a more pronounced business cycle, resulting in the periodic under-utilisation of productive resources. Noting that gold mining has experienced rising production costs, falling ore grades and a weak gold price, Nattrass (1995) observes that South Africa's annual gold production fell as a share of world output from 66.6 per cent in 1981 to only 32.8 per cent by 1993, which meant a loss of some 166,000 jobs since 1987, or around a third of total direct employment in the industry. Finally, Bethlehem (1994) has argued that 'socio-political turbulence' and falling economic growth have been strongly correlated in the post-war South African economy.

Both pre- and post-apartheid administrations have followed monetary and fiscal policies broadly consistent with macroeconomic stability, notwithstanding some deficit financing of public spending and a degree of currency volatility. However, it has long been recognised that the South African economy has severe structural problems which have to be addressed before economic growth can be increased. Eckert and van Niekerk (1993) note that the first official proposal aimed at comprehensive economic reform was the 1979 Economic Development Programme 1978-1987, later amended to form the 1991 Revised Long-Term Strategy. This document proposed to reduce the role of the public sector in the South African economy so as to 'afford the private sector more opportunity to conduct business on a profit basis. It is hoped that in the process the natural operation of market forces will bring about a healthy competitive economic structure that will, among other things, create more job opportunities' (Economic Advisory Council of the State President, 1991:12). Although the essence of this official policy stance was retained and set out in some detail in the 1993 Normative Economic Model, the impetus for economic reform under the previous minority National Party government had already evaporated. The historic announcement by the De Klerk administration on 2 February 1990 unbanning the African National Congress and other political organisations included a commitment to freeze any further economic restructuring initiatives.

### **The Reconstruction and Development Program**

Like its predecessors, the new GNU has also been long on rhetoric and short on action. Indeed, it appears that the GNU is relying on its grandiose Reconstruction

and Development Program (RDP) to somehow ameliorate the structural rigidities which inhibit economic growth in South Africa. The RDP is based on 'six principles' set out in a 1994 RDP White Paper. These broad guidelines are: specific RDP programs must be 'integrated and sustainable'; initiatives must be 'people-driven and people-centred'; programs must 'promote peace and security for all'; RDP developments must foster 'nation-building'; initiatives must 'link reconstruction and development'; and finally, initiatives must 'democratize South African society'. Actual projects subsumed under the RDP have been launched. In his 'state of nation' address on 24 May 1994, President Mandela announced a series of key programs, or 'Presidential Lead Projects', to inaugurate the first year of the RDP. In total, some 21 projects had been initiated by early 1995 with an additional four programs launched at the end of the 1994-95 financial year.

Undoubtedly, there was a need for the RDP or some similar growth-orientated redistribution scheme to capture the imagination of the South African electorate, as much as to solve economic and social problems. But it is unlikely to remedy many of South Africa's structural problems. In these respects, it is just the most recent in a long line of extravagant politicised development plans. It is even not altogether dissimilar to its predecessor, the so-called program of separate development or grand apartheid, which was also designed to change the complexion of South African society. In any event, early indications are ominous. For instance, although R39 billion was touted as the total cost of the RDP during the election campaign prior to April 1994, it now appears that this figure may represent only annual expenditure on the RDP in its 1998 final year, with the cost of the entire program estimated at R135 billion (Nolan, 1995:163). Similarly, Simkins (1996:85) points to the inauspicious beginnings of the RDP:

What progress has been made? The RDP *Monitor* of August 1995 reported that more than R1.7 billion of the R2.5 billion allocated to the Reconstruction and Development Fund in 1994-95 had not been spent in that fiscal year, and estimated that at least 20 per cent of the 1995-96 allocation would not be spent. The major reason is lack of state capacity.

Moreover, Simkins argues that parliamentary appropriations will never be sufficient to fund the RDP adequately, and so alternative arrangements, like privatisation, will have to be employed. Some commentators are even less charitable about the prospects for the success of the RDP. For example, Nattrass has observed that the entire RDP is simply 'a costly and ultimately unnecessary piece of bureaucratic musical chairs' (*Weekly Mail*, 18 March, 1995). It would thus appear that, like its grand apartheid antecedent, the RDP may be fulfilling its political purposes rather more than its intended economic objectives.

### **Social Instability**

Numerous other trends, already evident during the Botha administration in the mid-1980s, continue unabated in the New South Africa. The disruption of black



primary and secondary school education in South Africa, which was initiated by the African National Congress/South African Communist Party (ANC/SACP) alliance in the 1980s under the slogan 'Liberation Before Education', persists despite personal pleas from President Mandela himself. Although the political focus of activist school pupils is much more difficult to identify nowadays, the tactics employed clearly derive from the earlier period and include arson, assaults on teachers and non-participating students, vandalism of school premises, a refusal to attend classes, and even the occasional necklacing of some 'enemy of the people', usually educational administrators. Failure rates remain catastrophically high and the quality of the majority of successful matriculation candidates, as measured against their coloured, Indian and white counterparts, is depressingly low. The so-called Lost Generation of millions of highly politicised but largely illiterate and innumerate black people who were part of the school system during the 'Liberation Before Education' campaign of the 1980s, and are now virtually unemployable, is thus continually being augmented by new generations of equally ill-equipped young people. Even those who somehow achieve university entrance qualifications generally perform so badly at tertiary institutions that almost all South African universities now spend millions of rands on 'academic support programs', a euphemism for remedial first-year classes. Furthermore, political unrest, as before under apartheid, regularly occurs on university campuses. Thus, whilst Wits University experiences continuing racial tension and sporadic disruption, other institutions, like the Pretoria Technikon and the University of Durban-Westville, have had to call in riot police and close for extended periods.

A similar ANC/SACP initiative introduced during the State of Emergency has also survived the transition to a post-apartheid South Africa and indeed now thrives as never before. This usually takes the form of rent boycotts but often includes a refusal to pay for electricity, water and other household utilities. Originally developed by ANC/SACP activists as a means of demonstrating the 'ungovernability' of the townships, these populist boycotts have now spread to other ethnic urban communities, due apparently to the widespread belief that the GNU is unable to force people to pay. This belief has apparently been strengthened as an unintended consequence of the Mandela administration's 'Masakhane Campaign' which exhorts township residents to pay rent and service charges through moral suasion. The result has been the accrual of massive debts by local authorities all over South Africa: a situation which is clearly untenable in the long run.

Another continuing feature of the South African political landscape, which is much better known to Australian audiences, is the continued violence in Kwazulu/Natal. Originally caused by Chief Mangusotho Buthelezi's rift with the ANC in the late 1970s and his development of the Inkatha Movement, political violence between the ANC and the subsequent Inkatha Freedom Party (IFP) intensified in the 1980s resulting in thousands of deaths in the province. The killing fields of Kwazulu/Natal continued through the transition to non-racial government and indeed intensified under the GNU. Despite the repeated personal intervention

of President Mandela, political violence persists in Kwazulu/Natal and some Transvaal townships.

### **Crime and Corruption**

Many Australians are also aware of the massive crime wave engulfing South African society. Johannesburg is now reported as having the highest recorded homicide rates among all nations that keep reliable records and car-jacked South African-made Mercedes Benz and BMW automobiles are sold throughout the rest of Africa. What is less commonly understood is that the present crime wave is simply an intensified continuation of a process which began with the ANC/SACP campaign to make the townships 'ungovernable' in the early 1980s. The aim of the campaign was to delegitimise the formal judicial system and replace it with 'people's courts' so that townships would become 'liberated areas'. Together with the flood of Soviet small arms into South Africa as part of the wider 'armed struggle', this campaign sanctioned violence as a legitimate means of achieving political and other outcomes in the eyes of the Lost Generation, and criminal as well as political violence rose inexorably. When the ANC/SACP alliance proclaimed the end of the armed struggle in the early 1990s, it had already bequeathed to South Africa tens of thousands of alienated and unemployable youths accustomed to armed violence and imbued with the notion that they were morally entitled to 'redistribute' material wealth at the point of a gun. Once again, the steady upward trend in violent crime in South Africa passed through the transition to non-racial democracy unaffected.

Corruption remains a depressing thread running through the country's post-1948 history. South Africans can readily cite examples of corruption in the apartheid era, ranging from clandestine purchasing of residential land reclassified under the Group Areas Act in the 1960s, to 'Muldergate' in the 1970s, where secret plans to buy *inter alia* the *Washington Post* with taxpayers' money led to the theft of tens of millions of rands. Indeed, a final desperate attempt by National Party politicians to squeeze the last corrupt drop of superannuation out of the old order at the constitutional talks in May 1996 seems to symbolise the moral degradation of the apartheid's ruling elite.

However, members of the new ruling elite in South Africa have proved astonishingly adroit at learning the ropes. Indeed, one of the very first acts of the new GNU was to more than double the salaries of parliamentarians. At the national level, corruption is now rampant. The Reverend Allan Boesak, a leading ANC activist, was obliged to withdraw his candidature as ambassador to the UN after a scandal about his misuse of foreign donor money intended for charity. Former cabinet minister Bantu Holomisa has testified before the Truth Commission that the ANC had accepted money from gambling magnate Sol Kerzner to protect him from prosecution with the full knowledge of President Mandela, Deputy President Thabo Mbeki and Sports Minister Steve Tshwete (Makhanya, 1995:4). This has since been confirmed by President Mandela. Former cabinet minister Abe Williams was obliged to resign from the GNU after a police investigation of corruption in his ministry. At the provincial level, widespread corruption is also endemic. Ri-

ani De Wet, North-West provincial Member of the Executive Council (MEC), was dismissed amidst corruption allegations. Similar fates have befallen Free State MEC Vax Mayekiso and Mpumalanga political adviser Eugene Nyati.

Corruption is also widespread among the new bureaucracy. For example, mounting anecdotal evidence appears to suggest that although extensive and long-standing tariffs apply to most imported goods coming into South African ports, corrupt customs officers often no longer impose these duties on billions of rands worth of goods (Old Mutual Economic Research Unit, 1996:5). Similarly, a commission led by Mr Justice White has found evidence of the illegal promotion of thousands of civil servants to inflate their salaries, including around 8,000 police.

The fact that political change in South Africa has not been matched by underlying socio-economic trends is hardly surprising. True, much desirable change has occurred. After all, the relatively non-violent demise of apartheid in South Africa remains one of the wonders of the late 20th century. But the Western media are once again systematically misrepresenting South African society by presenting a false juxtaposition of a mythical satanic old order against an angelic new age. Unfortunately, human nature seldom changes and utopia is not found this side of the grave.

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## **Allocating Water Rights in New Zealand: The Role of Tradable Permits**

**Susan Begg**

**M**AJOR conflicts exist in New Zealand between using water for consumption or electricity generation, and protecting in-stream water to produce conservation, cultural and recreational outputs. Under the Resource Management Act 1991 (RMA), in-stream values are generally protected by councils,<sup>1</sup> which establish minimum flows through regulatory means, though the government may impose more extensive restrictions on a water body or waterway by means of a water conservation order. But information about the value of water in competing uses is generally very limited. The difficulty of measuring the demand for conservation, recreational and cultural outputs makes it hard for users or councils to choose optimally between conservation and other uses of water.

If individuals and groups could obtain permits to leave water in-stream, then conservation, recreation and cultural outputs could be privately provided, increasing the quality of water for all. Extending the tradability of water permits to in-stream uses could help resolve the conflict between conservation and other uses of water.

### **Institutional Background**

Tradable water permits are possible in New Zealand under the RMA. Responsibility for managing fresh water rests with the twelve regional councils and four unitary authorities guided by broad principles set out in the RMA. The RMA governs the abstraction of water and disposal of effluent, and sets out restrictions on the use of the beds of lakes and rivers, water use and the discharge of contaminants. These restrictions are binding unless they are waived by a rule in a regional plan, or a council has issued a resource consent (a 'permit'). A permit to extract and discharge water from rivers can run for no more than 35 years. If it is not exercised, it expires after two years or such shorter or longer period as is expressly provided for in the permit.

In setting rules for water use and discharges into water, councils are required to meet standards set out in the RMA. The RMA specifies minimum standards for water quality, allowing councils to specify higher standards if they wish. Standards may be lower if consistent with the Act: if, for example, there are mitigating benefits. Water standards are generally descriptive rather than quantitative.

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<sup>1</sup> Regional councils and unitary authorities are responsible for resource management and related functions. Here, the term 'council' is used to cover both types of authority.

*Susan Begg is an associate director at First NZ Capital Limited.*

The RMA does not allow the transfer of discharge permits from site to site. But it does allow transfer of water permits either through the consent process or by councils specifying conditions for transfer in a regional plan. Although water permits can be transferred through the consent process, a market for water permits is unlikely to develop without councils specifying the conditions for transfer in a regional plan. Regional plans have the potential to reflect the specific circumstances of a catchment or groundwater system that are relevant in developing a transferable permits regime and potentially make it easier for trading to occur.

Several councils are investigating transferable water-permit regimes; and one limited regime is currently in operation in the Oroua River catchment. In the proposed and existing regimes, permits to abstract water are transferable within constraints defined in the plans. In all cases, councils continue to set minimum in-stream flows through administrative means rather than integrating in-stream use into the transferable water permits regime.

### **Integrating In-Stream Values into a Tradable Water Permit Regime**

Conservation, cultural and recreational outputs are produced by leaving water in-stream. If permits to leave water in-stream could be obtained, then conservation, cultural and recreational in-stream outputs could be provided by private groups which obtained permits. Under the current regime, this effect could be achieved by groups obtaining permits to abstract water, and then not exercising them.<sup>2</sup>

The impact of not exercising a permit would depend on how permits were defined. If defined as a proportion of in-flows, permits held by conservation groups (and not used to abstract water) would increase in-stream flows in all circumstances. If defined as different priority volume entitlements, the non-exercise of permits that increased in-stream flows would increase the security of flows and allow other abstracters to appropriate the allocation left in-stream unless special provisions were made for conservation users. Under current arrangements, a plan change would be required to increase or decrease minimum flows. Since a plan change is a time-consuming and inflexible process, procedures would need to be established to facilitate protection of conservation values.

If individuals were able to obtain a permit for water abstraction and could choose not to exercise it, then, under a tradable permit regime, conservation interests would be able to compete with abstractive users for permits. Conservation interests could purchase permits from abstractive users and by choosing not to abstract water could increase in-stream flows. Allowing the trading of permits for both in-stream and abstractive use would help ensure that water was allocated to the use

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<sup>2</sup> The RMA provides that a resource consent lapses after two years, or after such shorter or longer period as is expressly provided in the consent, unless it is exercised. Thus, it appears that if a council specifies a period significantly in excess of two years within which permits must be exercised, private conservation groups could obtain water permits and not exercise them. However, the development of case law suggests that permits cannot be issued for non-active uses. Thus, an amendment of the RMA may be necessary before in-stream uses could be incorporated into a transferable permits regime.

creating the most value. Conservation groups could express their preferences for in-stream water directly through buying and selling permits rather than being forced to lobby councils for protection of in-stream amenities.

The 'public good' nature of some of the cultural, recreational and conservation outputs that are created by leaving water in-stream means that private interests may underprovide in-stream flows,<sup>3</sup> since it may be difficult to exclude non-payers from enjoying the cultural, recreational and conservation outputs, and the enjoyment of these outputs by one person would generally not reduce the scope for use by others. To overcome underprovision, the councils could provide the outputs themselves by setting minimum in-stream flows or holding permits for minimum flows. If the councils establish minimum in-stream flows by regulatory means, conservation and other groups could still increase in-stream flows above the minimum set by the councils by buying permits; but they could not reduce flows below the minimum.

Alternatively, councils could allocate permits for in-stream flows to private groups, or councils (or central government) could subsidise private groups to purchase permits for in-stream flows. The agents qualifying for funding could include conservation groups, research and philanthropic foundations, Maori organisations, and possibly commercial entities such as tourism operators.

If private conservation interests or a council agency held permits for current minimum flows, a possible option would be to allow them to trade the permits to maximise in-stream amenities across rivers. For example, in areas of relatively low environmental significance, permit holders could sell all water permits for in-stream flows, potentially reducing minimum flows to zero. The private groups or council could use the funds thus obtained to buy water permits in other rivers with more valuable environmental or other amenities. They could maximise conservation outputs by purchasing permits in high conservation areas where competing uses of water were limited rather than high conservation areas where the value of water to other users was also high. Allowing the permit holders to trade entitlements would help ensure that they maximised the overall conservation value of in-stream flows and that water was allocated to its most valuable use.

This trade-off approach was adopted in 1990 by the Department of Conservation and Electricity Corporation of New Zealand in the Waitaki catchment under the current regime. Electricity Corporation of New Zealand enhanced the environment in the Ahuriri River, which provides black stilt habitat, in exchange for having no minimum flow on the Pukaki River.<sup>4</sup> Mandatory minimum in-stream flows would preclude such mutually preferred outcomes.

Environmental standards would be determined by the level of funding provided privately and by councils and central government. But it is difficult to assess the appropriate level of such government funding, taking into account the existing provision of national parks and other government-sponsored environmental amenities,

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<sup>3</sup> Note that the alternative of political allocation may equally result in too little (or too much) conservation from an efficiency perspective.

<sup>4</sup> Russell Howie, personal communication, February 1995.

as well as private collective provision and the incidental provision of conservation values by other water users (such as those involved in the tourism industry). As well, the difficulties of assessing the value of the conservation, recreational and cultural outputs provided would make it hard to ensure that private groups were accountable for any council or government funding they received. Matching private funds with a council or government subsidy could increase the accountability of conservation and other groups, since organisations would receive private and government funding only to the extent that they met the needs of their constituents better than competing organisations.

However, groups relying on council or government funding run the risk that the council or government might force them to compromise some of their principles to obtain funding. Unexpected changes to funding arrangements may adversely affect long-term management of resources. In addition, special interest groups will not necessarily reflect all the public interests in water but may reflect their own particular preferences and uses. Councils concerned about this could participate in the market, although they may themselves reflect the values of particular interest groups.

A market approach to water allocation is sometimes opposed because of objections to, or measurement problems with, putting a monetary value on water used for recreation, scenic appreciation, cultural sustenance or conservation. But since a measurable opportunity cost to water left in-stream exists in the form of its alternative value in abstractive uses, a monetary value for water left in-stream is at least implied.

In deciding whether to leave water in-stream under current arrangements, the councils need to trade-off preferences for in-stream outputs against the opportunity value of water in alternative uses. Determining the value of water left in-stream to those who benefit is problematic. Under an administrative approach, the beneficiaries have incentives to overstate their preferences for in-stream water. Under the market arrangements discussed above, these groups can directly express their preferences by buying or selling permits. This ability to trade provides incentives for these groups to make explicit trade-offs between in-stream and development values. Trading would generate information about the value of water in non-conservation uses and therefore about the opportunity cost of water left in-stream. Note that a tradable regime does not prevent lobbying of government for additional funding of conservation outputs.

### **Integrating Water Quality Considerations**

Water can carry effluent from industrial and farming activities. This use competes with other uses of in-stream water and abstractive use. Abstraction of water reduces the ability of surface water to assimilate waste. Poor water quality is inconsistent with some conservation, recreation and cultural uses of water. In establishing water quality standards, the value of water for in-stream or abstractive uses as opposed to carrying effluent needs to be considered. If water standards are too high, industries discharging to a waterway may invest too much in pollution control, output may be

constrained and some abstractive uses may be prevented. If standards are too low, environmental damage may result and cultural and recreational uses may suffer.

Currently, councils set water quality standards by administrative means and use discharge permits to control water quality. This requires councils to determine the assimilative capacity of a waterway and issue discharge permits up to this limit.<sup>5</sup>

The RMA does not allow the transfer of discharge permits from site to site. Although a number of difficulties are likely to limit the scope for a tradable discharge permits regime (Begg et al., 1995:48-9), there seems no good reason to block the development of such a mechanism. Experimentation will not be possible as long as a tradable discharge permit regime is not allowed in New Zealand.

Incorporating effluent disposal into a tradable water permits regime may facilitate the trade-off between effluent disposal and other water uses. One option would be for councils to define the amount of water necessary to assimilate a certain quantity of pollutant or combination of pollutants, and then require dischargers to purchase water permits to leave in-stream the quantity of water needed to carry the pollutants. Polluters would have to buy water permits in competition with other users (both abstracters and other in-stream users), allowing a direct comparison of the values of different uses. Others who had in-stream permits for conservation or recreation uses could on-sell some of the assimilative capacity of their water.

Nevertheless, an integrated approach does not avoid the need for councils to define administratively the quantity of water required to assimilate pollutants. By so doing, councils define the lowest acceptable quality of a water body. If all permits for in-stream water were used to assimilate pollutants, the lowest acceptable quality of water would prevail. If permit-holders left water in-stream for reasons other than effluent disposal, water quality would be higher than the minimum. Thus, the overall quality of water would, at least in part, be determined by competition for water permits for different uses.

However, the proposed approach would not handle the discharges from run-off that are responsible for many quality problems. A further difficulty would be that the quantity of water needed for assimilation would differ for each pollutant and the use of water to assimilate one pollutant would not preclude its use for other pollutants.

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<sup>5</sup> Councils generally do not require permits for discharges such as animal waste, pesticide, and sediment in run-off because of the administrative costs. Instead they generally handle such discharges by administrative tools such as restricting land-based activities, siting potentially polluting industries away from waterways, ensuring they operate to minimise pollution, and encouraging the planting of riparian strips.



## Repeal the Ban on Drugs in Sport for Fairer Contests and Reduced Health Risks

**Terry Black**

**T**HE International Olympic Committee banned from sporting contests certain stimulants and analgesics in 1971, and anabolic steroids in 1974. Since then, an army of sport administrators and medical personnel has become actively involved in attempting to ensure that sporting contests are drug-free. Yet despite two decades of effort, at the cost of millions of dollars, they have not achieved their objective.

Is it worth the effort to try to stop the use of drugs? Only, surely, if the arguments for the ban are compelling. But are they?

### Drugs and Fairness

One of the two main reasons advanced for the ban is that it is necessary to ensure that sporting contests are fair. But, before the ban, any advantage gained from artificial devices, including drugs, was 'competed away', and would be similarly 'competed away' if the ban were removed.

There is little doubt that, if the ban were lifted, the use of drugs would increase, particularly in physically demanding sports. But the greater the number of athletes that use a new training technique, or a new diet, or drugs, the less chance each of them has of gaining an edge on their competitors. Before drugs were banned, it is very likely, particularly at the highest level, that the benefits of training, diet and drugs cancelled out among the athletes, leaving the athlete with the greatest natural ability as the winner. Take training. At the outset, athletes who train do benefit relative to athletes who do not train. But, as they improve, the probability that they will compete against athletes that also train increases until, at the elite level, it is likely that all competitors are maximising their performance through training. At the limit, if all athletes are using a performance-enhancing device, then the only difference between athletes is natural ability.

Because the rewards from success in high-profile events such as the Olympic Games are large, athletes have strong incentives to maximise the use of performance-enhancing devices. Prior to the drug ban, artificial devices such as training, coaching, diet and drugs cancelled out and equality of opportunity prevailed. Every athlete had a free choice whether or not to train, be coached, and use vitamins, amino acids and drugs, with the result that sporting contests were as fair as they could be. So the ban

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

on drugs could not be justified on the grounds that drug use made for unfair contests. Conversely, the ban on drugs introduced unfairness between drug users and non-users: since not all athletes abide by the rules, the drug ban benefits drug users, at least those that are not caught. The minority of athletes who continue to use drugs gain a significant unfair advantage over non-users.

The drugs ban would result in fair contests only if it could ensure that no contestant was taking drugs. But no drug-testing procedure is comprehensive and reliable enough to enable officials to provide an absolute guarantee that no contestant is on drugs. It is unlikely that such testing procedures could be devised or, even if they could, that they would remain reliable in view of the strong incentives to come up with new undetectable drugs and masking drugs. No one in the drug-detecting industry could ever give such a guarantee.

Arguably, an absolute guarantee is unnecessary, since the public would accept a reasonable degree of certainty. But the point is that, if the tests are less than foolproof, some cheating, and therefore unfairness, can result. So, rather than making sporting contests fairer, the drug ban in fact has turned sporting events into unfair contests between users and non-users of drugs. By restricting the majority of athletes, the ban acts as a barrier to entry and thereby provides monopoly-like rewards to drug-users who are protected from performance-enhanced competition from non-users.

### **Drugs and the Health of Athletes**

The second major argument advanced in favour of the ban on drugs in sport is that it protects the health of athletes. However, it appears that there is no unambiguous answer to the question whether banned drugs are harmful to health. Various submissions to an Australian Senate inquiry in the late 1980s also indicated doubt. For example, the Health Department of Western Australia claimed the long-term effects of the substances were unknown (Senate Standing Committee on Environment, Recreation and the Arts, 1989:52).

Even if the use of drugs such as anabolic steroids did harm the health of athletes, the ban could not be justified on that basis alone. The ban itself exacerbates health risks, in several ways. It reduces the incentives for research into safe doses and ways to overcome harmful side effects; it restricts medical monitoring; it encourages athletes to acquire black market drugs; and it contributes to excessive consumption of drugs by users.

*Research into safe doses.* An explanation for the uncertainty about the long-term effects of drugs such as anabolic steroids is the lack of identification of dose quantities.

It is only when the quantity consumed exceeds a particular level that it constitutes a danger. For example, even known poisons are ineffective below a certain quantity. The Senate Inquiry's 1989 Report expressed the view that 'substances such as amino acids do not pose any health risk' (p. 24). However, amino acids, vitamins and steroids are all dangerous to health if consumed in excessive quantities. To protect the health of users, it is unnecessary to ban drugs; what is needed is knowledge of safe doses. This is the case with vitamins, which are sold with clear instructions on how

they should be consumed. When vitamins were first discovered, they were hailed as the wonder cure; but some consumers suffered health problems because of lack of advice on safe doses. Subsequent research has solved that problem, allowing consumers to purchase safe doses. Should the ban on drugs in sport be removed, pharmaceutical firms would have huge incentives to establish safe doses for steroids and other drugs.

Of course, information about safe doses would not in itself prevent athletes from overdosing. But it would probably significantly reduce overdosing, particularly overdosing due to ignorance. Research into the effects of excessive doses would enable those athletes who wanted to take risks to do so in a more informed way.

*Medical monitoring.* Some athletes currently obtain advice from unqualified sources, such as black market suppliers and anecdotal evidence from other users: hardly reliable advice.<sup>1</sup>

The ban denies athletes access to medical advice on the side effects of using steroids. The Senate Report pointed out that 'All the dangers associated with drugs used to enhance performance are made much greater by the fact that athletes using these drugs are likely to be doing so without medical supervision, in uncontrolled doses' (p. 52). If the ban were removed, the health of athletes would be medically monitored, probably resulting in fewer and less serious medical problems.

Against the legalisation of drugs in sport, it could be pointed out that a number of athletes have died from drug usage. Examples include American footballer Lyle Alzado, who died in 1992 apparently from excessive quantities of steroids, and a 23-year-old Australian body builder, Maurice Ferranti, who died in 1989 of a heart attack attributed to steroids and a masking drug. But the significant point about such deaths, along with the harmful side effects that innumerable athletes suffer, is that they all occurred under the drug ban. The ban has not only failed to protect the lives and health of athletes, but has contributed to such deaths and illness because it has denied athletes access to medical advice.

If drugs were legalised, they could be taken under strict medical supervision, significantly reducing the health risks that athletes are exposed to at present. Removal of the ban would increase the dissemination of information, allowing athletes to become informed about health risks and to have access to the best medical advice.

*Black market drugs.* The ban encourages athletes to obtain from the black market anabolic steroids that were produced for use with animals. These are unlikely to be fit for human consumption; they may be contaminated and cause diseases. The Senate Report pointed out that 'Drugs obtained on the black market and not from a registered medical practitioner will always be suspect. . . [involving] the dangerous possibility of contaminated material. This may lead to AIDS or Hepatitis' (p. 54). The high prices that black-market suppliers command reflect the high costs that the ban im-

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<sup>1</sup> It is true that reliable scientific information about banned substances can be found on the internet. Yet the fact that athletes have died from the effects of drugs suggests that many users are not fully informed.

poses on drug traffickers; for example, pharmacists who dispense steroids face a life-time loss of their licence to practise. The opportunity to earn large profits attracts hardened criminals into the black market. Athletes pay high prices for black-market drugs that are unhygienic.

A parallel can be drawn with alcohol prohibition in the US in the 1920s. Prohibition famously failed to stop the supply and consumption of alcohol; but it did result in a black market in which criminals, lured by high prices and large profits, supplied alcohol to consumers. When the ban was removed, the criminals left the industry. In the same way, removal of the drug ban would allow reputable pharmaceutical manufacturers to produce hygienic products, pursuing the huge potential economic rewards from supplying low-risk drugs.

*Excessive consumption.* An argument for retaining the ban on drugs in sport is that, athletes would otherwise use excessive doses of steroids, to the detriment of their health.

In fact, athletes who are currently using drugs would benefit from the removal of the ban, since this would reduce the risks they currently face from using black-market steroids. Further, access to pharmaceutical companies producing safe-dose quantities with warnings against excess use is likely to reduce the health risks faced by these athletes. For these reasons, removal of the ban would save the lives of some of these athletes and reduce the health risks of others. This is not to say that all deaths and all health risks that occur under the ban would be eliminated. But they are likely to be greatly reduced.

One version of the excessive-use argument against lifting the ban holds that the ban prevents long-term harm to athletes in the same way that regulations administered by referees exist to prevent boxers harming themselves when they want to keep fighting despite the risk of severe injury. But the analogy is not precise, since, unlike punch-drunk boxers, athletes are able to make reasoned decisions. Further, in the absence of regulations requiring the referee to intervene, the boxer's trainer or manager has an even stronger incentive to do so if necessary, since their incomes are dependent on the boxer's health.

### **Would Legalising Drugs Force Non-Users to Become Users?**

A further health-related argument against deregulation is that it would force non-users of drugs to start using them. For example, countries like the former East Germany might require their athletes to take steroids. In December 1994, eleven female Chinese athletes were stripped of their medals from the October Asian games for testing positive to drugs, thus raising suspicions that the communist regime in China has adopted a similar drug-use policy. But such countries will adopt such policies whether the ban exists or not. The ban has not deterred them, but it has given their athletes a huge advantage.

Without the ban, would athletes who had not previously used steroids be forced to use them so as to be able to compete with established drug users? Not necessarily. Steroids are not beneficial in all sports. As well, in free societies athletes may choose

to use steroids, to adopt high-altitude training, to train abroad, or whatever. Each athlete will assess the costs and the benefits of different courses of action and some will reject steroids.

Those who claim that athletes would be forced to use steroids tend to have in mind the high-risk steroids that are currently in use. But these steroids are harmful because of the ban itself, which, as has already been observed, promotes a black market in drugs, prevents doctors and pharmacists from giving advice and monitoring the effect of consumption on users, limits information about safe doses, encourages users to consume dangerous masking drugs, and generally inhibits the emergence of a safe drug market.

While drug taking would unquestionably be safer if it were legal, it would also be much more widespread. This raises the question of whether a reduction in the harm done to athletes who currently take drugs would translate into a reduction in the aggregate level of harm. For the existing high-risk drugs, the answer is unknown. But since lifting the drug ban would bring forth new, researched, hygienic drugs, administered under doctors' supervision, it is likely that the consequent reduction in average harm would lead to a reduction in aggregate harm.

### **Authenticity**

The final argument for the ban on drugs in sport is that it promotes 'genuineness' in sporting contests. According to this argument, the sports-watching public (and many sport participants) have a clear idea of what constitutes a genuine sporting contest. For example, a race among drugged runners could be fair in the sense that all participants had the same opportunity to use drugs; but it may offend against the public's desire for authentic sporting behaviour, as a swimming contest would if the contestants were allowed to wear flippers.

Yet the rules and equipment used in sport are constantly changing, and improvements in technology are widely adopted. Consequently, the idea of what makes for a genuine contest evolves over time as athletes constantly search for performance improvement. During the 20th century, sport has left amateurism behind and today is dominated by professional athletes who earn their living from playing and promoting sport. Records continue to fall as a result of the increase in competition. Athletes resort to every possible device, such as coaching, high-altitude training, videos, vitamins, amino acids and drugs. Governments assist by funding training facilities, trips abroad, and sporting scholarships. The day of the 'natural' or 'genuine' athlete no longer exists, if it ever did. Instead, all athletes improve their performance 'artificially' with training, diet, coaching and so on. In this sense, performance-enhancing drugs are just one device among many. Steroids and other drugs are performance enhancers just as the use of graphite is in pole vaulting and tennis. The general public has accepted the use of technology as part of contemporary sport, and has not turned away from it on the grounds that it is not 'genuine'.

Since sport is a commercial enterprise, it has to be responsive to public tastes.<sup>2</sup> Would removal of the ban and any subsequent increase in the use of drugs make sports contests less popular? In the case of steroids, probably not, since the major effect of using steroids is to increase physical strength. After all, the athletes on public display are already strong by virtue of natural endowment and training, particularly weight-training, making it difficult for the public to identify any increase in strength due to steroids. The public is more interested in performance standards and the breaking of records. For example, it is doubtful that the public would welcome professional golfers using equipment from the early 20th century rather than up-to-date balls and clubs.

Drugs in sport are little different from the many other devices that athletes employ to improve their performance. They reflect humanity's unceasing drive for improvement. Athletes follow this genetic imperative and the public demands it.

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One suggestion is that sports be divided between those that allowed drugs and those that banned them. But, as happens today, some athletes would undermine the no-drug sports by covert drug-taking.

## **The Impact of New Zealand's Employment Contracts Act: A Response to Rod Lingard**

**Chris Eichbaum**

**A**S New Zealand awaited the formation of its first government under the new mixed-member-proportional electoral system, nothing seemed more certain than that the Employment Contracts Act (ECA) would change. Such change could involve the repeal of the Act and its replacement with a statute more in keeping with International Labour Organisation (ILO) Conventions on collective bargaining and freedom of association, the introduction of a comprehensive minimum code, and greater encouragement for collective bargaining arrangements, including multi-employer contracts where appropriate. Alternatively, change could take a more incremental form, with the general scheme of the Act retained. A government of the centre-left would be likely to seek to repeal and replace the Act, while a centre-right coalition would probably entertain incremental reform.

In the event, a centre-right National-New Zealand First coalition has emerged, and, while only marginal changes are envisaged, both parties to the Coalition Agreement appear to have influenced the agenda for reform. Those commentators who have represented the ECA as an 'incomplete revolution' may be encouraged by references in the Coalition Agreement to the need to limit 'judicial activism'. On balance, it is not clear that there will be any substantial softening of the Act, notwithstanding the claims that will no doubt be made for some of the cosmetic changes by New Zealand First.

It is clear, however, that there is no suggestion of a return to a formal system of conciliation and arbitration, to monopoly rights of union representation, or to a system of bargaining dominated by multi-employer awards. But there is a concern to ensure that labour law promotes equitable outcomes, while ensuring the necessary degree of flexibility and responsiveness required for labour-market efficiency.

Any assessment of the impact of the ECA, and, by implication, the prospects for legislative reform, should explicitly articulate the preferences of stakeholders. Those who stand to gain from the present arrangements, which is to say those who have a vested interest in them, have an obligation to declare that interest if the debate over the merits of the ECA is to have the necessary integrity.

### **Labour Market Failure**

With the passage of the Industrial Conciliation and Arbitration Act in 1894, New Zealand became a pioneer in labour legislation. It is salutary to reflect on the im-

peratives that led the Liberal government of the time to sponsor the legislation. Evidence of 'sweating' — the exploitation of women (many of them outworkers) and child labour in the clothing industry — prompted widespread community concern. And the consequences of the 1890 Maritime Strike were of sufficient magnitude and concern to suggest that the orderly conduct of labour relations might appropriately be prosecuted by way of *public* policy. In short, labour legislation was justified by clear evidence of market failure, and informed by the dual imperatives of equity in outcomes and order in process. Moreover, in respect of the former imperative, market failure was most evident in what we would now refer to as the secondary labour market.

The evidence that Rod Lingard (1996) cites in his recent note in *Agenda* — survey results on the preferences of employers and employees, and on the outcomes of bargaining under the ECA — should not obscure the fundamental issue that separates supporters and opponents of radical labour-market liberalisation. That issue goes to the heart of the nature of the labour market. Those of a libertarian persuasion argue that 'It is a common delusion to treat people's choice to sell their labour as fundamentally different from other economic choices they might take' (Garvey, 1994:11). In stark contrast, others have suggested that

The heart of the problem is that the labour market cannot be visualised as a market like any other, with unions blocking prices from doing their proper job of equalising the supply and the demand for labour. Human beings are not tradeable commodities. As . . . Robert Solow argues, the theoretical categories that might apply to analysing trade in chocolate bars, fish or computers cannot be extended to labour because we have to confront the issues of fairness, morale and human motivation that permeate human action. (Hutton, 1995:98-9)

Much empirical evidence exists relating to the impact of the ECA. But identifying cause and effect, particularly with regard to the macroeconomic impacts of the ECA, is problematic, particularly in view of the absence of a counter-factual. Moreover, the impact of the ECA is not easily separated from other policy changes. Legislating for an effective reduction in union influence, increased individual contracting at the lower end of the market, and a tightening of benefit eligibility and reductions in entitlements will tend to result in the expected shifts in supply and price. That has demonstrably been the case in New Zealand, and the ECA has been only part of the story.

### **Bargaining Outcomes**

Lingard's use of evidence is at times selective, and some of his conclusions appear not to be supported by any evidence at all.

Lingard cites approvingly research undertaken by the New Zealand Institute of Economic Research (NZIER) on the impact of the ECA, but his reporting of the research is somewhat selective. Of the employers surveyed by the NZIER, 42.6 per



cent indicated that they had reduced overtime rates, and 38.8 per cent had reduced other allowances and/or penal rates. Some 40 per cent of employers surveyed reported no change in ordinary-time wage rates in the period from the passage of the ECA to December 1995 (Savage, 1996).

There is absolutely no evidence to support Lingard's assertion that those covered under collective contracts have made relatively smaller 'gains' than those employed on individual contracts. Statistics New Zealand simply has no way of identifying the type of contract coverage in computing wage/income changes. What we do know is that there is evidence of inequality in bargaining outcomes: in the past year, 46 per cent of wage rates have not changed, but a quarter have increased by more than 3 per cent.

We also have evidence on the pattern of collective-contract coverage by size of enterprise and by sector. Approximately 23 per cent of workers are covered by collective employment contracts, but only 16 per cent of those workers are under contracts covering fewer than 100 workers. This creates a less than 3 per cent chance that a worker in a small (under 100) workplace will be covered by a collective employment contract; yet 75 per cent of workers are in that situation (NZCTU, 1996). A recent review of the data on contract coverage concludes with the observation that 'the right to collective representation in setting conditions of employment has nothing to do with democracy or free choice. It is simply a factor of scale of employment' (NZCTU, 1996:63).

What about the much vaunted productivity dividend? The NZIER reports that 'aggregate data implies that productivity performance in recent years has been below average' (1996:11), and the OECD has noted that, 'there is not much evidence at the macroeconomic level . . . that the ECA has led to increased flexibility and improvements in productivity' (cited in NZCTU, 1996:12).

Lingard fails to report evidence of the impact of the ECA on a labour market that is segmented by gender. In May 1996, Douglas Myers, Chairman of the New Zealand Business Roundtable, suggested that the ECA had been good for women, and argued that 'Women's interests rarely got a fair hearing in male-dominated trade unions committed to a 40 hour week; the extra flexibility in working hours and growth in part-time jobs have been of great advantage for them' (Myers, 1996). In fact, research on bargaining outcomes suggests that, under the ECA,

women are less likely than men to be employed on contracts that contain penalty rates of pay. Women are disadvantaged in that the sectors in which they are most commonly employed are exactly those sectors where penalty rates, for working at weekends and other hours that have traditionally been deemed sufficiently anti-social to attract a premium rate of pay, have been eliminated. (Hammond & Harbridge, 1995:372)

The same authors suggested, prior to the introduction of the Australian government's Workplace Relations Bill, that decentralisation of bargaining in Australian

workplaces risked a worsening of the 'structural inequalities of industry segmentation' (Hammond & Harbridge, 1995:374).

### **Employee Representation**

Lingard notes that there has been a decline in levels of union representation, and offers the observation that this is part of a 'steady and relentless' (p. 495) and 'continuing decline' (p. 496). That there has been a decline is without question. That the ECA has largely contributed to the decline is likewise not in dispute. But what it is about the ECA that has prompted this decline is an issue on which there is a greater range of views than Lingard's assessment might suggest. And Lingard's commentary, while selective, attests to this by suggesting, variously, that the decline is a function of a 'free and contestable labour market', and that a decline in unionisation in the services sector may have something to do with the fact that, for unions, this is a 'difficult' sector in which to organise (p. 496).

The above observations on the pattern of collective bargaining are clearly apposite in this regard. There is simply no evidence to support the suggestion that unions are losing market share: quite the opposite. A recent review of the pattern of representation (for 3,216 contracts covering 403,000 employees) suggests that

Non-traditional unions (in-house unions or bargaining agents) have not developed as an important force. . . They continue to represent just 2 per cent of employees in our sample. Traditional unions have maintained their market share representing some 89 per cent of employees. (Harbridge, Crawford & Kiely, 1996:10)

### **The ECA and ILO Conventions**

The ECA fails to meet the tests of the relevant ILO Conventions. Reviewing the Final Report of the ILO Committee on Freedom of Association, which undertook a Direct Contact Mission to examine the impact of the ECA, Haworth and Hughes (1995:154) report that

the ILO continues to entertain grave concerns about the operation of the ECA on two counts. First, the status of individual bargaining given by the ECA is in direct contradiction to ILO principles of collective bargaining and, by extension, to the parallel principles of tripartism. In the discourse of the ILO, this criticism remains a fundamental issue putting the ECA at odds with ILO practice. In a host of contexts, not only that of Convention 98, the ILO has established precedence for collective bargaining in labour relations and the ECA contradicts this precedence.

It is interesting to note that Australia's Workplace Relations Bill may be inconsistent with ILO Conventions to which the Australian government is a signatory.

## Conclusion

Advocates of the kinds of neoclassical policy prescriptions of which the ECA is an exemplar typically justify the need for radical liberalisation, in part at least, on the grounds that formal systems of conciliation and arbitration militated against the necessary degree of flexibility in process and outcomes. Lingard's conclusion paints a picture of a set of institutional arrangements in Australia, by implication under the ALP-ACTU Accord, corrupted by vested interests, characterised by statist control, creating distortions, and pricing individuals out of the labour market. This commentary is not the place to contest Lingard's jaundiced assessment of those arrangements. Suffice it to say that the recent course of Australian public policy and the emerging debate over the future policy trajectory deserves more than the facile treatment that Lingard offers.

Australia has a choice. The relevant issues do not revolve so much around whether jobs can be produced by the kinds of supply-side reforms that the ECA and adjustments to welfare arrangements permit. Rather, they revolve around the kinds of jobs that will be generated; whether or not international competitiveness is a function solely of the relative *price* of labour; and the contribution made by the *quality* of a nation's human capital.

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## Rejoinder

Rod Lingard

IN his critique of my *Agenda* note, Chris Eichbaum tries to anchor his views to the notion that labour law should promote 'equitable outcomes, while ensuring the necessary degree of flexibility and responsiveness required for labour-market efficiency' (p. 107). There is an analytical confusion in his attempt to conceptualise a labour market that is re-regulated to be both equitable and efficient at the same time: surely an example of having your cake and eating it. Eichbaum also claims that 'Those who stand to gain from the present arrangements, which is to say those who have a vested interest in them, have an obligation to declare that interest if the debate over the merits of the ECA is to have the necessary integrity' (p. 107). I agree. Obviously, as a director of a labour market consultancy (which the by-line of my note indicated), I have a 'vested interest', a fact I have never disguised.

Disappointingly, Eichbaum maintains this confused approach in his critique proper by claiming that, as an experiment in radical labour-market liberalisation, the Employment Contracts Act (ECA) has failed because it has not delivered the 'equitable outcomes' he believes it should have. Ignoring the mounting evidence I cited of improved labour-market efficiency (a matter Eichbaum claims to be as much concerned with as 'equitable outcomes'), he then goes on to state that the fundamental issue with the radical reforms is that the ECA's supporters espouse the standard libertarian view that labour is a tradable commodity. Quite apart from the false assumption that only labour markets involve human beings and their economic choices, or that a person's labour somehow substitutes for the person himself or herself, the biggest flaw in Eichbaum's argument is the converse implication that regulated labour markets deliver 'equitable outcomes'.

Exactly what Eichbaum means by 'equitable outcomes' is unclear. But if it has to do with the fact that differential wage increases have occurred under the ECA, as well as some real decreases, then presumably Eichbaum favours standardised national wage movements for all workers topped up with second-tier bargaining arrangements to satisfy exigent labour market demand factors: yet another example of having your cake and eating it. This raises the question: does Eichbaum seek so-called 'equitable outcomes' for *all* labour market participants, including employers, irrespective of the inherent contradictions of such a term, or is he interested only in a return to a regulated industrial-relations system based on collective bargaining?

Eichbaum answers this himself, and also exposes the fallacy of his argument, when he condemns the ECA for its impact on women workers. A study by Brosnan and Walsh (1996) of non-standard employment reports no significant differ-

ences in the way women and men were employed under the ECA during the period 1991-95. Moreover, job growth statistics for the same period (Statistics New Zealand, 1991-96) show that total jobs for women workers increased at a slightly higher rate than those for men. No thinking labour market commentator would deny the existence of structural inequalities that constrain women workers. But in this instance Eichbaum is hard-pressed to show that the ECA is blameworthy, notwithstanding his unconvincing argument about gender segmentation affecting the wages of women workers. Pay differentials these days are much more likely to be symptomatic of industry segmentation (reflecting wider economic circumstances), enterprise segmentation (reflecting a firm's competitive advantage or lack thereof), or even individual variations (reflecting aspects of a worker's personal performance).

These diverging views nevertheless expose a significant problem. As I observed in my note, claims and counterclaims about the ECA are difficult to substantiate given the paucity of quality labour-market information. Much of the blame for this lies with labour-market academics. If they were not so obsessed with collective bargaining, and instead extended their research to encompass the remaining 80 per cent of the labour market that is governed by individual contracting, then comparative studies would arguably be more reliable and present fewer opportunities for academic obfuscation, particularly on contentious issues such as labour productivity.

Where we do have reasonably accurate data, however, is in the area of union membership density. Here, by misconstruing my comment about 'shrinking' union membership so as to imply that I suggested that unions are 'losing market share', Eichbaum does himself no credit at all with his very selective use of statistics. True, the collective bargaining data sub-set concerning employee representation shows that unions are holding their own in this area. But this ignores the overwhelming fact that, in terms of actual employee representation (not to mention potential coverage) across the total labour market, union coverage declined from 65 per cent in the 1960s and 1970s to 43.5 per cent in 1985; fell further to 41.5 per cent in 1991; and plummeted to 19 per cent in 1995. The 1.3m New Zealand workers who do not have direct representation amount to 80 per cent of the potential market in which unions now only enjoy 17 per cent coverage. Once again, higher-quality academic research on the experiences and preferences of these much-neglected individual workers would cast light on what is actually happening in the market for employee representation understood in its widest possible sense.

About the prospects of further labour market reform, there is less doubt. The new National-New Zealand First coalition government recently announced in its *Coalition Agreement and Policy Document* an industrial relations policy whose Statement of General Direction says that 'the industrial relations environment desired by the parties is one based on fairness, flexibility and neutrality, recognising that the environment plays an important part in achieving high sustainable economic growth rates in New Zealand'. Of the 13 key policy initiatives specified within the policy document, five in particular signal that the ECA will not only be retained with its labour-market efficiency and freedom-of-choice principles intact, but the changes may even enhance some of the existing structural arrangements.

These five policy initiatives are as follows:

1. Access rights for bargaining agents (including unions) will be strengthened on the basis of existing case law, but will also remain limited to the contract negotiation process, so denying unions a general right of access that would otherwise facilitate membership 'fishing expeditions'.
2. Multi-employer collective contracts will retain a no-strike/no-lockout prohibition, denying unions the opportunity to pursue industry-wide industrial campaigns.
3. 'Fair' bargaining, a new concept, will oblige contracting parties to respect each other's choice of bargaining agent and not to undermine the bargaining process. This is significantly less onerous than the prescriptive process of so-called 'good faith bargaining' favoured by the New Zealand Labour Party and the Alliance.
4. Employment Court decisions will be scrutinised for the purpose of 'minimising judicial activism' in the employment arena against parliament's express intentions. This could have major implications for the way employment institutions approach fixed-term contracts, redundancy settlements and contract termination arrangements in future.
5. The minimum adult wage will increase from NZ\$6.37 an hour to \$7.00 from 1 March 1997, and possibly to \$7.50 an hour in March 1998, generating some concern that a 10 per cent increase may slow employment growth for youth and other marginalised workers.

Amended with such pro-business changes, the ECA will apparently continue to flout ILO Convention 98 concerning the promotion of collective bargaining. But the fact remains that the global trend is towards increasing liberalisation of all markets, including labour markets. In the process, New Zealand continues to lead the way in developing minimalist structural arrangements that prevent 'vested interests' from distorting or impeding an otherwise efficient and free labour market, while delegating to its politicians the proper role of legislating for a social safety net where appropriate.

In this respect, Australia still has some way to go in freeing its own labour market from structural rigidities, notwithstanding the recent passage of the Workplace Relations Act. Eichbaum also has some way to go in coming to grips with the labour market's dynamics of supply and demand. If he understood that the *price* of labour was a function of its *quality* rather than treating these two factors as separate market components, he would be less inclined to the view that driving up the price would necessarily improve the quality, let alone produce 'equitable outcomes'.

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## **REVIEWS**

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### **Strengthening Crime Deterrence**

*Cathy Buchanan and Peter R. Hartley, Controlling Crime in New Zealand,  
New Zealand Business Roundtable, Wellington, 1996*

*Reviewed by Joe Wallis*

**T**HIS publication received relatively short shrift from the New Zealand popular press, being largely dismissed as the sort of thing one would expect to come out of a 'New Right think tank'. Attention has been focused mainly on those of its policy recommendations (the privatisation of prisons, the reallocation of police resources from family violence to deterring property crime and the endorsement of recent microeconomic reforms as ways to expand employment opportunities) which seem to be consistent with an ideologically-driven reform agenda. In my opinion, such reviews fail to do full justice to what is a well-written, accessible application of standard economic theory to an analysis of crime and crime control. The study is presented in a 'user-friendly' form, with its main arguments being gathered together in its first chapter with a fuller discussion of the underlying economic model of criminal behaviour, statistical tests of this model, alternative theories of crime, and policy implications of the economic theory of crime being developed in the later chapters. What perhaps sets this report apart from similar works of 'economic imperialism' is the care the authors have taken to defend, on philosophical grounds, their application of the standard model of *homo economicus* to the problem of crime.

Cathy Buchanan (who teaches philosophy at the University of Houston-Clear Lake) and Peter Hartley (currently director of the Melbourne-based Tasman Institute) argue that since criminal behaviour, like other forms of behaviour, is responsive to changes in incentives, criminals can be treated as rational individuals who choose to commit crimes on the basis of their comparisons of the expected net benefits of criminal and legitimate uses of their time, effort and other resources. The authors contrast this approach with that taken by the sociological, psychological and criminological theories which have shaped the 'official' view that criminals are less rational than other individuals and are driven by social factors beyond their control (such as unemployment, family breakdown, poverty and poor education) to commit crimes. The main implication of these 'deterministic' theories is that the incidence of crime can be most effectively reduced by directing more resources toward the mitigation of those factors which drive people to engage in criminal activities. While the authors acknowledge that an individual's assessment of these factors may influence the attractiveness of criminal activities relative to legitimate employment opportunities, they hold strongly to the belief that criminals are rational indi-

viduals who are responsible for their own actions. To believe otherwise 'diminishes their moral stature and makes them fit only to be the objects of social or psychological engineering' (p. 7). In this regard, the economic theory of crime (ETOC) they advocate is closer to the view of the 'general public' that criminals must 'expect to be punished if they are found guilty, and punished sufficiently harshly to satisfy the (public) demand for retribution and to deter the incidence of crime' (p. 6), than it is to an official view which, in its attempt to reflect a 'civilised sensitivity to external factors', is in danger of degenerating into 'sentimentalism' (p. 7).

Through a careful analysis of the supply of and demand for crime (after taking into account the protective response by victims), the writers show how the two main testable hypotheses of the ETOC can be derived. These are that the incidence of crime is negatively related to (i) the expected penalty for criminal acts and (ii) the attractiveness of alternative legitimate employment activities. The expected penalty for crime is the product of the criminal's assessment of (i) the probability of being detected, convicted and punished, and (ii) the size of the penalty associated with the crime, which would include not just the costs associated with legally imposed penalties but also the costs arising from a stricken conscience, family discipline, social ostracism and so on. After acknowledging the difficulties associated with statistical testing, the authors cite an impressive body of evidence, gathered in other countries, which provides a rather firm corroboration for the significance of expected penalties in crime deterrence. They do, however, concede that no such firm inference can be drawn from studies of the significance of income and unemployment variables in explaining variations in crime rates.

Nevertheless, they conclude that there is a relatively strong theoretical and empirical support for the ETOC. They criticise some recent changes in New Zealand's criminal justice system and recommend a redirection of crime control policy on the basis of this theory. In particular, they argue that the more stringent procedures which have been imposed on the police and the courts by the Bill of Rights Act 1990 and the Children, Young Persons and their Families Act 1989 have lowered the expected penalty for crime by making it more difficult to catch and punish criminals. They propose a re-evaluation of the criminal justice system with a view to strengthening its role in serving the interests of victims by deterring crime rather than scrupulously protecting the rights of criminals. Another proposal which seems to follow directly from the ETOC is that there should be greater use of fines and electronic surveillance of criminals under 'house arrest', with incarceration being used as a punishment of last resort.

The policy section of the publication adds to these policy recommendations a number of others which are derived less from the ETOC than from agency theory, contestable market theory and the 'new institutional economics'. These include the recommendations that prisons and the traffic surveillance functions of the police should be privatised, that social workers should deal with problems of family violence so that the police resources can be reallocated towards crimes which they have a comparative advantage in detecting, and that police performance should be assessed in terms of its impact on 'outcomes' such as crime rates and costs per arrest.



While these recommendations have merit, they are not necessarily derived from the ETOC and their inclusion has left the book open to the criticism that it uncritically advocates the general policy line advanced by the New Zealand Treasury and the New Zealand Business Roundtable.

Any substantial criticism of the report should, however, be directed toward the ETOC and those policy recommendations which are directly derived from it. One possible line of criticism could be directed toward the assumption of stable individual preferences which, as Gary Becker has emphasised, is crucial to this type of analysis. The assumption that individual preferences remain stable over choice processes implies that the identities of individuals are unaffected by their decisions. This may be a reasonable assumption to make with respect to most types of decisions, including those to engage in relatively insignificant crimes such as speeding in traffic. But it would seem that certain factors can change people's self-understanding or identities so that their *ex ante* and *ex post* evaluations of these actions can differ. In particular, the price individuals attribute to certain crimes may fall sharply after they have committed them. This is because the commission of these crimes may cause individuals to 'cross the line' which separates a criminal from a non-criminal both in their own self-understanding and in the public identification or 'labelling' of them as belonging to either class. Put technically, a person's process of identity formation may be subject to 'hysteresis' effects which cause discrete shifts in their preference functions. The authors' criticism of the juvenile justice system may thus have failed to appreciate the way recent reforms have mitigated the hysteresis effects of 'labelling' juvenile offenders as criminals. Moreover, the establishment of self-help communities of 'reformed criminals', whether inside or outside the prisons, may facilitate the process of identity adjustment required for rehabilitation which tends to be ignored by the ETOC.

The suggestion that the ETOC should be modified to take these effects into account should not, however, be allowed to diminish the significance of the book, which has directed the attention of the crime policy network in New Zealand to the importance of ensuring that the criminal justice system provides adequate deterrents against crime.

*Joe Wallis is Senior Lecturer in Economics at the University of Otago. He is the co-author (with Brian Dollery) of 'An Economic Perspective on Crime and Punishment in Modern Australia', Agenda, Volume 3, Number 2, 1996, pages 235-40.*

## Margaret Thatcher Socialist?

*Simon Jenkins, Accountable to None: The Tory Nationalization of Britain, Hamish Hamilton, London, 1995*

*Reviewed by Michael James*

COMMENTATORS of Britain's Thatcher Government of 1979-90 have often observed that it had a statist, *dirigiste* side as well as a liberalising one. Simon Jenkins's thesis is that the continuing aggrandisement of the British state is the more significant part of Margaret Thatcher's legacy, and one that the present Major Government is entrenching. *Accountable to None* seems, therefore, to be the first revisionist interpretation of Thatcherism. Its influence will be all the greater for the lively style and persuasive arguments that the author, a seasoned journalist-commentator and former editor of *The Times*, brings to the task.

It is, of course, well known that public spending generally, and welfare-state spending in particular, continued to expand under the Thatcher Government, and has risen even faster under her successor. But this is not quite what Jenkins means by the 'nationalisation' of Britain. His book is about the transfer of power within the public sector away from the professions, autonomous state-funded bodies and, above all, local government, and towards the central ministries in Whitehall. Although this process had been going on since the 1940s, it accelerated under Thatcher. As Jenkins has it, the government's failure to cut spending and genuinely 'roll back the frontiers of the state' in its first two years of office prompted it to accede to the imperialist ambitions of the Treasury, which was resolved never again to endure the humiliation of IMF intervention such as had occurred in 1976. Jenkins describes how the Treasury has ruthlessly imposed financial control over the great areas of public administration: local government, the health service, the police, schools, universities, urban renewal, housing, judicial administration, the railways and the privatised utilities. Making it all possible is Britain's constitution, whose central principle of parliamentary sovereignty has allowed the unchecked growth of the executive power.

The statist tendency of Britain's Conservative governments has so far been relatively neglected most probably because internal public-sector reform has seemed a natural adjunct to deregulation and privatisation in Thatcher's drive to revive Britain's moribund economy. It seemed the obvious treatment for those many comatose, wasteful and union-dominated 'public services' of the 1970s that could not be quickly pushed into the private sector, especially as the Treasury stood ready and eager to get its hands on them. In his chapter on the schools, Jenkins says that, in responding to

a widespread parental aversion to the educational innovations of the 1960s and 1970s . . . Thatcher could have moved in one of three ways: privatisation (through vouchers), decentralisation (through local management of

schools] and a revitalisation of local democracy) or partial or total nationalisation. The last was the least painful in the short term and most accorded with the Treasury's desire for control . . . (p. 133)

The same three choices — privatisation, decentralisation and centralisation — applied more or less to all parts of the public sector. But the overriding goal of achieving efficiency diverted attention from the very different consequences of each option. Only now are those consequences coming to be understood.

Take school reform again. After an attempt to implement a voucher system failed in the early 1980s, the Thatcher Government decided to try to raise state school standards with a compulsory National Curriculum. It even tried (but failed) to impose it on the private schools as well. But the National Curriculum has since become a political football and has been largely captured by the kind of educational philosophy that Mrs Thatcher was hoping to eradicate. As well, the Thatcher Government tried to recreate the post-war practice of educational selection by allowing schools to opt out of local government control and to come under direct Ministry of Education control. According to Jenkins, when Mrs Thatcher and her ministers did this sort of thing, they seemed genuinely to think they were engaged in 'decentralising'. But, with a selection of telling quotations from her memoirs, Jenkins shows that Mrs Thatcher has since come to realise that she was really involved in an exercise in socialism and collectivism.

Jenkins tries to be fair about the Thatcher Government's achievement. He gives it due credit for reforming Britain's tax and industrial relations systems, and for making the bureaucracy treat the public as customers rather than pests. He thinks the centralisation of the health service has improved its performance (though not because of its 'internal market'). But he argues that the centralisation of the public sector has been a failure overall, for two reasons. The minor reason is that it has not brought public spending under control, as was shown decisively when spending and borrowing reached record levels in the early 1990s. In fact, in a spectacular example of the law of unintended consequences, centralisation has caused public spending to grow, so Jenkins argues, because cabinet ministers are *less* able to resist spending pressure than the autonomous public-sector bodies that they supplanted. For example, direct control over public-sector pay backfired on the government, since 'while overspenders might be kept within bounds by the nationalisation of pay policy, possible underspenders were under intense pressure to spend up to the norm' (p. 250). And 'Ministers were . . . reluctant to be seen as mean to nurses or teachers' (p. 249).

The more important reason for failure is that the Tory 'nationalisation' of Britain has undermined important constitutional freedoms. By emasculating local government, it has deprived the people of a form of public life that, so Jenkins believes, allows them to make their own decisions about the nature and amount of public services they want. This theme touches on Jenkins's own values and reveals his reason for writing the book. He thinks that Mrs Thatcher betrayed the Tories' traditional commitment to local autonomy and political pluralism, and weakened the

checks these used to impose on central government. Of the three reforming strategies listed above, Jenkins's own preference is for decentralisation — the one in which Mrs Thatcher and Mr Major have shown the least interest, despite their rhetoric. They also seem unaware of the revival of local government in several European countries, even in France, which is often cited as an example of technocratic *dirigisme* even though that description better fits Britain nowadays. Jenkins declares his support for the gathering movement in Britain for a written constitution.

In my view, Jenkins exaggerates the virtues and capacities of local government, and so fails to learn the most pertinent lessons from his own analysis. He admits that the worst local authorities used subsidised tenants in public-housing estates as electoral fodder to generate political support for punitive rates on property-owners, from which huge empires of patronage were built; and this did much to prompt Whitehall to impose central control over local government by way of rate-capping. But his claim that 'The ceaseless exercise of political freedom is not just a right: it is an obligation on every member of any sophisticated community' (p. 266) is not only dubious in itself, but seems to legitimise precisely the capture of government by activists and vested interests that he would deplore.

The point on which both liberals and conservatives like Jenkins could readily agree is that the centralisation of government crowds out decentralised activity of all kinds. From this standpoint, 'devolution' shades into 'privatisation': it need not stop with groups, but can continue down to the individual. Parents should of course have a greater say in the management and the curriculum of state schools; equally, they should be free to opt out of them and to use or set up private alternatives to them, without financial penalty. Easy exit from the public sector at all its levels is more valuable to most people than a voice in local politics. Still, devolved government is more likely than centralised government to promote diversity, competition and efficiency within the public sector.

For Jenkins's revisionism to become the received interpretation of the Tories' reign since 1979, he would need to show that the 'nationalisation' of Britain has vitiated the Tories' efforts to liberalise its economy. That would be hard to do. Just now, Britain is doing better economically than its partners in the European Union, with lower (and falling) unemployment reflecting lower labour costs, lower tax rates and lighter regulation; and even its utilities, whose privatisation, as Jenkins shows, has been compromised all along the line by central government, are in better shape than many of their continental counterparts. Moreover, several of the European countries that Jenkins cites as having revived local government have heavier tax and debt burdens than Britain's. And yet, as the struggle to contain the growth of government seems to be failing everywhere (with the possible exception of some communist or ex-communist countries), the centralisation of Britain's public sector could well turn out to have been another of those errors whose consequences are incalculable but which cannot be reversed by normal political means.

*Michael James is editor of Agenda.*

## Defending the Traditional Family

Alan R. Barcan and Patrick O'Flaherty (eds), *Family, Education and Society: The Australian Perspective*, Academy Press, Canberra, 1995

*Reviewed by Brian Crittenden*

THIS volume is based on papers presented to a conference held in 1994, the International Year of the Family. A chapter added by Alan Barcan sketches changes in the relationship between the family and education in Australia from European settlement to the present.

Although the authors pay some attention to different interpretations of the term 'family', they use it according to its standard meaning in the Western European tradition: a distinct social group composed of father and mother (joined in the life-long commitment of marriage) and their offspring to the age of adulthood. Variations on this definition that are admitted to the discussion include: a divorced parent (whether remarried or not); parents in a *de facto* marriage relationship; single-parent (usually mother-only) family; and children adopted or born into a previous marriage. I would not quarrel with this interpretation. Yet virtually no attention is paid to important historical variations in the characteristics of the standard nuclear family, let alone differences of interpretation and practices across cultures. There is no reference to the substantial body of recent historical work on the nuclear family in Western Europe. Many of the comments seem to assume that the family (in the standard sense) has exhibited no changes over time or among social groups within a given period. (I have reviewed significant changes in the history of the Western family in Crittenden, 1988.)

Ivan Petch's keynote address criticises various attacks on the 'traditional family', in particular the effort to extend the term to homosexual couples with children through adoption or *in vitro* fertilisation. Families (traditionally understood) are viewed as the primary cells in the social body; their role in moral education is stressed. It is argued that, in view of the high rate of divorce, much more needs to be spent on educating people for marriage and parenthood.

In Chapter 1, Geoffrey Partington notes the generally high correlation between a family's socioeconomic status, the parents' level of formal education and the children's educational achievement. He claims an educational advantage for children of intact two-parent families, and attendance at schools with a broad range of common moral and religious values. He draws attention to the educational harm done by treating different levels of culture in a society simply as instruments in the struggle for power or as expressions of divergent tastes or preferences. He argues that, given the complex diversity of the values that affect the interpretation of education, parents should be free to choose among schools. To facilitate choice, poorer parents should have access to a voucher scheme, and an assessment system should provide sound information on the relative efficiency of schools.

In Chapter 2, Barbara Fraser stresses the importance of collaboration and consistency between parents and schools on discipline. She suggests that schools with an enlightened approach to discipline (involving positive incentives and consistency, and avoiding capital punishment) should actively encourage the parents of their students to adopt a similar approach.

James Cox in Chapter 3 and Alan Tapper in Chapter 4 both address the same issue of how the welfare state in Australia has affected the family. Cox points out that the share of GDP spent by governments on education, health, social security and welfare has doubled over the last 30 years. A redistribution has occurred from childless young married couples and two-parent families (who now pay more in taxes than they receive in benefits) to the childless elderly and one-parent families. At the same time, the move from private to public welfare has brought a qualitative shift from personal to largely impersonal provision. Cox argues that government welfare should be scaled down and families encouraged, through lower taxes, to take more direct responsibility.

Tapper argues similarly that government policies in recent decades have favoured one-parent families and couples who separate, while reducing assistance to two-parent families and increasing the taxes they pay. This encourages single-parent families and parental separation designed to qualify for the single-parent pension, even though the evidence suggests that, generally, the welfare of children is better served by enduring two-parent families. While acknowledging that feminism and other factors may have contributed to the decline of the family, Tapper believes that welfare policies have been the main culprit, notwithstanding the moral ideals on which they were based.

In Chapter 5, Gerard Joseph also addresses welfare policy and the family, but ranges more widely than Cox or Tapper. He draws attention to the very wide degree of public bureaucratic involvement in the family and the tendency to interpret the term 'family' so loosely as to render it almost meaningless. In the process, the spiritual and moral ideals of the traditional family have been displaced by objectives of technical efficiency. The author proposes that governments should not take over functions better performed at family level, and that, while the tax level should reflect the number of dependants supported by an income, discretionary allowances should be replaced by tax credits that are unrelated to income.

In Chapter 6, Rita Joseph defends the traditional nuclear family as morally required by the basic features of human life and the physical world. But although she writes well, she underestimates the difficulty of arguing from the characteristics of the human and physical worlds to conclusions about the moral values by which humans should live. While some answers to the question of how human beings ought to live can be rejected as clearly undesirable, there may be several different defensible answers. Given what we know from history and anthropology, the author's defence of the traditional family would be stronger if it had been based on moral ideals rather than necessary conditions of the moral order.

Joseph underestimates the complexity of several moral issues. However strong the case against abortion, the practice cannot be deemed 'unnatural' on the grounds

that it depends on scientific means. This argument would exclude transplants and other surgery designed to prolong life. Another example concerns the right to procreate, which surely must be qualified by other moral considerations, both social and personal. One need not agree with the agenda of 'perfect ecology' to recognise that changing conditions of the human and physical worlds (for example, gross overpopulation, responsibility to future generations) are relevant to morally responsible decisions on human procreation. In addition, moral duties can conflict, and in such cases more than one conclusion may be rationally defensible.

It would have been helpful if something like Chapter 7 (which Alan Barcan adds to the collection) had been available to the contributors before they prepared their conference papers. Barcan provides an interesting and succinct account of the main changes that have occurred in the relationship between the family and formal education in Australia since European settlement. He also draws attention to varying characteristics among families, both at any one time and over the course of the past two decades. The conditions in the first 30 years or so show clearly the need for some flexibility in defining the family and its related moral values. Whether or not the social changes of the late 1960s were as far-reaching as the author claims they were, they have certainly had a significant effect on the role of the family and on how the very nature of the institution is being interpreted. Barcan concludes by noting that, although the state has been dominant in formal education during Australia's history, there have been encouraging moves during the past decade to increase parental influence on schools.

It would be unfair to expect a one-day conference to address the full range of issues raised by the book's title. Having said that, I am nevertheless surprised by the narrow range of issues with which the book deals. A number of the topics not discussed are mentioned in Barcan's chapter. These include the strength of peer-group values in relation to both family and school, and the powerful influence of television and other electronic modes of communication. There is very little on parental right of choice in formal education; the involvement of parents in the work of schools; and their distinctive role in moral and civics education. There is no comment on children's rights or the legitimate scope of the state's authority over education. (I have attempted to deal with some of these topics in Crittenden, 1988.) The main strengths of the collection seems to me to lie in the critical attention drawn to recent government funding policies for families and the suggestions for reform.

## Reference

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*Brian Crittenden is a former Professor of Education at La Trobe University.*

## Largely Hayek

*Suri Ratnapala and G. A. Moens (eds), Jurisprudence of Liberty,  
Butterworths, Sydney, 1995*

*Reviewed by Charles Richardson*

THIS book promises to examine 'connections between legal theory and liberty'. The editors, both members of the School of Law at the University of Queensland, explain that 'Law has potential to both promote and destroy liberty', but 'Textbooks on jurisprudence tend to focus on the great debates surrounding the various definitions of law' (p. vii). An alternative textbook which used liberty as a theme in the analysis of law might be useful; this, however, is not it. Instead, it is a loose collection of essays whose authors are no doubt inspired by the idea of liberty but who (with rare exceptions) do not discuss it, leaving the reader to draw their implications for the issue of liberty. This makes it harder to claim that there is anything distinctive about the book; precisely because law is so important to liberty, almost any work in jurisprudence could provide similar material.

The editors address this point with a helpful introductory essay. Their discussion of liberty, however, has to stand largely on its own; there is no hiding the fact that the other contributors are mostly concerned with peripheral matters. Only three of the other 14 chapters deal directly with liberty. M. N. S. Sellers gives a historical survey of the relationship between republicanism and liberty; Ian McEwin discusses 'law and economics', concluding that its goal of economic efficiency is inadequate because it fails to appreciate the value of liberty; and Ben Brazil reviews Wesley Hohfeld's analysis of legal concepts, with particular reference to liberty, in an interesting but very technical piece which the unwary will find heavy going.

The most common topic throughout the book is Friedrich Hayek, whose work is directly addressed in five chapters, and is relevant to several others. Hayek's contributions to jurisprudence have not received much attention from legal scholars, so this aspect of the book is most welcome (although the absence of any explicit consideration of Hayek's view of liberty remains puzzling). I found the most interesting contribution to be that by Neil MacCormick, who offers some 'genuinely respectful' criticisms from a broadly social democratic point of view of Hayek's case for the 'spontaneous order' of the market. MacCormick thinks that, while Hayek uses the blindness of the market to argue against claims for 'social justice', this argument is not available to modern-day Hayekians who are consciously (not 'blindly') attempting to (re-)establish a market order. If the result of moving to a market order is known to be, for example, greater inequality of wealth, then this can no longer be passed off as an unintended consequence. This seems entirely correct. However, I suspect that Hayek's attack on social justice is more extreme than is required by the rest of his jurisprudence: his system should be able to accommodate a limited role for social justice without too much difficulty.



MacCormick also claims that it is inconsistent for Hayek, who opposes social planning, to consciously plan the restoration of the market, since such restoration is itself an example of 'constructivist rationalism'. The editors, no doubt wishing to clarify the party line, point out (p. 9) that this criticism has been anticipated by Viktor Vanberg in Chapter 3. Vanberg distinguishes between two versions of constructivism: one referring to deliberate design of a social order (the central planning that Hayek opposes), and the other to deliberate design of the rules governing the social order (which is to some extent unavoidable). This solution works, but MacCormick would say that even if conscious changes to the legal order are acceptable, their scale makes a difference. Hayekians should prefer a gradual tinkering with the system ('piecemeal engineering', in Karl Popper's term) to wholesale social engineering. Instead, it seems, they have allowed themselves to become carried away and have embarked on radical restructuring. MacCormick suggests that more regard should be paid to the immanent criticism that may be embodied in the institutions of social democracy.

This criticism seems both just and important. However, there might be an alternative explanation available for apparent zeal for utopian engineering. MacCormick seems a bit too keen to blame it all on the Hayekians; as he says: '... the Thatcher administration has been the most rigorously centralist in its policies of any British government in the post-war years, presenting the paradox of a program continually increasing the powers of central government in order finally to let them wither away' (p. 76). But what this 'paradox' neglects is that politics is essentially a bipolar game, and there are factional imperatives which cut across intellectual categories. Might it not be that the main impetus for centralism in Thatcher's Britain (and under some conservative governments in Australia) did not come from Hayekians, but that they were driven into the arms of more traditional right-wing elements with a quite different agenda? Factional loyalties may also explain features like the hostility to postmodernism expressed in Ratnapala's essay on 'Law as a Knowledge Process'. Although the substance of his remarks is compatible with much of postmodernist theory (as he later acknowledges), he seems to feel obliged to start off by attacking it; almost as if it were necessary to prove his right-wing credentials.

Also puzzling is the presence of Douglas Kmiec's chapter. Kmiec is a defender of traditional natural law theory, and here he takes on Hayek's theory of spontaneous order. But what Kmiec shows, in spite of himself, is that it is extremely dangerous to ground claims for Hayekian spontaneity in a theological doctrine. If divine planning comes through with approval, then it seems central planning might be acceptable after all. More important, though, the unsustainable foundations of natural law render the whole structure vulnerable. Ratnapala and Moens remark (p. 7) that 'The utilitarian-positivist case against natural law is that it makes the law uncertain'. This is true, but surely a more serious problem is that the metaphysics of natural law is false or incoherent, and therefore cannot safely be used to support public policy. Claims that 'We have only one end: our reunification with God' (p. 134), or that common law is 'the necessary outgrowth of a divine lawgiver' (p. 136), are today likely to be met with stares of incomprehension. The debate has moved on since the 13th century, and rightly so.

It is clear that natural law envisages a fundamentally different role for the state from that espoused by the Hayekian liberal or libertarian. Kmiec objects to the coercive powers of the state not in themselves, but only when they are exercised improperly (roughly, when they violate the principle of subsidiarity). The real problem is not coercion, but godlessness, and Kmiec would limit the state only to leave the scene free for local coercion: 'the natural obligations between parent and child, husband and wife, neighbour and neighbour and even employer and employee' (p. 132). Kmiec does make a valid point when he says that Hayek's worship of the historical common law translates into a lack of enthusiasm for guarantees such as the US Bill of Rights, which were indeed inspired by a 'natural law' tradition. But, by holding strictly to a theocratic interpretation of natural law and natural rights, Kmiec lets this insight go by; he extols the ninth amendment, which extends the Bill of Rights beyond its listed categories, but he damns its most notable result, the abortion decision of *Roe v Wade*.

The fifth author to address Hayek's work directly is Alan Fogg. I find Fogg's easy identification of legal positivism and legal realism problematic; it is unnecessary for a defence of Hayek, since Hayek was not opposed to moderate positivists like H. L. A. Hart (as Fogg concedes; p. 202, fn. 107). Nonetheless, his essay contains much useful material, despite some polemics; Voltaire, for example, is condemned for advocating 'constructivist rationalism' (p. 185). It was Voltaire, however, who said in his *Philosophical Dictionary* of 1764 that 'law should never conflict with custom; for if the custom is good the law is superfluous'. Francesco Parisi's chapter gives an excellent account of customary law, and why its recognition is vital to a market order. The relevance here to Hayek's concerns is clear, although Hayek himself is cited only briefly. This material is rewarding, although the non-specialist might find some of it hard work.

I have concentrated on the Hayek material because that seems to offer the most common ground for debate. Many of the other essays, although peripheral, are still very interesting. Gabriël Moens reviews the proceedings against former East German border guards; Alice Tay and the late Eugene Kamenka survey some recent Marxist jurisprudence; Igor Grazin, an Estonian member of parliament, offers stimulating thoughts on the fall of the Soviet empire; Geoffrey de Q. Walker has a short but invigorating piece on re-establishing the rule of law in post-socialist societies; and R. C. van Caenegem discusses legal history in Europe.

Each of these would be of interest to particular audiences (as would Brazil's chapter on Hohfeld), though as they are unlikely to buy the book for the sake of one article, it is unclear what sort of a market Butterworths is targeting. Although the book's editing fails to impose much of a common theme on the contributors, the editorial standards of their contributions are high. There is no bibliography, but bibliographic footnotes are plentiful. (A serious flaw, however, is the cursory nature of the index: even proper names cited in the text often fail to appear, while the footnotes are hardly indexed at all.) For the reader who is looking for a range of thought-provoking material, and is not afraid of being led off on tangents, this collection is worth a look.

*Charles Richardson is a consulting philosopher and freelance writer living in Umina, New South Wales.*

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## **NON-AGENDA**

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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)

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### **Saving Australia's Parrots from the Export Ban**

**Brendan Moyle**

**T**HE international market for wildlife and wildlife products is large in scope and size. One important part of this market originates in Australasia. Australian wildlife is both distinctive and highly sought after; and, as few countries have similar ecological characteristics to Australia's, foreign breeders find it difficult to rear successfully many Australian species. New Zealand is a notable exception, with several difficult Australian species being captive-bred (Antram & Salisbury, 1991).

However, Australian residents are prohibited from engaging in this trade. The export of Australian parrots is effectively banned under the Wildlife Protection (Regulation of Exports and Imports) Act 1982. The few exceptions, involving household pets and scientific exchanges, are insufficient to meet the large overseas demand (Kingwell, 1993).

The ban ensures that foreign demand for Australian parrots is high relative to the legal supply. This is reflected in the price differentials between the domestic and foreign markets (see Table 1).

The rationale for the ban includes (but is not restricted to) conservation concerns: the export of specimens from endangered species is thought to increase the risk of extinction. But not all parrots that are in high demand overseas have an endangered status. The galah, for example, which is so abundant that it is regarded as an agricultural pest in some States, typically fetches relatively high prices in Europe and North America. Indeed, the species that make up the bulk of the international

trade are not recognised as endangered (Moyle, 1995). Moreover, a large and legal domestic market exists for Australian wildlife. So if trade is supposed to be detrimental to a species' chances of survival, the ban on exports alone is likely to be ineffective.

**Table 1**

**Average prices in selected countries for four Australian species of parrot: A\$ per pair, 1993**

<i>Species</i>	<i>Australia</i>	<i>USA</i>	<i>Italy</i>	<i>Germany</i>
Red-tailed black cockatoo	4,000	—	12,550	—
Galah	50	4,450	3,000	1,500
Major Mitchell	850	11,000	7,500	
Gang Gang	1,300	18,500	5,015	28,175

Source: TRAFFIC Oceania, Sydney.

### **Why the Ban is Difficult to Enforce**

It is extremely unlikely that the illegal export of parrots can be reduced by enforcement policy alone.

The Australasian area offers some distinctive advantages for smugglers. One is the Australian domestic market, which makes procurement of stock relatively easy; in a recent case the smugglers simply obtained their stock from a number of pet shops (Ansley, 1995). A second advantage is the abundant supply of some species in the wild. A third is the ease with which birds can be exported from New Zealand. Since New Zealand shares many ecological characteristics with Australia, New Zealand breeders can easily rear Australian parrots for the North American and European markets. In fact, New Zealand aviculturists provide the majority of internationally traded specimens of certain species (see Table 2). The legitimate trade in effect conceals the illegal trade, whether the smuggled specimens are intended for New Zealand customers or for re-export to overseas markets. Indeed, conditions are so favourable that wild populations of some Australian parrots, such as crimson rosellas and sulphur-crested cockatoos, have colonised New Zealand rainforest (Antram & Salisbury, 1991).

New Zealand and the United States put little effort into detecting laundered animals, since the activity is both costly and has a very low success rate. It is very difficult to prove that a specimen has an illegal origin once it has entered the aviary system. As a result, CITES export permits of Australian parrots from New Zealand can be obtained with little scrutiny from the authorising body. Antram and Salisbury (1991) report that in many cases the exporter has merely had to sign an affidavit attesting to the 'legal' origin of the specimens. A further difficulty is that partici-

pants in the illegal wildlife trade, unlike participants in other illegal markets such as the drug trade, can easily conceal themselves among the legal participants of the trade.

**Table 2**

**Total international and New Zealand commercial exports of three species of parrot: gross numbers, 1989-94**

Year	Major Mitchell		Galah		Gang Gang	
	Total	NZ	Total	NZ	Total	NZ
1989	23	14	82	15	10	10
1990	42	14	330	198	18	10
1991	42	20	275	191	2	2
1992	51	26	166	75	1	0
1993	101	92	315	226	1	1
1994	78	53	200	107	8	3

Source: World Conservation Monitoring Centre, Cambridge.

The dispersed nature of the market makes the market very reliant on the reputation of breeders, so that breeders with reputations for honesty can use this as cover for illegal activity. Law-enforcement agencies thus cannot rely on a high rate of tip-offs from suspicious honest breeders.

Border protection is also rather imperfect in relation to wildlife smuggling. Small aircraft can be used to fly stock out of Australia. Both Australia and New Zealand have a large number of unsupervised airfields as a result of their agricultural economies, enabling smugglers to avoid scrutiny entirely. Northern Australia has approximately 3,000 airfields suitable for smuggling (Halstead, 1992). Only one intercept of a light plane has occurred in New Zealand; most intercepts are of body-packs or egg-vests on couriers.

Fines for illegal activity are typically low. In 1992 the largest fine that had been applied in Australia was \$7,200 (Halstead, 1992). In New Zealand, authorities have declined to prosecute a smuggler on at least one occasion.

### **The Costs of the Export Ban**

Australia's export ban on parrots has a number of costs. As well as the forgone opportunities for Australian breeders to derive additional revenue from higher international prices, economic costs include those associated with attempting to enforce the trade ban. Prosecution costs are typically larger than the fines exacted. As eggs are now the most popular way to transport parrots, hatching them is necessary for identification for prosecution purposes. In a recent case in Australia, this cost \$25,000 (Halstead, 1992). This was in addition to the other costs associated with prosecuting offenders.

But there are conservation costs as well. First, the ban shifts the laundering point of Australia's parrots to its neighbours. This means that Australian parrots enter, say, New Zealand without going through a quarantine process. This in turn increases the risk of parrot diseases spreading among New Zealand's native parrot species. As all New Zealand parrots and almost all New Zealand parakeets are recognised as endangered, the appearance of a new parrot disease could be catastrophic.

A second conservation cost of the ban is that it encourages excessive taking from the wild. The survival rate of smuggled wildlife is generally low (Wildlife Conservation International, 1992). Smugglers must take a large stock from the wild to ensure that enough survivors reach their destination. For rare and valued species this too has a conservation cost as populations become depleted.

### **Effects of Lifting the Ban**

One of the goals of the current trade ban is to prevent rare species being exported from Australia at an unsustainable rate. But it is not obvious that lifting the export ban would result in a greater traffic of rare species; quite possibly, fewer rare species would be exported, since legal exports may depress prices.

The problem of taking wild birds for export could be overcome by allowing only captive-bred species to be exported. In fact, reputable overseas aviaries prefer captive-bred specimens as they are more familiar with humans and are likely to be healthier than wild ones.

However, a possible problem could remain with laundered animals. Some form of legal export trade would make it worthwhile for the criminally-inclined to launder their wild stock in Australian rather than New Zealand aviaries, thus reducing the risk of an exotic disease infecting native New Zealand parrots. However, some breeders could attempt to introduce eggs collected in the wild into their aviaries, whose offspring could then be passed off as having been bred within that aviary. (This in fact is one of the rationales for the export ban.) The problem here is that it is difficult to verify the origins of parrots. Yet other consumer goods have properties that are difficult to verify, such as reliability and durability. In such cases market mechanisms, like guarantees and brand names, have evolved to assure the customer that the goods have the properties claimed by producers. Corresponding mechanisms could evolve in a wildlife market. For instance, breeders may be able to establish a reputation for dealing only in legitimate animals by inviting independent experts to inspect their facilities regularly and without warning; and export permits could be revoked if laundered stock were detected. Such detection is becoming easier with the advent of DNA technology. The use of DNA testing is a very strong deterrent, as it can detect laundering well after the event.

Laundered animals can also be detected through the breeding success rates of rare species. A breeder that is supplementing his stock with specimens collected illegally will have a higher success rate than his honest competitors. This success rate is a signal to law-enforcement agencies (and the breeder's competitors) that poaching or smuggling may have occurred.

Breeders may find it advantageous to make use of DNA technology to prove the lineage of their species. This would also reassure customers about the breeder's credentials. However, while DNA technology is making laundering more difficult, it is the most expensive available method for establishing the origin of a species; and, with low domestic prices, there is little incentive for Australian breeders to bear the costs of this procedure. This is a standard property-rights problem: low prices lower the incentive to care for and defend an interest in the property. Conversely, the higher prices that could be obtained in the international market would increase the willingness of breeders to bear the cost of DNA typing. Less reliable, but cheaper, methods of establishing secure private property rights to parrots include the use of robust leg bands or implanted microchips.

The final advantage of opening up export trade in Australian parrots is the likely supply-side response by breeders. The fact that the skills of New Zealand aviculturists have surpassed those of Australian breeders (Antram & Salisbury, 1991) suggests that the New Zealand breeders have had a greater incentive to improve those skills: they can take advantage of higher international prices. Australian breeders would face the same incentive to improve their skills if they could obtain international prices for their stock.

### **Concluding Remarks**

The trade ban nurtures and supports an illegal traffic of parrots that authorities cannot stamp out. This traffic compromises the status of parrot species in New Zealand and encourages illegal takings from the wild in Australia. A preference for the illusion of certainty offered by the legislation stifles the opportunity to develop private-sector solutions.

Deterring the illegal traffic is made difficult by the small fines imposed by Australian and New Zealand courts. However, while smuggling networks utilise couriers who have low wealth or income, it is impossible to set fines at a level that deters. As a result, the illegal market in Australian parrots cannot be suppressed by law-enforcement agencies.

The economic costs of the ban include the lost export opportunities to Australian aviculturists and the costs of law enforcement. But it is not obvious that these costs are offset by desirable conservation outcomes. As the illegal traffic cannot be prevented under the current legislative framework, the current ban on the export of parrots should be reconsidered.

Should an export trade in parrots be permitted, exporters would have sufficient incentive to take steps to prove that their stock is aviary-bred. If collecting from the wild is permitted, for instance by a ranching approach, then exporters would take steps to prove that their stock is not from threatened populations.

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