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Contents

REVIEWS

CORRESPONDENCE

NON-AGENDA

Editorial Committee

Agenda, Volume 4, Number 2, 1997, pages 135-142

Reciprocity and Protectionism in Australia's Trade Policy

David Robertson

AFTER almost a decade of steady progress with unilateral liberalisation of trade barriers, uncertainty has reappeared during the past twelve months or so about the future of Australia's trade policy.

Some decisions by the Liberal-National Coalition government elected in March 1996 have contributed to this uncertainty, which the opposition Labor Party has used as an opportunity for demanding continued protection for some Australian jobs, notwithstanding its own previous commitment to trade liberalisation and microeconomic reform. The conclusion in July 1996 of the general tariff reduction program begun in March 1991 has been followed by reviews of protection for passenger motor vehicles and components (PMV) and textiles, clothing and footwear (TCF); these are required to establish further liberalisation beyond 2000, when PMV tariffs are scheduled to fall to 15 per cent and TCF tariffs to 15–25 per cent. The reopening of the protection debate, along with vacillating comments by some ministers, has encouraged some industrialists to expect a sympathetic reception for proposals for industry support schemes.

The optimism that followed the successful conclusion of the Uruguay Round of the GATT and the establishment of the World Trade Organisation (WTO) has also receded following the WTO Ministerial Meeting in Singapore in December 1996. The information technology agreement, followed shortly afterwards by an agreement on telecommunications under the General Agreement on Trade in Services (GATS), represent significant progress outside the normal negotiating round. The Singapore meeting gave some support for a new round of trade negotiations to begin in 2000, but gave time for reflection before real preparations begin. The APEC Summit in November 1996 reiterated the Bogor Declaration of 1994 and approved individual action programs, but it did not take any new initiatives.

Given that the arguments for continuing trade liberalisation remain valid, why has the political mood changed so suddenly? Can policy stability be restored?

The Economics and Politics of Trade Policy

The history of trade policy in Australia is one of contradictions and swings in policy. Occasional periods of enlightenment are followed by conservatism and back-sliding.

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The removal of general import quotas in 1960 was followed by rising tariffs and selective quotas under trade minister Jack McEwen. The 25 per cent tariff cut in 1973 was followed by the introduction of import quotas and increased access to antidumping duties in 1974-83. Now the unilateral liberalisation originally embraced by the Hawke Labor Government in 1988 is being reconsidered.

More than two centuries after it was elaborated by David Hume and Adam Smith, the case for free trade remains a mystery to most politicians and commentators. Yet the economics of free trade is simple, 'logically true and non-trivial' (Samuelson, 1969). The benefit from trade is that it enables a country to obtain imports at a lower price (in terms of real resources) than they can be supplied domestically. The real-resource cost of exports exchanged for the imports is lower than the equivalent domestically produced substitutes. The saving of resources represents the gain from trade, since those resources are available for additional production. Restricting the free movement of international commerce reduces the gains from trade.

The economics of trade policy has become more sophisticated in the past 30 years. New concepts, such as effective rates of protection, the theory of second best and general-equilibrium analysis, have been introduced. Many of these new approaches were devised and tested by prominent Australian economists, and have become embodied in the analysis of Australian trade policy in recent years (Corden, 1971, 1997; McDougall & Snape, 1969). Recognition that the effects of a tariff (or other trade instrument) spread throughout the economy established the link between import prices and export volumes, as traded and non-traded production compete for the same stock of domestic resources. In short, import tariffs are a tax on exports (Clements & Sjaastad, 1984). Reducing import protection has the effect of increasing exports.

But although the economic case for free trade is straightforward, in that economic welfare increases in aggregate with trade liberalisation, in practice any change in trade policy will benefit some interests and harm others. Other things being equal, a tariff reduction decreases producers' incomes in import-competing industries, while raising real incomes of consumers (through lower prices) and exporters, as increased imports release resources from the contracting import-competing industries. It is therefore rational for import-competing industries to pursue higher prices and profits by persuading governments to raise tariffs or apply other trade-restricting measures.

Why do governments submit to these pressures? The problem is that the political system reacts to the 'identity bias' arising from changes in protection. Businesses and workers in a protected industry are identifiable 'losers' from trade liberalisation. Consumers and exporters, on the other hand, are dispersed, and their gains are difficult to identify. Politicians and governments react more to obvious effects than to invisible ones. Localised hardship in a community has more political impact than general, dispersed welfare gains, even though the economic value of the latter may be much larger.

The political economy of trade policy has been formalised by Baldwin (1989). Some industries apply real resources to influence trade policy decisions to earn economic rents from quasi-monopoly status. These resources are applied to the political process up to the point where marginal returns equate with marginal outlays in terms of political/economic goals, being spent on research, legal briefs, party contributions, and so forth. Bhagwati (1988) has called this 'directly unproductive profit-seeking'. These activities reduce rather than contribute to the gross national product. They offer potential returns only for the lobbyist, but represent waste in national economic terms.

One recent innovation in trade theory has caused new confusions among policy-makers. In conditions of imperfect competition in an industry, subsidies or tariff protection could improve its international competitiveness. This 'strategic' protection argument revived protectionist demands from many quarters, even though the conditions under which this sophisticated adaptation of infant-industry protection and terms-of-trade arguments for tariffs would be beneficial were strictly limited (Krugman, 1987). Such increases in protection are contrary to the rules of GATT/WTO. In general, the conditions for strategic protection apply only where economies of scale and R&D expenditure require large markets. But these seldom need to be larger than the internal markets of the United States or the European Union, and even there foreign competition tends to improve efficiency.

Unfortunately, the theory of 'strategic' protection generated arguments for 'picking winners' and 'strategic marketing' that suited political interests favouring government intervention in Australia as elsewhere. This contributed to the continuing protection of PMV in Australia and the view that a substantial domestic market is essential for exporting (supported by subsidies in the form of export facilitation schemes). It is also evident in recent calls for industry policies by the Chief Executive Officers of some Australian corporations (*The Australian*, 3 March 1997). The adoption of strategic protection by the US authorities to promote high-tech industries encouraged its use by smaller countries (Tyson, 1992).

Rising Uncertainty

The average tariff on Australia's manufactured goods is now close to that of the OECD. Even in PMV and TCF, Australian protection is probably no higher than in most OECD countries, which in these sectors commonly employ import quotas and/or voluntary export restraints. Yet Australia's effective rates of protection in these sectors are higher relative to the average manufacturing effective rate of protection than they were before 1991 (Pearce & Stoeckel, 1996). This distortion of resource allocation is holding back Australia's economic growth, both directly by discouraging new activities and indirectly by encouraging an ethos of government intervention to support industry.

The politically sensitive issue of protection was forced upon the new Coalition government partly by the need to refer PMV and TCF to the Industry Commission after the program of general tariff reductions was completed in July 1996, but also by external pressures. The Uruguay Round Agreement on Subsidies made export

facilitation measures unacceptable, and liable to attack under the WTO's dispute settlement procedures. At the same time, the Uruguay Round agreement on textiles and clothing requires import-quota arrangements to be phased out progressively by 2005. Neighbouring countries have been exerting pressure on the Australian government over its rules of origin and market access for TCF. The WTO and other international bodies such as APEC require changes to trade policies affecting TCF industries.

Yet the Coalition government has also stimulated the protectionist debate with initiatives of its own. In July 1996 it reintroduced a 3 per cent revenue tax on imports of capital goods and inputs by revoking the tariff concession scheme, which exempted from duties imports for which no domestic substitute existed. The effect of this is to raise the cost of equipment and intermediate imports to domestic producers and exporters. In February 1997, ICI ceased production of plasticisers in Australia because the combination of the 3 per cent import tax on inputs and reductions in tariffs on outputs made the process unprofitable.[1]

A further source of uncertainty has been the growing involvement in trade policy by government bodies other than the Industry Commission. In recent years the Department of Foreign Affairs and Trade (DFAT) has produced several reports on trade, of which the most recent are *Winning Markets* (1995) and *Trade Outcomes and Objectives Statement* (1997). These reports reflect the old mercantilist doctrine that holds that national economic welfare is promoted when exports are maximised and imports minimised. They focus on Australia's export performance and propose strategies for opening overseas markets to Australian exporters, but largely ignore the effects of Australia's trade policy on the domestic economy. Reciprocity in trade negotiations is granted priority over domestic reasons for industry assistance. In addition, domestic departments such as Industry, Science and Technology (DIST), Communications and the Arts, and Primary Industry and Energy usually act for their client industries and support industrial development schemes of various kinds, even though the Uruguay Round agreements contain many provisions that circumscribe national governments' freedom to support industries and make member governments subject to correction through the WTO's dispute settlement mechanism.[2]

To differentiate its trade strategy from its predecessor, the Coalition government has endorsed bilateral negotiations and reciprocity, and has made some

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[1] A zero tariff on final output combined with a 3 per cent tariff on imported inputs results in a negative effective rate of protection on the processing, which encourages imports of the final product. See *The Australian*, 28 February 1997.

[2] With so many organisations involved, contradictory proposals are often presented to Cabinet. In the recent Howe Leather case, the US authorities threatened to take Australia to the WTO Dispute Settlement Body because export facilitation payments contravened the Uruguay Round Agreement on Subsidies. When Cabinet considered this problem, conflicting recommendations were presented by DIST and DFAT. Ultimately the government decision to discontinue export facilitation acknowledged the commitments made in the Uruguay Round.

claims of success in the 1997 DFAT report *Trade Outcomes and Objectives Statement.* Yet Australia's scope for exerting bilateral leverage is limited by its size (it accounts for only around 1 per cent of world exports). The strategy will encourage Australian firms to seek government assistance. Emphasis on reciprocity in international negotiations, shoring up as it does the notion that protection from foreign competitors provides a lever for opening other countries' markets, devalues the argument for liberal trade, as well as upsetting trading partners accused of 'free riding' for offering small tariff reductions in negotiations. It brings into question the seriousness of Australia's commitment to the APEC goal of free trade and investment flows for developed-country members by 2010.

Another serious effect of the government's stance on industry protection has been to encourage the opposition Labor Party to follow suit. The recent statement on PMV tariffs by the Labor leader, Kim Beazley, represents a complete reversal of his party's position in government, when it promoted trade liberalisation (with support from the Coalition parties): ' ... we say to the rest of the world that we will look for downward movement in their protection levels before we move further' (*The Australian,* 11 March 1997). Other front-bench Opposition spokespersons have followed this lead, even though it has been rejected by former Labor leader Gough Whitlam, who as Prime Minister implemented the 25 per cent tariff cut in 1973. According to Mr Whitlam, 'There is nothing in the traditions of the modern Labor Party which endorses industry protection ... Protection has always protected profits, not jobs' (*The Australian,* 14 March 1997).

Reciprocity

The principle of 'reciprocity' that lies at the heart of Australia's present trade policy regime is a mercantilist notion with a long history in international trade relations. Reciprocity requires that one country's tariff liberalisation should be balanced by equivalent reductions by another country to give 'balanced' bilateral trade. In reality, a multilateral trading system, offering overall balanced trade, is much more efficient. Hence the goal of multilateral trade and payments for the post-World War II Bretton Woods system. Unfortunately, reciprocity survived in the GATT because each liberalising step required broad reciprocity. In times of fixed exchange rates and limited currency reserves, shifts in trade balances were a major concern. In practice, negotiators sought to balance concessions made, not to achieve full equality of market access.

The survival of reciprocity in the GATT processes has encouraged the US to advocate a new form of reciprocal trade balancing. This requires equal market shares in broad industry categories, as well as overall balance in bilateral trade (which is usually defined as merchandise trade without any reference to trade in services or investment flows and income). This so-called 'full' reciprocity is the foundation for the 'managed trade' doctrine.

Reciprocity has now been accepted by Australian politicians, without question and with little understanding. No attention is given to trade statistics or tariff effects. It is buttressed by the argument that trade liberalisation in the past decade has

caused rising unemployment. But how would it be applied when Australia has a large trade deficit with the United States but substantial trade surpluses with Japan and Korea? This trade pattern reflects broad measures of comparative advantage. Australia's resource-based exports go to Japan and Korea, while they and the US all supply manufactured goods to Australia. (As it happens, Australia's large trade deficit with the US is almost balanced by its trade surpluses with Japan and Korea. If trade in services is included, the gap disappears.)

Mercantilism is evident in the tendency to identify export performance in specific markets as an indicator of diplomatic effort. DFAT's 1997 *Trade Outcomes and Objectives Statement* (like the earlier *Winning Markets*) emphasises access to overseas markets as a target for foreign economic policy. But this focuses on only a fraction of the trade policy program, and ignores the benefits to exports that arise from domestic trade liberalisation. As well, the benefits from increased exports depend on domestic resource allocation. And the use of exports as an indicator of performance in foreign economic policy provokes domestic producers to seek government assistance to raise profits and income. But all such assistance is costly, whether it takes the form of export promotion or import protection.

Multilateral liberalisation enables Australia to exert its influence through associations, such as the Cairns Group. Moreover, multilateral agreements, like the WTO, underpin trade liberalisation and minimise back-sliding, which bilateral approaches can seldom prevent. Promoting reciprocity offers little reward for a medium-size mixed economy. Only large economies like the US stand to gain from bilateral trade threats.

Trade and Domestic Policies

New WTO disciplines add another dimension for trade policy. The scope of trade policy was expanded by the Uruguay Round agreements, and further disciplines are evident in the new WTO agenda that came out of the December 1996 meeting in Singapore. These new rules (some of which are still embodied only in framework agreements) affect investment, industrial subsidies and standards, trade in services, quarantine standards, intellectual property, and so forth, and restrict governments' freedom to assist their national industries. This imposes a limit on interventionist policies that goes far beyond traditional trade policy measures. With the backing of the WTO dispute-settlement procedures, the freedom of governments in domestic policies is being constrained in ways that are only now becoming apparent. These new constraints are recognised in DFAT's 1997 *Trade Outcomes and Objectives Statement*.

The Australian Antidumping Authority is under review. One of the failures of the Uruguay Round was the lack of real amendments made to the GATT antidumping provisions. 'Unfair trade' provisions in the GATT remain an open invitation to use new duties against competitive imports which can be 'made to measure' to block foreign competition. The principal traditional users of antidumping measures were the US, Canada, the EU and Australia. Now antidumping legislation is being employed in many middle-income countries too. Because the GATT rules

are unclear, antidumping is effectively an invitation to protect. With Australia adopting low tariffs (with a few exceptions), the antidumping rules should be tightened to take account of consumer interests and user-industry concerns. At present, only producers' interests are assessed in antidumping cases, in Australia as elsewhere.[3] In economic terms, 'dumping' is a dubious concept. To allow easy access to this anti-competitive measure in the reformulation of the Antidumping Authority would send another protectionist message to the Australian community.

Concluding Comments

Australia and New Zealand are not the only high-tariff countries that adopted unilateral trade liberalisation in conjunction with domestic economic reforms in the 1980s. The revival of market economics in the US and Britain at the turn of the 1980s influenced the economic reform programs adopted by highly indebted middle-income countries in Latin America. Following the East Asian model of export-led development, these countries chose economic reform and trade liberalisation as the way to correct domestic imbalances (guided by the IMF and Western banks). Deregulation became the accepted economic model.

In Australia, deregulation of the financial sector at the end of 1983 broke the stranglehold of regulation and opened other economic sectors to liberalisation, including trade policy. The Hawke Government accepted the idea that unilateral liberalisation brought major benefits to an economy, whereas reciprocity was a slow process bringing uncertain returns. It was presented strongly to the Australian public as the only way to prevent the country becoming a 'banana republic'.

Against this trend, the Coalition government has been sending mixed messages to Australian industry and foreign suppliers about its trade policy intentions. The uncertainty has weakened the community's will to accept economic reform — ironically, at a time when the international economic system has advanced in openness and disciplines.

Industry leaders have revived calls for a comprehensive and cohesive industry policy, and the Labor Party has followed their lead. They argue from casual observation that Asian economies like Malaysia and Taiwan use industrial strategies, ostensibly to good effect. But, however industrial policy is packaged, it represents a transfer of income from consumers and taxpayers to the favoured industries. Once begun, the capacity of the government to refuse similar requests from other industries becomes difficult, causing the expense of industrial supports to increase and their effectiveness to decline.

The economic theory of trade establishes that trade liberalisation raises national output and welfare. True, the gains for the liberalising country will be greater if other countries liberalise at the same time; but there are gains regardless of whether other countries reciprocate. The difficult question that receives little attention in the present debate is how the domestic losers (such as PMV production workers) should be compensated by the gainers (PMV purchasers) as tariffs are dismantled.

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[3] This is also true of quarantine: see the Nairn Report (1996).

Labour markets do not clear efficiently in all regions of Australia; labour market failure deserves more attention in the trade debate.

The attitude adopted towards the inquiries into PMV and TCF will set the tone on trade and industry policies beyond 2000. After a decade of trade liberalisation and economic reform that has helped to reshape the Australian economy, the stance adopted towards trade policy during the next decade will be crucial to cementing that progress. Participation in another WTO round of negotiations and in APEC liberalisation depends on reform and adjustment in the domestic economy, including adjustment to continuing trade liberalisation.

The forthcoming White Paper on Foreign and Trade Policy provides the Commonwealth government with an opportunity to remove much of the recently created uncertainty. The seeds of doubt sown in the community by vacillating and avoiding a clear commitment to continuing liberalisation must be removed. The necessary political commitment to market forces is evident in current macro- and microeconomic policies. What is now needed for continuing microeconomic reform is the reassurance that demands for any continuation of protectionist policies will not be heeded.

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Agenda, Volume 4, Number 2, 1997, pages 143-154

Promoting Efficiency and Contestability in Australia's Ports

Keith Trace

HISTORICALLY, Australia's ports have been notoriously inefficient, forming the weakest link in the supply chain between Australia and its overseas markets. Despite numerous attempts at reform, productivity in container and breakbulk facilities remains low by international standards (Trace, 1991:15). In part, the inefficiency has arisen because Australian ports have been havens of monopolistic practices. Given the geography of the Australian continent, each of the capital-city ports has enjoyed a natural monopoly over an extensive area of hinterland; competition between ports has been limited to areas such as the Riverina and Northern New South Wales. Natural monopoly was reinforced by State ownership of port facilities and the non-competitive practices of State rail systems. Furthermore, cargo handling services have been provided by a single firm or by a duopoly in most ports, while towage and pilotage services have been in the hands of single providers.

The Waterside Workers' Federation (WWF) fought for, and subsequently successfully defended, its monopoly over the provision of waterside labour throughout Australia. Before 1989, waterside workers were employed on an industry rather than a company basis, and the waterfront had a long tradition of trade-union militancy. Unreliability and low productivity, especially in container terminals and the handling of breakbulk cargo, detracted from the competitiveness of Australian producers. Since the cost of disruption was high for exporters and shipping companies alike, employers tended to give in to union demands, passing on the additional cost more or less automatically through higher stevedoring charges and freight rates.

Australia's bulk ports, in contrast, are relatively efficient. Whereas container and breakbulk facilities are controlled by a few service providers but used by many shippers, bulk handling facilities are controlled by a few service providers and typically used by a few large shippers. The relatively small numbers of bulk shippers are able to exert significant countervailing power. In other cases, bulk handling facilities are simply one stage in a vertically integrated production process, in which the vertically integrated company has an incentive to minimise cargo handling costs and the ability to control its costs.

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Stevedoring Industry Reform Since 1986

The costs of waterfront inefficiency have been recognised for many years, numerous commissions and inquiries having investigated the causes of low productivity. The most recent began in December 1986, when the Hawke Government asked the Inter-State Commission (ISC) to formulate an integrated industry plan for waterfront reform. The ISC's (1988) report stressed the urgency of reform, arguing that the industry suffered from abuse of monopoly power, introspective industrial attitudes, ineffective management, and poor workforce training schemes. The ISC recommended replacing the traditional industry-based labour pool with company-based employment, as well as reducing and rejuvenating the workforce by means of a special retirement and redundancy package, partially funded by government. The report recommended further that government should grant port authorities substantial autonomy, while retaining ministerial control over major investment decisions, pricing guidelines and rates of return; and it envisaged the Trade Practices Commission (now the Australian Competition and Consumer Commission) monitoring industry performance. The Hawke Government accepted the broad thrust of the proposals, and created the Waterfront Industry Reform Authority (WIRA) to implement its reform program. Beginning in 1989, the reform program was wound up in 1992.

The immediate outcomes of the stevedoring industry reform program appear limited, especially when compared with the outcomes of equivalent reform overseas. On the positive side, there was a sharp reduction in the stevedoring labour force, from 8,872 in September 1989 to 5,081 in June 1992, with a high proportion of eligible workers accepting redundancy packages. The waterfront also shifted from industry to company employment, although the negotiation of enterprise agreements proved difficult. The reform process was accompanied by significant productivity gains. Between 1989 and 1992, the number of containers handled per manshift increased by 88 per cent, and vessel turnaround time was reduced by 39 per cent (Prices Surveillance Authority, 1992:2). These productivity gains translated into a fall in the real cost of stevedoring: the Pricing Surveillance Authority's estimates suggested that the average cost of handling a 20-foot container fell from $254 in 1990 to $190 in 1992. This price fall appears to be a result of the cost savings brought about by the reform program, but it may also reflect a fall in the volume of cargo handled by Australian ports as a result of recession. Stevedoring companies appear to have reacted to falling cargo volumes by 'sharpening their pencils'.

The WIRA reform program lost momentum in 1993-94, as the Keating Government seemed to lose interest in the waterfront. More disturbingly, Australian waterfront productivity declined in 1993 and 1994. A productivity league table, published by the container owner Contship for more than 40 ports worldwide, suggests that container handling rates in Melbourne fell from 26.7 teu/hr[1] to 18.8 teu/hr in 1993, with the result that the port slipped from 20th to 34th position in the

[1] Teu: 20-foot equivalent unit. The standard shipping container measures 20 feet by eight feet by eight feet

league table, while Sydney's handling rate fell from 19.9 teu/hr to 13.8 teu/hr (*Australian Financial Review*, 20 September 1994). In short, while port productivity improved during the WIRA period, there was a marked decline in productivity during 1993 and 1994.

Although container terminal performance in Australia improved in 1996, productivity is not significantly higher now than it was at the end of the WIRA process in 1992. In mid-1996, the crane rate,[2] the most commonly used measure of productivity in container handling, averaged 20.3 teu/hr in mainland capital city ports, compared with 20.1 teu/hr in late 1992 (BTCE, 1996:2-5). However, crane productivity (the average number of containers moved per crane per working hour, not allowing for interruptions to the flow of work) averaged only 13.7 containers per hour during 1995. Yet productivity in overseas ports continues to improve: cargo handling rates in European, North American and Asian ports are generally higher, often significantly higher, than those attained in Australian ports (BIE, 1995:65ff). Thus, crane productivity rates at European ports visited by vessels operating direct Australia-Europe services averaged 20.0 containers per hour, or 46 per cent above the average for Australian ports (13.7).[3]

Crane intensity (the average number of cranes used to work a ship) is generally lower in Australian than in major European, North American and Asian ports. Estimates for the Australia-Europe trade suggest that crane intensities, 1.7 in Sydney and 1.4 in Melbourne, compare unfavourably with 2.4 in Felixstowe and 2.0 in Rotterdam. Higher crane intensities in Europe and Asia are associated with larger numbers of containers exchanged at individual ports, and higher ship working rates. In general, Australian container terminals have fewer container cranes than major Northern Hemisphere ports, a consequence of the thinner trade flow. Poor crane rates and lower crane intensity mean that it generally takes 50 to 100 per cent longer to unload and load a container ship in Australia than it does in a comparable overseas port (BIE, 1995:xvi).

In contrast to New Zealand, where core reforms took place within a year, the Australian reform process has not only been protracted but remains incomplete. The ISC began investigations in 1986. Its report, calling for urgent reform, was released in 1989. A decade after it was launched, the reform process is unfinished, waterfront productivity remains relatively low and many problems remain to be resolved.

Port Reform in New Zealand

As suggested above, the Australian experience of reform contrasts markedly with that of New Zealand, where an historically inefficient port sector was shaken out of its lethargy by a reformist government. Before 1987, New Zealand's ports were

[2] Crane rate: the number of teus or containers moved per crane per net hour worked. Net hours worked allows for time during which work was not possible.

[3] Crane productivity at Zeebrugge (26.2 containers per hour) and Tilbury (23.5 containers per hour) was well above the highest figure for an Australian port, 14.9 containers per hour in Melbourne.

administered by Harbour Boards under the aegis of the New Zealand Ports Authority. Most Boards were inefficient and uncommercial in approach, while competition between ports was discouraged. Wharf labour, employed on an industry basis with stevedoring companies bidding for the workers they required for a particular job, was administered by the Waterfront Industry Commission,

The Port Companies Act 1988 abolished the New Zealand Ports Authority and handed over control of ports to local government. Harbour Boards were replaced by port companies, which were required to operate on a commercial basis and pay dividends to Regional Councils. Inter-port competition was encouraged. Up to 49 per cent of shares in port companies could be held by the private sector (New Zealand Business Roundtable, 1989:4). While subsequent legislation permitted 100 per cent private ownership, the majority of port companies remain in the hands of regional councils.

Recognising that labour market reform was essential to raise waterfront productivity, the government introduced the Waterfront Industry Reform Act 1989, winding up the Waterfront Industry Commission, and replacing the labour pool system with an enterprise employment system (James, 1996:11). Under the Employment Contracts Act 1991, employers and employees must enter into employment contracts, which may be collective or individual, and unions no longer have exclusive rights to represent employees. Under this legislation, port companies have sought customised agreements that reflect their unique operational requirements. Most employers have sought and gained contracts containing some or all of the following conditions: flexible working hours; ordinary pay for the first 40 hours in any seven days; time off in lieu of overtime payments; unlimited use of casual labour; the right to use labour outside the confines of the wharf; and employment contracts of between two and three years' duration (Page, 1993:2-4).

The outcomes of the New Zealand waterfront reform program have been impressive. Substantial gains were achieved within a year and benefits have continued to flow. Port companies have become efficient and profitable operations. Competition between ports has increased (Auckland and Tauranga now compete for containerised cargo), forcing management to improve performance or face losses of throughput and revenue. Productivity has risen sharply. For example, the forestry industry has benefited from a sharp fall in stevedoring costs, and log carriers now load within two to three days compared with six to seven days previously. Similarly, New Zealand Associated Smelters has experienced significant decreases in stevedoring costs. Port charges have fallen. Employment has fallen significantly: before October 1989 New Zealand had over 3,100 waterside workers, but only 1,300 several months later.

Port Reform in the United Kingdom

In the UK, as in New Zealand, port reform has included both changes in ownership and labour market deregulation. In its 1989 white paper *Employment in the Ports: The Dock Labour Scheme*, the government argued that British ports would face intense competition from European ports in the 1990s as a result of the Single

European Market and the opening of the Channel Tunnel, and suggested that the abolition of the National Dock Labour Scheme (NDLS) would create a level playing field, enabling Britain's ports to compete more effectively (Turnbull & Weston, 1993:109). The subsequent repeal of the Dockworkers (Regulation of Employment) Act 1946 and the abolition of the NDLS removed restrictive and archaic employment regulations, creating an environment favourable to the introduction of a range of flexible employment practices.

The Ports Act 1991 may be regarded as enabling legislation, providing for the transfer of statutory port undertakings (trust ports) to companies limited by shares and registered under the Companies Act 1985. The Act provided a further stimulus to the UK port privatisation program, which had begun with the creation of Associated British Ports (ABP) in 1983. By 1994, over 60 per cent of the tonnage handled by 'commercially-significant' ports was performed by privately owned ports.

The restructuring of UK ports has involved:

- *decentralisation*: operations have been broken up into smaller (strategic business) units. For example, port operations at Tilbury are sub-divided into six separate profit centres, with their own dedicated labour and management teams; and

- *detachment*: typically, port authorities no longer own or operate stevedoring services, although they may retain some control through market or contractual relationships.

As Turnbull and Weston (1993:111) note, port authorities still control cargo movements through UK ports, but they do so through new contractual relationships or operational structures whereby cargo handling is now undertaken predominantly by small stevedoring firms.

The privatisation program has enhanced inter-port competition, as well as enabling port owners such as ABP to expand through the acquisition of a 49 per cent stake in Tilbury Container Services and the purchase of small ports such as Colchester and Teignmouth, and to diversify into non-port activities. The short-term effect of the abolition of the NDLS has been to fuel competition within the industry. As in New Zealand, privatisation has also led to changes in the conditions of employment, including the introduction of individual contracts.

Benefits in terms of port efficiency and improved productivity have as yet to be fully documented. Anecdotal evidence suggests that the port reform program has been successful. In the Port of Tilbury, 950 workers handled 6.8 million tons of cargo in 1991, whereas a year earlier 1,800 workers handled 5.8 million tons. In other words, the port improved its throughput by 17 per cent with its workforce cut in half (Thomas, 1994:145). Most of the major ports in the UK claim significant improvements in productivity, mainly resulting from new working arrangements which offer greater labour flexibility, reduced staffing levels, and increased responsiveness to customer needs.

The Continuing Presence of Monopoly Power

As noted above, most activities within Australian ports are highly concentrated, reflecting relatively thin trade flows and high costs of entry. Australian shippers typically face a chain of service providers, each of which has substantial market power. In Melbourne, for example, towage and pilotage services are provided by a single private-sector operator, although container terminal operations are currently offered by two suppliers.[4] Moreover, since there is limited competition between ports, in part because of the high cost of land transport within Australia, shippers find it difficult to exert leverage on monopoly providers of port services.

Increased competition between ports would clearly help limit such market power. The potential market power of a port authority, and of the suppliers of services within ports, is constrained where shippers have alternative gateways for their cargoes. Although competition between Australian ports will always be limited by geography, lower-cost road, rail and coastal shipping services would enable users to switch cargo between ports more readily than at present. The removal of constraints on road-rail competition, the adoption of benchmarking aimed at enhancing efficiency in the provision of road, rail and coastal shipping services, the abandonment of cabotage and the opening of coastal trades to competition from foreign-flag shipping would expand the options available to shippers and enhance contestability. The current pricing structure for container and breakbulk shipping also discourages inter-port competition. Stevedoring charges, hidden within the total transport charge, lack transparency. Under the pan-Australia freight-rate regime, the rates to any given overseas destination are the same from all Australian ports, irrespective of differences in the relative efficiency and the costs of using the different ports.

Historically, the most significant monopoly has been that possessed by the WWF, now the Maritime Union of Australia (MUA). Waterfront unions, emboldened by their influence within the Australian Council of Trade Unions and the Australian Labor Party, have demonstrated their willingness and ability to wield monopoly power. Experience on the waterfront suggests that labour market reform is a necessary condition for improved port performance. New Zealand's experience also reinforces the importance of labour market reform. The Howard Government's Workplace Relations Act 1996 contains measures aimed at curbing union power, including the reinstatement of secondary boycott provisions based on Sections 45D and 45E of the Trade Practices Act. More generally, the legislation opens the way for existing employers to create a more competitive environment. The opening up of the labour market will also make it easier for new stevedores to enter the industry, perhaps bringing with them new attitudes and new ways of approaching old problems. One 'new kid on the block', Keon Stevedoring, has achieved record rates of timber loading in Brisbane, while Western Stevedores and Strangs provide competition in Fremantle and Melbourne.

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[4] Melbourne Port Corporation announced in early 1997 that it had selected Hong Kong-based Orient Overseas Container Line to be the sole re-developer of Appleton Dock, thereby introducing a third container terminal operator (*Daily Commercial News*, 3 February 1997).

The sequencing of port reforms has differed between Australia and New Zealand. Whereas New Zealand corporatised its ports and encouraged inter-port competition before undertaking labour market reform, Australia has undertaken labour market reform prior to undertaking reforms designed to enhance contestability and competition within ports. The danger inherent in the Australian approach is that, in the absence of vigorous competition or credible threat of entry, the benefits of labour market reform may flow to stevedoring companies and the MUA rather than to the consumers of port and shipping services. The sequencing of reforms may matter.

While labour market reform is a necessary condition for improved port performance, changes in ownership and incentive structures, designed to enhance contestability, appear vital. Unlike reform of the labour market, which is primarily a Commonwealth responsibility, changes in port ownership and contestability rest primarily with State governments and port authorities.

Creating a More Contestable Environment

The Victorian government's 'guiding principles' for reform of the port sector (Office of State Owned Enterprises, 1995:4) provide a convenient framework for discussing ownership and contestability:

- an environment should be created which encourages competition and the provision of services by the most effective provider;
- asset ownership should rest with the party able to make the best use of the asset;
- the private sector should have the predominant role in commercial service provision and port investment;
- non-commercial activities should be separated from commercial activities;
- monopolistic activities should be separated from competitive (or potentially competitive) activities wherever practicable; and
- consumer interest should be protected where market power is concentrated.

While Australian port authorities have adopted, in varying degrees, commercialisation and corporatisation, most remain subject to a range of operational and financial constraints imposed by State governments. Such constraints may include, *inter alia* : controls on port charges; ministerial direction, which may conflict with commercial decision making; obligation to undertake community services without compensation from government; limitations on borrowings; and public service conditions of employment. Such controls inhibit decision making, rendering it difficult for ports to operate in a commercial manner. Effective port reform requires

that corporatisation and/or privatisation be undertaken further and more systematically.

The port reform program in Victoria, which builds on earlier corporatisation, provides one possible model for the future Australian-wide reform. A new statutory authority will act as 'landlord' in the Port of Melbourne, with responsibility for planning land use and berth development. While responsible for maintenance and planning, as well as the operation of common-user facilities, the port authority will not itself invest in new facilities. Onshore port assets at Geelong, Portland and Hastings will be sold, while underwater assets at Portland and Hastings are to be retained in public ownership and leased to the respective port owners. A new statutory authority (ChannelCorp) will be responsible for harbour control, the dredging of navigation channels and the provision of navigation aids. Non-core assets will be divested. The Victorian government has announced that it will encourage contestability in the provision of port services and establish an economic regulatory regime as soon as practicable.

Arguably, the board of a corporatised port itself has a real opportunity to enhance the level of competition and contestability. In the case of those functions historically performed by port authorities, typically dredging, maintenance, and ancillary services, boards should consider the relative merits of providing them inhouse as opposed to contracting them out. Such services could (and arguably should) be provided through a contestable market. The adoption of such a policy might require the establishment of a division or subsidiary company of the port corporation. This body would be required to: provide a defined range of services, creating a contestable market for each service; define a set of rules for tendering; and monitor the performance of successful tenderers.

Boards may also enhance the level of contestability in areas historically performed by the private sector (container terminal operations, towage and pilotage services). Greater contestability may be expected to lead to greater efficiency. In turn, greater efficiency will enable the port to expand its hinterland, increasing throughput and spreading fixed costs over a greater volume of cargo. A port's ability to enhance the contestability of container terminals is limited by the economics of terminal operation. Container terminal operations are characterised by relatively high capital investment (some unrecoverable on leaving the industry), economies of scale, and difficulties in obtaining suitable sites for new terminal development. Under such circumstances, contestability may best be promoted through the terms and conditions of the leases which the terminals obtain from the port landlord. Do existing leases promote efficiency and contestability? Do they provide for the monitoring of terminal performance? What sanctions exist if terminal performance is unsatisfactory? In practice, improvements in the terms and conditions of leases may have to be negotiated when those leases come up for renewal. Meanwhile, the existence of greenfield sites suitable for container terminal development may enhance contestability through the possibility of new terminal operators being introduced.

Port corporations may also be able to promote a more contestable market in towage. The towage industry, which is concentrated at the national level, is characterised by significant barriers to entry and cooperative arrangements between the major operators (BTCE, 1989). Most capital city ports are served by a single operator, frequently a joint venture between the industry's two major players, Adsteam and Howard Smith. Following the takeover of J. Fenwick, Waratah Towage, jointly owned by Adsteam and Howard Smith, is the only tug operator in Sydney. Brisbane's towage services are provided by a single, privately owned firm, Queensland Tug & Salvage Pty Ltd, which operates four tugs. The BTCE (1989) notes that Queensland Tug & Salvage's net earnings were the highest of any Australian towage company during 1981/82–1986/7. The company may have been super-efficient, but the more likely explanation is that it was able to exploit its monopoly power.

The ability of a port authority to create a more contestable environment within the towage industry depends on the powers it possesses to impose economic regulation on towage operators. If a port corporation has the power to call for tenders for the provision of towage services, the remedy may lie in the development of an efficient tendering process designed to encourage contestability and economic efficiency. If a corporation does not have the power to call for tenders, it may be necessary to persuade government to regulate the towage industry.

Similarly, a port may be in a position to influence contestability in pilotage. Pilotage is normally provided privately, usually by associations. The issues raised when considering the contestability of the market for pilotage are similar to those raised for towage, except in so far as the provision of pilotage services is less capital-intensive and more labour-intensive. Boards should ascertain whether pilotage charges are 'excessive' and/or whether pilots are imposing 'unreasonable' terms and conditions on users. Pilotage may be under the control of the port authority or the State government. Contestability may be enhanced through an efficient tendering process.

We have noted that the transport chain through the ports is characterised by low levels of competition, many links in this chain (towage, pilotage, container terminal services) being controlled by monopolies or duopolies. Moreover, under Australian conditions importers and exporters usually have to use their nearest port. Under such conditions, notwithstanding our argument that governments and port authorities may be able to enhance contestability, an economic regulatory regime such as that proposed in Victoria is required to ensure that opportunities to capture excess profits at the expense of port users are not exploited.

The Victorian proposal gives the Victorian Office of the Regulator General responsibility for the economic regulation of the State's ports. Where the Regulator General is satisfied that effective competition exists, the office's role will be limited to periodic monitoring. However, where the Regulator General is not satisfied that competition is effective, the office's powers will extend to: the determination of maximum prices; investigation of price-related complaints; facilitating access to essential port facilities; and dealing with complaints concerning the abuse of market power. Under the Victorian proposal, the Regulator General will ensure shipown-

ers and shippers access to monopoly and market-dominant assets and facilities, to guard against abuse of market power. The government notes that, while the access regime will protect the legitimate interests of owners of port facilities, such owners will be required to treat customers in a non-discriminatory way. For example, it will be illegal for the owner of a facility to charge vessels under its control a lower rate than it charges vessels owned by competitors or to give its vessels priority over competing vessels (Office of State Owned Enterprises, 1995:9).

Privatisation

While thoroughgoing corporatisation offers benefits, further privatisation of ports and/or privatisation of specific cargo handling facilities within corporatised ports creates the possibility of substantial productivity gains. Australia's privately owned coal and iron ore ports and/or loading facilities operate at or close to world best practice.

The benefits of privatisation are evident at the Port Kembla coal terminal. Before 1991, under the ownership of the New South Wales government, the Port Kembla coal terminal was inefficient, overstaffed and subject to frequent industrial disputes. Coal producers shipping through the terminal were disadvantaged by high handling charges and low productivity, giving rise to substantial demurrage (ship waiting time) charges. In 1991 the coal shipping subsidiaries of BHP, CRA, Austen & Butta, Clutha, Denehurst and Oakbridge formed Port Kembla Coal Terminal Limited (PKCT). PKCT negotiated a 20-year lease on the terminal, with the option of a further 20 years, for a payment determined initially by the volume of coal shipped. The lease payments were designed to cover, over the 20-year period, the terminal's book value ($192m), interest payments on that money, as well as a 'bonus' payment to the Maritime Services Board (MSB) of $117m.

By 1993 the benefits of privatisation were clear. The tonnage of coal handled by the terminal rose from the 10m tonnes achieved by the MSB in the last year of public ownership to 15.6m tonnes in 1991/92 and over 16m tonnes in 1992/93. The terminal's productivity improved, allowing PKCT to cut its handling charges from $5.58 a tonne to $4.27. Vessel turnaround times improved and fewer ships incurred demurrage charges (*Daily Commercial News*, 21 January 1993).

Conclusion

Australia has yet to introduce thoroughgoing waterfront reform. While the early outcomes of the stevedoring industry reform program of 1989-92 were encouraging, momentum was lost in 1993 and 1994 and present productivity levels are little, if any, better than those achieved in 1992. Meanwhile, productivity in overseas ports has continued to improve, with the result that many ports in competitor countries achieve crane rates that are 25 to 50 per cent higher than those in Australian ports (BIE, 1995:73).

The consequences of waterfront inefficiency flow through the Australian economy. As the Bureau of Industry Economics (1995:34) notes, 'Australian exporters

cannot demand a premium for their products simply because they use low volume Australian ports whereas their rivals may use a high volume, and potentially lower cost, port such as Rotterdam or Singapore'.

With reform of the labour market and institutional change aimed at enhancing contestability, Australia could realistically aim to raise its port productivity to levels achieved by the reformed New Zealand ports. It would be unrealistic to expect such reform to lift productivity to the world's best levels, such as Singapore achieves in its cargo handling. In part, this is the result of Australia's thin traffic flow: the limited container flows to and from Australia cannot sustain a high level of port investment. As a result, the average crane intensity per ship is much lower in Australia than in major hub ports, resulting in slower vessel turnaround.

However, thoroughgoing labour and product market reform should enable Australia to lift productivity to levels achieved by the best comparably sized overseas ports. This would imply raising crane rates from the 16-17 lifts per hour currently achieved in Sydney to the 30 lifts per hour achieved by ports such as Laem Chebang (Thailand) and Oakland (US). The first Australian port to improve its productivity significantly will gain a considerable competitive advantage, extending its hinterland at the expense of its competitors.

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Agenda, Volume 4, Number 2, 1997, pages 155-164

Privatisation and the Government Cost of Capital

Neville Hathaway

If the cost of capital is lower for government for than for the private sector, then instead of privatising their assets governments should buy all the shares listed on the public stock exchanges. They should also undertake to invest in many of the risky new ventures that the private sector considers too marginal for investment.

If the government cost of capital were the government bond rate, then government ownership would raise the aggregate market value of all the listed stocks on the Australian Stock Exchange from the current figure of about $400 billion to about $800 billion. The private sector requires about 14 per cent a year for equity investments but the government ten-year bond rate is only about 7.5 per cent a year. If we ignore, for the moment, the question of company tax payments, the same cash flow under government ownership as under private ownership would be discounted at 7.5 per cent a year rather than the private sector's 14 per cent, thus approximately doubling the value of all equities. We would be better off if we bought government debt and governments, in turn, invested in equities (indeed, *all* assets) on our behalf.

If the government cost of capital were lower than the private sector cost, then government could accept investment proposals that the private sector rejected as uneconomic because they have a negative net present value (NPV): that is, the present value of future benefits arising from an investment proposal is less than the capital investment. An investment with an NPV that was negative for the private sector could very well become positive under government ownership. Projects that the private sector rejected as too risky could be pursued by the government on behalf of the public. If the government cost of capital was just the government bond rate, then the cost of capital for any government project would be *independent* of the risk embodied in that project.

These unacceptable conclusions should serve to indicate that the argument that the cost of capital is lower for government than for the private sector is fallacious. This argument has two strands: that the government sector need not pay company tax, and that the government sector can borrow at lower rates than the private sector. But although both of these observations are correct, it does not follow that the government cost of capital is lower than the private sector cost.

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The argument has been used to oppose the privatisation of government business enterprises (GBEs) and to give the impression that the public has lost value from past privatisations and will lose from future privatisations such as the proposed sale of Telstra (in part or in whole). For example, John Quiggin states that

> … the discount rate used by stock markets in evaluating the expected flow of returns from a privatised GBE may be much higher than the government's opportunity cost of funds. Hence, other things being equal, a policy of selling profitable assets and using the proceeds to pay off debt will reduce public sector net worth (Walker, 1994) … (Quiggin, 1995:25)

Such arguments violate the basic logic of the valuation and cost of capital. If any investor, public or private, sells shares to the value of $100 and deposits $100 in the bank (or, equivalently, reduces his bank debt by $100), he has not destroyed wealth but just reallocated it from higher-risk shares to lower-risk debt. Certainly there will be different annual cash flows (returns) arising from this change in asset allocation; but this merely reflects the different risks involved. The case for privatising GBEs does not turn on the cost of capital for GBEs.

The GBE cost of capital must be the same as the private sector's pre-tax cost of capital. There is, therefore, no 'valuation wedge' between private and public ownership, given the same operating efficiencies of the enterprise, notwithstanding the corporate 'taxation wedge' between private and public ownership. This finding has important implications for the case for privatising GBEs.

Basic Principles

Any analysis of the cost of capital applicable to government assets, particularly GBEs, needs to recognise the following points:

- Since government equity in GBEs is traded only when the asset is sold, the risk in government equity holdings cannot be observed.

- The market return for risk (that is, the price of risk) represents the appropriate charge for risk to be added to the GBE discount rate, particularly, but not solely, for the equity holding.

- Since GBEs do not pay company tax (notwithstanding the practice of their owners charging GBEs 'tax equivalents'), the cash flow to government owners will be different from that to private-sector owners. The introduction of imputation tax credits has reduced this difference.

- The market rate for government debt is not directly applicable to a GBE investment appraisal because the government rate reflects its profound ability to service debt through its power to raise taxes.

- The low government cost of debt represents the guaranteed service cost of debt, whereas investment appraisal and GBE valuation must reflect the cost of application of the funds.

- Selling (privatising) a GBE and retiring debt does not destroy value but restructures the debt-equity mix that a government holds in its portfolio of assets.

Taken together, these points simply confirm that it is the nature of the asset, and more particularly the net cash flow, that determines the required return (the cost of capital).

Each of the points is explored in detail below. The cost of debt and the cost of equity are explored first separately and then jointly in the implications for the financial structure (the relative proportions of debt and equity).[1]

The Unobservable Cost of Government Equity

The routine non-tradability of government equity forces analysts to use discounted cash flow (DCF) to value GBEs. Governments rarely inject equity into GBEs.[2] But although the equity component of the business is invisible unless and until it is privatised, it should not be ignored. For instance, before being restructured, Melbourne Water was valued at between approximately $6 billion and $8 billion, with debt outstanding of between approximately $3 billion and $4 billion.[3] Clearly, there was substantial book equity involved in Melbourne Water, stemming from retained earnings and the proprietary claim over the cash flows of the metropolitan water business that government conferred on Melbourne Water. Further examples are the large equity components of Victoria's electricity distribution and generation businesses.

Some GBEs are financed almost wholly with debt, which capital markets are prepared to provide precisely because government is empowered to raise future capital through taxation in order to repay the debt. Such excessive debt financing represents future tax collections and there are good reasons, in terms of reduced agency costs, to 'load up' GBEs with debt. So, in valuing a GBE or appraising a GBE's investments, allowance must still be made for the cost of equity implicit in the enterprise.

If the GBE equity or that of a comparable company was traded on the open market, its value, and hence its cost of capital, would be visible. The absence of comparable companies with traded equity creates significant validation problems. For example, the privatised GBE may undergo extensive restructuring, be operating in a different regulatory environment, and possibly have to undertake large capital

[1] In valuing an enterprise, whether state-owned or privately-owned, the weighted average cost of debt and equity capital (WACC) is typically used to value the free cash flows. The weights in the WACC are the proportions of the enterprise value reflected in equity and debt respectively.

[2] An exception for many years has been the Australian National Line (Trace, 1995).

[3] Private commissioned report.

projects, particularly infrastructure investment. The monopoly power that GBEs frequently enjoy enables them to share the risk inherent in such projects with the customers by way of cost-plus or take-or-pay contracts. And the privatised GBE's prospective level of earnings and growth may be quite different from its historical results. These difficulties usually force us to conduct valuation from first principles, in the form of DCF analysis, for which the cost of capital (the discount rate) is needed. Assessments of the government cost of capital must make allowance for the (hidden) cost of equity and the subsidised cost of debt.

GBE Equity Risk

Whereas private sector investors choose to bear the risk involved, taxpayers involuntarily bear the risks of government equity in GBEs. GBE investments must therefore include an allowance for risk that these investors would require had they invested voluntarily. As a voluntary investment would generate a market return for risk, the appropriate allowance for GBE risk is the market price of risk. For example, competition from Victoria's privately owned electricity generators is adding to the risk that is borne by New South Wales taxpayers, the involuntary investors in their State's generators.

If held under government ownership, the risk in a GBE investment cannot be totally diversified. Using this logic, Bailey and Jensen (1972) have demolished arguments for a zero-risk premium (that is, for using risk-free rates) in GBE investment. When assets are held in widely diversified portfolios, that part of the risk unique to that asset is eliminated (diversified away) leaving only the risk in common with the rest of the portfolio (the systematic risk). Regardless of who holds the assets, a widely diversified portfolio risk will always exist, since systematic risk is an attribute of the asset, not of the owner of the asset. In addition, since government income and the cash flows (such as electricity sales) from significant GBE investment will vary with the state of the economy, it is extremely unlikely that government ownership of GBEs will permit further diversification of risk than is already achieved in the portfolios widely held by households. The non-government sector holds an extremely widely diversified portfolio of assets, to such an extent that any additional assets held by the non-government sector provides no further diversification benefit. The argument that governments have access to opportunities for risk diversification that are unavailable to private investors suggests that there is some impediment in risk diversification in the private sector. But there is no logical reason why this should be the case, nor is there any evidence that it is.

It has been claimed (for example, Mehra & Prescott, 1985) that the observed return on risky equity investments includes a risk premium (a return in excess of the risk-free rate) that is higher than would be warranted by the risk inherent in these investments. This is known as the 'equity premium puzzle'. It arises from comparing the observed market risk premium with that predicted by models that attempt to describe the tradeoff between current consumption and future consumption (that is to say, that attempt to model the required discount rate and hence the required risk premium). But which should we believe: the evidence of the observed risk pre-

mium from capital markets, or a model based on a theory that claims the risk premiums are too high? The 'puzzle' does not invalidate the observed market risk premium; rather, the observed market risk premium proves that the model is flawed.

GBEs and Company Tax

The fact that GBEs do not pay company tax (notwithstanding their owners charging GBEs 'tax equivalents') is the most widely cited basis for the argument that the government cost of capital is less than the private sector cost.

The concept of the 'social opportunity cost of capital'[4] is sometimes invoked to specify the return governments require when making investments on behalf of the community. It is the rate at which society is willing to forgo present consumption for the sake of future consumption. With this discount rate, the discounted value of future consumption goods equals the value of forgone present consumption goods. It is thus a consumption-based opportunity cost of capital (COC).

For government investment replaceable by private investment, the appropriate discount rate is the private sector's pre-tax investment opportunity cost (IOC). Private sector investment to supply future consumption goods would incur taxation. In order to meet expected future consumption needs, private investments would therefore need to yield an allowance for taxation.[5] In this case, the private sector would willingly invest to supply the future good if it made its market rate of return reflect all its costs. Society would be supplied with both a future good and a taxation payment. Hence, if the government replaces private sector investment with a GBE, its opportunity cost is the cost of the good *and* the forgone taxation payment. As long as government does not waste tax revenue, *the appropriate discount rate for GBEs is the private sector pre-tax cost of capital.* This is no more than a recognition that the appropriate discount rate is an opportunity cost: in this case, the government's opportunity cost of capital.

As a government investment in a GBE does not incur company tax, its cash flow and its required return should be calculated on a pre-company tax basis. The observed cost of capital for the private sector, in contrast, is the cost of capital *after company tax but before personal tax,* since the vast majority of debt and equity securities traded in the market render investors liable for personal tax but not for further company tax. This does not pose a problem because the GBE valuation can equally be performed on a post-tax basis, as is commonly done for private enterprises, since pre-tax cash flows discounted at pre-tax discount rates and post-tax cash flows discounted at post-tax discount rates should give consistent valuations. The important point is that there is no valuation wedge caused by the taxation wedge between private and government ownership.

Since the value of an asset does not depend on the tax status of its owner, it must be the same for both the private sector and the public sector. For the same

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[4] This section draws heavily on Baumol et al. (1983).

[5] Namely, $IOC(1-T_c) = COC$ or $IOC = COC/(1-T_c)$ where T_c is the effective tax rate.

operational efficiency, the pre-tax cash flow is the same for both forms of ownership. The government sector's cost of capital for a GBE is the private sector's pre-tax cost of capital.

Dividend imputation has obscured this somewhat. In the private sector, the pre-tax cost of capital depends on the amount of corporate tax that the company pays. This is the amount of the tax collected at the company level that is not claimed (redeemed) by shareholders as pre-payment of their personal tax. The redeemed amount of the collection flows to shareholders as an addition to their pre-personal tax cash flow. If all the tax collected at the company level were distributed as franking credits and the shareholders could fully utilise them, then, strictly speaking, no company tax would actually be paid. In other words, the pre-tax cost of capital would be the same as the post-tax cost. In Australia, where foreign shareholders do not pay Australian personal tax, an average of about 45 per cent of the tax collected from companies is redeemed as franking credits on personal tax (Hathaway & Officer, 1996). This reduces the private sector's pre-tax cost of capital but not to the level of its post-tax cost.

The cost of capital to government is the private sector's pre-tax cost taking into account the reduction in company tax caused by the imputation credit system. Tax equivalent payments, which under government ownership take the form of cash, under private ownership become franking credits, whose market value depends on the pay-out policy of the firm concerned and its ability to distribute franking credits. Since retained earnings are available for reinvestment by the company, they should earn their opportunity cost of capital, so compensating investors for the time value of money caused by not distributing the earnings as dividends. However, franking credits remain with the Australian Taxation Office until redeemed at their face value by personal taxpayers. As there is no compensation for the time value of money, they are a 'wasting' asset while they remain undistributed. The market value of companies with stored credits will embody any discount that investors consider appropriate.

The upshot is that the cost of capital to government will depend on the market value of the imputation credits generated by the particular GBE. This adds one more parameter that must be estimated in order to establish the GBE cost of capital. Nevertheless, the government as the owner of a GBE receives a pre-tax cash flow for the same market pre-tax cost of capital as the private sector.

Government's Borrowing Advantage

The government's borrowing advantage reflects its ability to service debt by its power to tax. Its borrowing rate is low because it reflects this very strong guarantee to repay. Indeed, governments can finance *consumption* expenditure with debt which has no future cash flow to meet the debt obligation. Lenders know that the power of taxation stands behind the debt obligation. Only if there were a risk of default on this obligation would the debt rate be affected. The risk of the investment to which the debt is applied is not reflected in the cost of servicing the debt.

But its borrowing rate is not the opportunity cost of debt that should be used in appraising GBE investments. If a private borrower could supply the same security of repayment, it too would be able to secure debt at a lower cost.

Servicing Cost vs Investment Cost of Debt

The appropriate measure of the cost of capital for investment valuation is the cost of the *application* of the capital in the investment, not its cost at *source.* For example, if one borrowed long-maturity debt in order to purchase equities, then the required return on the capital would be the investment return on equities (say, 14 per cent a year), not the cost of servicing the debt (say, 7.5 per cent a year). Clearly, the difference in the costs reflects their different risks. When government raises debt capital, the service cost of debt is the repayment rate, as guaranteed by taxpayers. Without the guarantee, the cost of the debt would reflect the risk to the lenders in making the loan. This is the cost of debt that should be used in investment appraisals.

There is no reason to subsidise a GBE and its clients with the guarantee which taxpayers supply. In theory, this guarantee could be applied to any investment, private or public. But it does nothing to enhance the efficiency of the investment. It is all external diseconomy in production: it costs society more than it costs the GBE. State Treasuries now acknowledge this and charge a guarantee levy to their GBEs, though it remains unclear whether it is sufficient to wholly eliminate the diseconomy.

Debt Retirement and Net Worth

An investor who sells higher-risk equity to reinvest in lower-risk debt securities (or, equivalently, to reduce his sale of debt securities by repurchases) does not thereby make himself worse off, because the higher equity cash flows compensated him for bearing the higher equity risk. The risk in the equity cash flow from Telstra, for example, is surely greater than the risk-free rate of interest due on government debt. Selling \$100 of equity in Telstra and investing in \$100 of debt securities (or retiring \$100 of debt) does not destroy wealth, apart from any transaction costs incurred. To claim that taxpayers are made worse off by privatisation is essentially to claim that the *mix* of debt and equity is wrong. This is to assume that there is an optimal mix of debt and equity for the government. Yet there is no compelling evidence that any such optimal capital structure exists.

The arguments about the debt-equity mix apply equally to the private sector and the public sector. According to Jensen (1986), large, mature listed companies generate substantial 'free cash flow' which cannot be profitably reinvested within the company. Managers are inclined to employ such cash flow to underwrite growth at the expense of profitability: for example, they may attempt to gain market share in a mature industry or purchase diversification investments which add no shareholder value. But a high level of debt takes away this freedom to be profligate with shareholder's cash by placing contractual obligations on the company.

Because managers of GBEs are even more remote from their ultimate shareholders (the public), Jensen's free cash flow argument is more compelling for GBEs than for private companies, which may help explain why GBEs are more loaded with debt than are private corporations. For example, free cash flow may be wasted on excessive allowance for contingencies or excessive investment in reserve equipment (such as standby electricity generation equipment instead of more power outing compensation contracts with large consumers). But higher debt levels than would otherwise be the case could counter any tendency for such profligate behaviour and for political interference in GBE operations. This is because high debt levels remove much of the managers' discretion to accede to such demands and pressures. Yet, notwithstanding these possible differences between private and government ownership, no obvious conclusion can be drawn about the optimal mix of debt and equity for government investment.

Owning GBEs, which are essentially domestic businesses, 'doubles up' the government's exposure to the Australian economy. As economic conditions fluctuate, so do the general tax collections of government and the earnings of GBEs. As the owner of GBEs that are financed with long-term debt, the government has levered itself to the Australian economy. Prudent investors might regard this degree of leverage as unwise and judge that a lower level, such as privatisation would achieve, would improve their welfare.

Privatisation

The arguments about privatisation turn on considerations of efficiency rather than the cost of capital. An exclusive focus on valuation effects and debt retirement would lead the sellers (governments) to maximise their net benefit upon sale by privatising monopolies, at the expense of consumers. There is little or no public benefit in transferring a monopoly from public ownership to private ownership, unless it is accompanied by some efficiency gains.

The investment decision to create an asset and deliver a service should not be affected by the issue of the ownership of that asset. If the private sector can deliver a service, to the extent demanded by the community, more efficiently than the government sector, then that is the more valuable form of ownership. Capital released from inefficient businesses can be relocated to generate wealth elsewhere, so increasing national wealth. The resources used in generating a service should be the same under all forms of ownership. If they are not, then control of assets should pass to those individuals who judge they can manage them better and who are prepared to back their judgment by paying a greater capitalised value for an asset.

Privatisation lowers the agency cost of ensuring that managers act in the interest of shareholders. The publicly listed corporate structure has evolved to a form that suits the needs of all of its stakeholders: clients, managers and employees, owners and lenders. Managers are charged by the owners to act as their agents in promoting the interests of the business. Public listing imposes a discipline on the company. The enterprise will have to pay market rates for its inputs, whether physical or human capital; and this will be visible in the marketplace. A publicly listed company

that is poorly managed will be punished in the marketplace. However, in government businesses, the returns that would otherwise accrue to private sector shareholders may be partially captured by others, such as employees and favoured customers, at the expense of the ultimate shareholders, the public.

The market-based system is largely self-regulating and it has little need for a bureaucracy to impose a negotiated allocation of resources between the managers of GBEs and their political masters. Corporatisation has been adopted to overcome this problem, but it cannot fully eliminate it. The market assumes the role of monitoring the performance of a privatised company. The well-being of the enterprise is succinctly embodied in one simple statistic: the stock price. The alternative is to impose a whole series of performance measures based on both input and output metrics for the enterprise. But the interpretation of such a series of statistics is bound to be more subjective than the market price of the stock, which is a simple and cheap form of information about managerial performance (among other things) and provides a powerful means, through the possibility of takeover bids, of disciplining poor performance.

Privatisation is often accompanied by reforms that enhance market competition and so ensure that consumers benefit from the reduced costs of production. Even when public monopolies are transferred intact to private ownership, they are often subjected to regulations that render management of the enterprise more open to scrutiny. Ideally, this should also help reduce the agency costs of making management act in the best interests of the enterprise.

If the GBE has community service obligations (CSOs) and they are deemed necessary, they can be handled just as easily (though more visibly) by private owners as under government ownership. They should not be obscured by being embedded in a lower required return on the asset when under government ownership. Any CSO should be explicitly identified, either as a subtraction from commercially priced cash flows or as a quarantined portion of the assets. As there are often joint costs involved in supplying commercial as well as subsidised services, it is difficult to quarantine the asset base used to service the CSO. The optimal solution is to subsidise the appropriate *user* of the service and require all investment decisions to be made on a commercial basis. Embedding CSOs in a lower required return creates the risk that the GBE will capitalise a prospective business at too low a rate of return by over-investing in assets or charging too little for its output: both of which represent a sub-optimal allocation of scarce national resources. Unfortunately, it is often easier politically to disguise CSOs as opportunity costs through reduced GBE dividends than to identify them explicitly as budgeted outlays by the government in combination with commercial dividend receipts from the GBE. Privatisation need not affect the issue of CSOs at all; but it does make CSOs more visible and forces politicians explicitly to allocate capital to them.

Conclusion

The cost of capital for GBEs is the opportunity cost of the capital, both debt and equity; and the cost of the equity is the appropriate before-tax risk-adjusted return

on the business. Government equity invested in GBEs carries an opportunity cost, since the government can always use the capital for other purposes. The non-tradability of GBEs' equity makes it difficult to estimate the equity risk premium; but this measurement problem does not validate the claim that the cost of capital is no more than the cost of debt.

The cost of capital for government is not less than it is for the private sector: it is the private sector's pre-tax cost of capital. The corporate tax wedge between private and public ownership of assets does not place a valuation wedge between private and public ownership; nor does the low rate of debt at which governments can borrow, because that is not the cost of debt that is relevant to an investment appraisal. Dividend imputation has somewhat obscured the difference between government and private sector costs of capital by lowering the effective company tax rate; but that is only a measurement problem. The basic principle still applies: given the same operating efficiency, there is no valuation gap between public and private ownership of assets, and no automatic loss of net worth when governments privatise their GBEs and retire debt with the proceeds of the sale.

The argument that privatisation should not proceed on the grounds that the capital costs government less than the private sector is therefore unsound. The case for privatising GBEs is based entirely on the efficiency gains it makes possible.

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Options for Reforming Australia's Indirect Taxes

John Freebairn

AUSTRALIA'S Commonwealth and State governments collect a number of different taxes on the sale of goods and services. In some cases, and in part, such taxes are crude forms of user charges for government services, and some are justified as taxes on external adverse effects of production and consumption. But most indirect taxes are designed to raise general revenue. In total, indirect taxes collect a third of all taxation revenue, and are more important for the States than the Commonwealth. On the assumption that they mostly are passed forward to consumers, indirect taxes add an average of 13.5 per cent to the purchase cost of final consumption expenditure.

Indirect taxes in Australia are vulnerable to many criticisms. They have narrow bases with many consumption items exempt; rates are high and variable; they have a high incidence on some (but not all) business inputs; they are highly regressive and offend principles of horizontal equity; and in many cases they are complex and costly to comply with. Australia is far from having a broad-based consumption tax of the type found in most other developed countries. Non-neutrality of indirect taxation of different economic choice options distorts choices on the goods and services produced and consumed and also on production methods.

Major reform of the indirect tax system should proceed from first principles. Here, three reform contexts are relevant. First, where indirect taxation is used as a means of charging users or of countering externalities, the base and the rate should directly and explicitly reflect the user charge or externality. Second, insofar as indirect taxes serve to raise general revenue, the use of a single-rate tax on a broad base of consumption expenditure has strong appeal; as well, technical and political feasibility is achieved most easily if indirect tax reform is presented as a revenue-neutral rationalisation.

A third and more complex economic and political context for considering indirect tax reform is the use of an expanded revenue-raising broad-based consumption tax as part of a change in the tax mix. Australia in 1985 and 1993 considered using revenue from an expanded indirect tax to replace part of the present income tax. A tax mix change involves transition adjustment problems and large changes in the distribution of the tax burden.

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Current Indirect Taxation

Table 1 provides a list of indirect taxes collected by the Commonwealth and State governments and the revenue yielded in 1995-96. Inevitably, there is scope for legitimate debate over which taxes should be included and which excluded. For example, the table does not include tariff revenues or land taxes.

Table 1

Indirect taxes collected on expenditure of goods and services, Australia, 1995-96 ($m)

Type of tax	*Commonwealth*	*States*
General		
Wholesale sales tax	12,792	
Payroll tax		7,088
Financial and capital taxes		
Financial institutions duty		1,904
Stamp duties		4,165
Excise and franchise fees		
Petroleum products	10,224	1,531
Tobacco	1,585	2,621
Alcohol products	1,026	735
Gambling	10	
Lotteries		958
Poker machines		1,256
Race betting		643
Casinos and other		450
Motor vehicle taxes	35	
Registration, licences, other		2,382
stamp duties		1,050
Third party		225
Insurance contributions		1,505
Others		
Departures taxes, broad-cast licences	362	
Total	26,034	26,513

Constructed from: ABS (1996a); Commonwealth of Australia (1996).

The most important general revenue-raising indirect taxes are the wholesale sales tax levied by the Commonwealth and the payroll tax levied by the States. The wholesale sales tax has a narrow tax base: all services are tax exempt, as are some goods, including clothing and food. Currently there are five rates of tax: 12, 22, 26, 32 and 45 per cent. Ostensibly, the higher rates apply to luxury goods, but much of the classification reflects views that were current in 1930, when the tax was introduced. More than a half of the initial incidence of the wholesale sales tax falls on business-input purchases of cars, furniture, appliances, paper, and so forth, rather than final consumer sales (Chisholm, 1993). The multiple rates and taxable categories give rise to uncertainty and some litigation.

Payroll taxes levied by the States apply to firms with annual salary bills above a threshold of around half a million dollars (from a low of $456,000 in South Australia to a high of $750,000 in Queensland) with marginal tax rates of 5 per cent in Queensland, 6 per cent in Western Australia and South Australia, and 7 per cent in other States. There are exemptions for decentralised industry, some classes of special industry assistance, and some employment schemes (see New South Wales Treasury, 1996). Wages and salaries, and some fringe benefits including superannuation in two States, are taxable. In effect, just over a half of employees are subject to payroll tax. Grouping provisions and exemptions, together with separate State administrations, give rise to some complaints about tax compliance.

Financial and capital taxes are general revenue-raising taxes. The financial institutions duty is payable on receipts (credits) of financial institutions at a general rate of 0.06 per cent (except Queensland, where it is zero, and the ACT, where it is 0.1 per cent) with a maximum per transaction ($1,200 in most cases) and a special lower rate for the short-term money market. Stamp duties are levied on contracts and conveyances, the sale of motor vehicles, life insurance, share transfers, hiring arrangements, leases of land, and mortgage and loan security. The rate structure varies: some are progressive, others have flat rates. Rates vary from item to item and across States, and sometimes there are exemptions and special rates. This hotch-potch of taxable and non-taxable items and different tax rates results in narrow tax bases and different rates on different forms of capital items and financial transactions. Like the wholesale sales tax, distortions associated with stamp duties apply to business-choice options as well as to household consumption-choice options.

The other indirect taxes listed in Table 1 are, in part, user charges or taxes on externalities as well as raisers of general revenue. Insurance contributions and departure taxes are entirely fees for services provided.

In aggregate, revenue collected from excise and franchise fees on petroleum products, motor vehicle taxes, and the wholesale sales tax on vehicles amounts to roughly twice the level of government expenditure on road construction and maintenance (Docwra & Kolsen, 1993). Further, debate persists on the relationship between these charges and actual road service usage by different categories of vehicles (see for example IAC, 1986).

Some of the revenue collected from excise and franchise fees on petroleum products is available for meeting externality effects, including pollution and congestion. However, the present tax arrangements are poor indicators or measures of the externalities involved. If taxation of petroleum products is designed to deal with greenhouse-gas pollution, why are off-road uses of diesel, the burning of coal for electricity generation and other purposes, and liquid petroleum gas tax-exempt? But if it is designed to curb traffic congestion, why does it apply in rural and suburban areas, and for fuel consumption around the clock in urban areas where congestion occurs mainly during peak hours? The combination of a specific tax per litre, the Commonwealth excise on petroleum products and the *ad valorem* State franchise fees appears to be inspired by expediency and revenue-raising opportunities rather than a rational estimate of the marginal externality effects of the consumption of selected petroleum products.

Relatively high indirect tax burdens are levied on alcohol products through the Commonwealth wholesale sale tax and excise and the State franchise fees (see Scales, Croser & Freebairn, 1995). As well, the tax burden differs widely from product to product (it is highest for spirits, lower for beer, and lowest for cask wine) and it varies according to whether the wine is sold at the cellar door or elsewhere. And here too there is a mixture of specific taxes per litre of alcohol (excise), which probably comes closer to the source of any externality, and *ad valorem* (wholesale sales and franchise) taxes. The particular tax burdens on alcohol products do not systematically reflect the pattern and magnitude of externality effects.

Gambling taxes are an increasingly significant source of State revenue (for details of the different gambling taxes, see New South Wales Treasury, 1996). No case has been made to the effect that gambling may have some negative externality effects, let alone any attempt to quantify these. Moreover, the differences between the tax rates on different forms of gambling, and even between win/place and trifecta bets on races, lack justification in terms of efficiency, equity or simplicity.

General Assessment

In terms of economic efficiency, the present indirect tax system has many deficiencies (Freebairn, 1993; Albon, 1996). A case can be made for levying special taxes, or applying relatively high tax rates, on goods and services that generate external effects. However, the existing higher tax burdens on some petroleum products, the different taxes on different alcohol products and on different gambling activities, and the very high tax burden on tobacco are not supported by logical and realistic estimates of net marginal externality effects. Similar, though weaker, criticisms can be made of the use of indirect taxes as user charges for government-provided road, insurance and other services.

As a general revenue raiser, the indirect tax system with its different tax rates on different choice options distorts consumer decisions. It also distorts producer decisions, both on what to produce and on how it should be produced. Many critics of the system (such as Chisholm, 1993; Albon, 1996) ignore its effects on the latter type of producer choice. For example, the heavy taxation of transport distorts loca-

tion decisions; payroll tax favours small business enterprises over large business enterprises; and the heavy taxation of motor vehicles favours rail and air over road transport.

As for vertical equity, the current system is regressive in terms of tax paid as a share of disposable income, and approximately proportional in terms of tax paid as a share of household expenditure. Table 2 reports ABS data for about a half of the indirect taxes, prepared on the conventional (though debatable) assumption that such taxes are fully passed forward as higher prices. Because of life-cycle effects and temporary periods of above- and below-normal income, a more useful measure of the distributional burden is indirect tax as a share of expenditure. While the exemption of food from most taxes initially favours those on low incomes, in reality food prices include some taxation because of the taxation of fuel, motor vehicles, and other inputs used in its production. The exclusion of most services from current indirect taxation is highly regressive.

Table 2

Estimated vertical equity distributional effects of Australian indirect taxes, 1993-94

	Households by gross income quintile					
	Lowest 20%	*Second*	*Third*	*Fourth*	*Highest 20%*	*All households*
Disposable income* ($/w)	150	336	512	738	1196	586
Total commodity and services expenditure ($/w)	303	426	573	714	994	602
Selected indirect taxes paid** ($/w)	28.9	43.2	59.0	73.8	96.6	60.3
Indirect taxes as % of disposable income	19.3	12.9	11.5	10.0	8.1	10.3
Indirect taxes as % of expenditure	9.5	10.1	10.3	10.3	9.8	10.0

Notes: *Disposable income is market income (wages, interest, etc) plus government direct payments (pensions, benefits) minus personal income tax paid. **Indirect taxes cover about a half of all indirect taxes. It is assumed they are fully passed forward to consumers.

Sources: ABS (1996b, c).

The mixture of tax-exempt and highly taxed items under current indirect taxes results in horizontal inequity. For example, a family that indulges in luxury expenditure on cars and electronic gadgets pays more indirect tax than a family with similar income that purchases expensive clothing and restaurant meals.

While there have been many criticisms of the allegedly high compliance costs imposed by indirect taxes, available estimates indicate that they are relatively low,

and much lower than those of income tax (Pope, 1993). In part, this arises because a relatively small number of medium and large business enterprises initially pay most of the indirect taxes.

External Costs, User Charges and Indirect Taxes

Levying specific taxes on goods and services whose consumption or production generates external costs on third parties raises the private price to reflect these costs, and so improves economic efficiency as well as generating revenue. To be effective, the tax base should be as close to the direct source of the externality as feasible, and the tax rate should reflect the net external cost caused by the activity.

In principle, a number of Australian goods are candidates for specific indirect taxes that reflect externalities. These include alcohol and tobacco, and transport where it involves congestion. More controversial is the argument that petroleum products for off-road use as well as on-road use, and the burning of fossil fuels for electricity generation and other purposes, should be taxed to mitigate the greenhouse effect. Equally controversial is the claim that gambling should be taxed because it gives rise to large externality effects, especially beyond the family level. Whatever the case, Australia's present indirect tax system is poorly designed to counter externalities. For example, current taxation of alcohol products consists of a mixture of specific taxes (the excise taxes) and *ad valorem* taxes (including the wholesale sales tax and franchise taxes); moreover, effective tax rates vary widely across different products. Generally, one specific tax at a common rate on all sources of the externality would correct the market failure, be equitable, and simplify the taxation system.

The present raft of indirect taxes on road transport includes the wholesale sales tax on motor vehicles, excise and franchise fees on petroleum products, registration and licence fees, stamp duties and third-party insurance. Often they are defended, at least in part, as amounting to a user charge for road construction and maintenance, policing, and so forth. Ideally, there would be a single charge per unit of road services consumed. The present system, relying heavily as it does on indirect taxes on fuel, is poorly correlated with road damage by different users (Industries Assistance Commission, 1986; Docwra & Kolsen, 1993). Given the importance of fixed capital costs in the total costs of providing road services, and the prevalence of decreasing costs, it is likely that an up-front or access charge based on the registration fee would be part of a sensible two-part tariff system for pricing and funding the provision of road services; the other part of the tariff would consist of a user charge reflecting at least some marginal costs.

General Revenue Raising and Indirect Taxes

A broad-based consumption tax. Apart from special externality charges and user fees, the current maze of indirect taxes could be replaced with a broad-based consumption tax levied at a single rate.

A revenue-neutral rationalisation of existing indirect taxes would create a tax base consisting of a comprehensive basket of final consumption of goods and services, including necessities such as food, clothing and housing. This would largely eliminate the distorting taxes on some business inputs. A common tax rate on all consumer items would simplify the tax system. It would remove most of the present distortions to consumption decisions. In addition, the broad base and single rate would achieve horizontal tax equity.

Importantly, such a tax would result in roughly the same level of vertical equity as occurs under the current set of indirect taxes. It would raise the cost of consuming goods and services for all households by the tax rate. It would amount to a proportional tax in terms of household expenditure. This is the same average outcome as occurs with the aggregate effects of the existing indirect taxes, as illustrated in Table 2, although the general revenue-raising wholesale sales tax and payroll tax are slightly less regressive in their effects than the excise, franchise fee and motor vehicle taxes.

Exemptions and multiple rates. Arguments for exemptions from a broad-tax base and for multiple rates have serious weaknesses. First, as already observed, the vertical equity argument is unwarranted; further, equity concerns are more directly and efficiently achieved by changes in the personal income-tax and social-security systems. Second, arguments for varying tax rates according to product elasticities of demand and with degrees of product substitution and complementarity with untaxed leisure may make theoretical sense (see Creedy, 1993), but they are questionable in practice: for example, we have inadequate knowledge of the elasticities, and different tax rates create incentives for wasteful lobbying and rent-seeking expenditures. Third, a single rate is simple and transparent.

Varieties of broad-based consumption tax. Serious contenders for a broad-based consumption tax comprise the single-stage retail sales tax (RST), such as is used by the states of the US; and the multi-stage tax known as the valued-added tax (VAT) in the European Union and as the goods and services tax (GST) in New Zealand and Canada.

There is growing support for the view that a broad-based, single-rate multi-stage VAT or GST, best illustrated by New Zealand, is superior to the single-stage RST (Cnossen, 1989). In principle, the two impose the same final tax incidence on domestic consumption expenditure. In practice, the multi-stage system is more effective in exempting business inputs from taxation (thus reducing distortions to production choices and eliminating tax-on-tax cascading causing different effective retail tax rates on different consumer products) and has a broader base and lower tax rate for the same revenue (thus reducing consumption choice distortions). Typically, the RST either involves taxation of business inputs, as would the Option C proposal at the 1985 Tax Summit, or has a relatively small tax base, as in the US. Under the multi-stage system, registered businesses claim a credit for tax paid on business input purchases. In this way, it provides an automatic procedure for distinguishing

between taxation of final consumption, which is desired, and taxation of business inputs, which is undesirable. The degree of additional paperwork required with the multi-stage system easily is exaggerated because the system uses the same records as those kept for income-tax purposes. While all tax systems are subject to some evasion and avoidance, the invoice trail of the VAT and GST provides a good framework for administrative checking. Finally, 21 of the 24 OECD countries have some form of multi-stage system.

Proposals to end the coverage of the wholesale sales tax and/or to add a new tax on services involve a number of deficiencies relative to the broad-based consumption tax options. To remove the input taxing component of the wholesale sales tax, so that it falls only on final consumption purchases, would reduce the current tax base by 60 per cent; and it is not easy to distinguish between business input and final consumption purchases. Retaining input taxation would mean a continuation of distortions to production decisions, tax-on-tax cascading, and differential effective tax rates at the retail level. As well, the base of the wholesale level is very much smaller than the base of a retail tax. Adding a new tax on services involves numerous measurement problems. For example, what part of a new car would be subject to a service tax, especially if the wholesale sales tax still applied to the manufactured good? Again, many services, like goods, are used by business as inputs as well as by households for final consumption: for example, car repairs and legal services. To expand the wholesale sales tax and/or to add a tax on services would mean large changes, with transition costs, and probably also political costs, comparable to those of introducing a VAT or a GST. That is to say, rationalisation of existing indirect taxes for general revenue-raising purposes would be more successful in terms of efficiency, equity and simplicity if effected through a comprehensive multi-stage indirect tax than through the band-aid strategy of modifying the wholesale sales tax and/or introducing a new tax on services.

Operation of a VAT/GST. In practice, a workable VAT or GST would not have a truly comprehensive base (see Bascand, 1989; Chisholm, Freebairn & Porter, 1990). Leisure and non-market goods and services would avoid the tax net, as they do for income tax. Imputed services provided by owner-occupied housing and consumer durables would not be taxed, but the purchase price of new items could and should be taxed as a form of a prepaid consumption tax. No country with a VAT or GST fully taxes financial services; but inputs used by the finance sector typically are taxed. Otherwise, most other goods and services included in private final consumption expenditure would be taxed.

The payroll tax. To achieve tax neutrality, the present payroll tax system should be broadened to encompass all labour income. This would mean removing the small-business and other exemptions, and including employer superannuation contributions. In effect, the present base could be doubled. Such a broad base easily could be built on the existing pay-as-you-earn income tax, fringe benefit tax and superannuation guarantee levy systems operated by the Commonwealth. This also would

significantly reduce compliance costs. More controversial would be an extension of the payroll-tax base to include a deemed labour income component of the income of the self-employed, which includes returns for own labour, management and investment.

A comprehensive payroll tax could be used along with, or instead of, a VAT or GST. In longer-run equilibrium, a broad-based labour tax, such as the proposed payroll tax, has the same economic incidence and effects as a broad-based consumption tax (see Bascand, 1989; Ryan, 1995). Both effectively exempt saving or the income from capital from taxation. The VAT tax base for each business enterprise consists of gross sales, minus expenditure on goods and services purchased and minus cash outlays on gross investment items; the residual consists largely of the labour costs that supply the base for payroll tax.

The payroll tax taxes financial services more effectively than a GST or a VAT. Its disadvantage is the need either to deem a labour component of the income of self-employed persons, or to exempt from taxation this element of the potential tax base. One appeal of payroll tax is that it is a State tax. However, as noted, it could be better administered through existing Commonwealth tax systems. Given these advantages and disadvantages, a case could be made for using a combination of a broad-based single-rate VAT and a broad-based single-rate payroll tax to replace the general revenue-raising component of all existing indirect taxes.

Changing the Tax Mix

Recent attempts to introduce a broad-based consumption tax in Australia, such as Option C at the 1985 Tax Summit (Keating, 1985) and the GST proposed by the Liberal-National Coalition in 1991-93 (Hewson & Fischer, 1991), sought not only to rationalise some existing indirect taxes, as discussed above, but also to use part of the consumption-tax revenue to fund a reduction in the overall level of personal income tax. Such a change in the tax mix, if introduced in an aggregate revenue-neutral way, would reduce the taxation on saving and increase it on consumption. It brings a set of efficiency and equity effects that are additional to those generated by the rationalisation of indirect taxes and that are also more controversial in the minds of analysts, politicians and the public.

Shifting the tax mix away from income to consumption changes the incidence or distribution of the overall tax burden. It reduces the tax level on saving. However, over a half of Australian saving is already wholly or mainly exempt from taxation: the imputed rent from, and capital gains on, owner-occupied dwellings are not taxed, business investments in human capital and research and development are written off in the year of expenditure, and the earnings of superannuation funds are subject to a flat 15 per cent tax; as well, the deferment of tax on real capital gains until realised reduces the effective tax rate. Only those who save in forms that are taxed as income, as are debentures and deposits in financial institutions, would gain from a tax mix change. Even so, those on higher incomes who are responsible for most household saving would predominate among the gainers. Losers under a

change in the tax mix would include many on low incomes and the elderly self-funded retired who are consuming their past savings.

Any attempt to maintain the present distribution of the tax burden under a change in the tax mix would require some form of compensation for the losers. This could be attempted only crudely. It would involve a combination of making the remaining income tax system even more progressive, increasing social security payments, and introducing special rebates.

The efficiency effects of a tax mix change point in different directions, and there is much uncertainty about their magnitude (see for example Goode, 1991; Randolph & Rogers, 1995). By shifting the tax burden away from the returns to saving and investment towards labour income, a revenue-neutral tax mix change would increase distortions in the labour market, including choices between work and leisure. But it reduces the distortions to two key sets of capital-market decisions. First, it reduces disincentives to save and to defer income from present to future consumption. Second, lower income-tax rates would reduce, but not eliminate, the non-neutral taxation of different savings and investment choice options under Australia's present hybrid income tax system, which taxes different forms of saving and investment in different ways (Pender & Ross, 1993). A tax-mix change would in this way raise the productivity of national saving and investment.

Concluding Observations

Discussion of structural reform of the tax system is simplified by assuming that aggregate revenues remain unchanged. Government can be expanded by scaling the tax rates upwards, or reduced by scaling them downwards.

Potential gains in economic efficiency, horizontal equity, transparency and simplicity provide *prima facie* arguments for reform. Further, other countries have in place superior working examples that could be copied.

Rationalisation of the revenue-collecting function of indirect taxes would take two forms. First, broad-based taxes with a single rate should be used as general revenue raisers. Here, a multi-stage VAT or GST, with New Zealand as the preferred prototype, and a broadened payroll tax would replace most existing indirect taxes. These taxes are proportional to consumption expenditure and similar in progressive distributional effect to the taxes they would replace. Second, additional specific taxes would be imposed, both on externalities such as those generated by tobacco and alcohol, and as user charges for government-provided services, such as roads. Further research is needed on the details of the form and level of such taxes.

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Economic Liberalisation and Manufacturing Productivity in Nepal

Kishor Sharma

IN recent years, the debate about trade orientation and productivity growth has produced a number of studies of individual developing countries and of comparisons between them. These studies have confirmed that outward-oriented economies grow faster than inward-oriented economies because they utilise their resources more efficiently. Such studies have concentrated on middle- and high-income rather than low-income developing countries. But the experience of the former cannot be generalised to the latter, given that the level of human capital, the state of physical infrastructure, and the level of R&D are substantially lower in low-income developing countries. The analysis of the experience of a wide range of economies with different backgrounds could therefore provide fresh insights into the impact of economic reform in different environments (Papageorgiou et al., 1991).

Nepal is a low-income, land-locked developing country that adopted an outward-oriented strategy from the mid-1980s. Before then, it was widely believed in Nepal that policies of import substitution would encourage the growth of a wide range of industries and also generate a sufficient level of government revenue from tariffs and quotas. As well, the country's land-locked position and open border with India forced it to adopt a tariff and incentive regime similar to India's: a lower tariff than India's would have promoted smuggling, thus draining Nepal's foreign exchange reserves, while more generous export incentives would have caused the re-export of Indian goods.[1] But the resulting inefficiencies prompted the Nepalese government to substantially liberalise the economy from 1986/87. This article assesses the impact of this policy shift on the growth of manufacturing productivity.

Historical Background

Nepal virtually had a free trade policy until 1955. With the advent of the first economic plan in 1956, import restrictions were introduced to promote import-substituting industries (ISIs). Domestic and foreign investment was regulated by means of a rigorous licensing system, and industrialisation was supported by subsidised credit. Under legislation introduced in 1961, ISIs were protected from exter-

[1] See Blejer and Szapary (1991) for further discussion of this issue.

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nal competition for a minimum of five years; but in many cases protection was extended for a longer period. By the late 1960s, the domestic market had been shielded from external competition. Many large-scale industries were established in the public sector, on the assumption that the private sector lacked resources and management skills. The number of manufacturing public enterprises rose from two in 1962 to 23 in 1985. They were given privileged access to imported inputs and technology, and received a high level of protection; but their returns were disappointing.

Exports, meanwhile, were regulated through an export licence system and an export tax. Rice and oil producers were required to sell a certain percentage of their output to the Nepal Food Corporation at below-market prices. By the early 1970s, exports of rice, the major export item in the 1970s, were channelled through the Paddy and Rice Exporting Corporation (PREC), whose prices, being much lower than the international market prices, resulted in a sevenfold fall in the value of rice production between 1972/73 and 1986/87. Exports declined as well, and PREC was dissolved in the mid-1980s.

Table 1

Nepal: macroeconomic indicators (annual percentage of real GDP, unless otherwise stated)

Indicators	*1974/75*	*1976/77-1986/87*	*1987/88-1993/94*
Real GDP growth	na	3.0	4.1
Exports	5.4	5.1	7.0
Imports	10.9	17.4	22.6
Trade deficit	5.6	12.3	14.8
Current account deficit	0.7	3.5	7.2
Budget deficit	1.3	6.9	7.2
International reserves (months of imports)	7	3.8	6.5

Notes: GDP deflator is used to obtain the real data. Real GDP growth rate is average annual.

Sources: Ministry of Finance, *Economic Survey* (various issues) and Nepal Rastra Bank, *Quarterly Economic Bulletin* (various issues).

The licensing of imports of intermediate inputs discouraged production of manufactured goods. Obtaining an import licence could take several weeks. Manufacturers tended to build up inventories of intermediate inputs for future use or even to sell the import licences to merchants. Even though ISIs and export-oriented industries (EOIs) were accorded equal priority in development plans, in practice ISIs received more protection because of the widespread view among bureaucrats that they could eventually lead to export development. The consequent

deterioration in real export earnings led to a tightening of restrictions on imports of intermediate inputs and consumer goods, resulting in poor capacity utilisation in private sector industries. By 1985, about 95 per cent of Nepal's imports were subject to licensing, foreign-exchange controls or tariffs; and the dispersion in statutory tariff levels was huge (IMF, 1992). Widespread under-invoicing of imports promoted a black market in foreign currencies.

By the mid-1980s, the net effects of these restrictive policies were visible (see Table 1). Per capita GDP was growing slowly due partly to sluggish growth in output and partly to rapid population growth, which reached 2.6 per cent a year in the late 1970s and early 1980s. It became clear to policy-makers and planners that sustainable development could not be achieved without substantial policy changes.

Economic Liberalisation

Trade policy, the foreign exchange market, investment policy (including foreign investment), and the operation of public sector enterprises were all reformed from the mid-1980s. The process of liberalisation in trade policy began from the mid-1980s by lowering tariffs, expanding the import-licence auction system, and increasing the number of items under the open general licence system. The number of commodities requiring import licences was reduced from 143 to twelve by mid-1992; licensing was finally ended in 1993/94. Since February 1993, the Nepalese currency has been fully convertible for all current-account transactions at market-determined exchange rates.

Attempts have been made to reduce the dispersion of tariff rates. Until the mid-1980s, there were more than 300 import duty rates, ranging from 1 per cent to 450 per cent. By the early 1990s the range had been reduced to between 5 per cent and 110 per cent. The 17 sales tax rates were reduced to four by 1991/92 and to two by 1993/94. Currently, sales tax rates are linked to import duty rates in the interests of making the trade regime more transparent. Similarly, the number of excisable products has been reduced from 33 to eleven, and the ranges of excise duties have been rationalised.

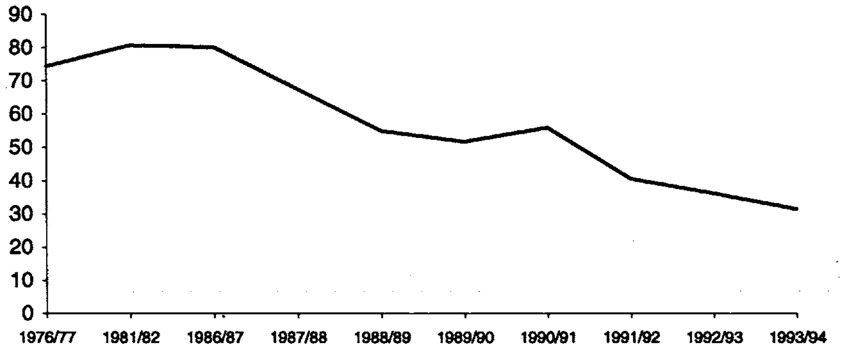
Additional duties on the imports from countries other than India were also cut to a range of 15–50 per cent by the early 1990s and to 3–12 per cent in March 1993. Additional duties on goods imported from member countries of the South Asian Association for Regional Cooperation are exempted at the rate of 10 per cent, while the difference between import duties on industrialists and those on traders has been abolished. A substantial fall in tariffs, sales tax and excise duties has resulted in a decline in the trade-weighted nominal rate of protection from about 80 per cent in the mid-1980s to about 31 per cent in 1993/94 (see Figure 1).

On the investment front, a liberal industrial policy was declared in 1987. This policy was designed to remove distortions by simplifying the registration procedures and extending incentives such as the provision of pre-export loans, duty drawback (import duty repaid to exporters) and bonded warehouse facilities to EOIs. Industrial registration and licensing procedures have been extensively amended. No licence is required for establishing, expanding or modernising industries, or, since

early 1996, for foreign investments of less than US$300,000, apart from those concerned with defence, public health and the environment.

Figure 1

Trade-weighted nominal rate of protection (%), 1976/77-1993/94



Notes: Imports from India are subject to lower protection than other imports, since they are subject to the basic tariff only, whereas imports from the rest of the world are taxed using the basic plus additional tariff. A single trade-weighted nominal rate of protection is obtained from the trade shares of India and the rest of the world.

Sources: Department of Customs and Department of Sales Tax and Excise Duty.

Finally, government interventions in production and trading activities have been gradually reduced by privatising state-owned enterprises and liquidating financially unviable enterprises. By 1993, two public corporations had been liquidated and eight enterprises privatised. The government is currently privatising cigarette and sugar factories operating in the public sector.

Liberalisation and Total Factor Productivity Growth

Total factor productivity (TFP) growth can be estimated in either value-added terms or output terms, which give similar results (Krueger & Tuncer, 1982). However, the latter approach, in which intermediate inputs are treated as a separate factor of production, is adopted here. Like many developing countries, Nepal relies extensively on imported intermediate inputs, whose availability substantially influences capacity utilisation and productivity growth. The pre-reform licensing system often prevented firms from importing sufficient inputs, leading to a lower level of output and poor capacity utilisation. Estimates of TFP growth based on gross output should capture the effect of changes in the availability of imported inputs on output and TFP growth.

TFP growth is defined as output growth minus the weighted average input growth where the weights are the value shares of each input. To estimate TFP growth, initial and terminal year observations were taken from each of the pre-reform and post-reform periods. The average of the factor shares in the first and the last year of each period was used to obtain the weighted average growth in factor inputs. This choice of measurement was guided mainly by the nature of data: for the pre-reform period, manufacturing data are available every five years, while for the post-reform period these data are available annually except for 1992/93.

To test the robustness of our results, TFP growth was estimated for both sub-periods, based on the growth rates obtained from two alternative techniques: (i) a regression, which uses all available observations, and (ii) the average of the first two years' and of the last two years' data. Applying the sub-periods' average factor shares, TFP growth was estimated from the growth rates obtained through method (i). To estimate TFP growth from the growth rates obtained through method (ii), the average of the first two years' and of the last two years' factor shares was used. The TFP growth estimates, based on the growth rates obtained from the initial and terminal year observations, do not significantly deviate from those obtained from methods (i) and (ii), indicating that the results are robust.

Table 2

Average annual percentage growth in output, weighted factor inputs and manufacturing TFP, before and after liberalisation

	Pre-liberalisation (1972/73-1986/87)			*Post-liberalisation (1987/88-1993/94)*		
	EOIs	ISIs	Total mfg	EOIs	ISIs	Total mfg
Output growth	12.23	0.68	1.72	16.98	8.99	10.83
Weighted material	5.07	-0.012	0.05	11.86	0.92	7.09
input*	(41.4)	(-1.7)	(2.9)	(69.8)	(10.2)	(65.4)
Weighted capital	3.60	1.29	2.17	10.95	1.06	3.53
input*	(29.4)	(189.7)	(126.1)	(64.4)	(11.8)	(32.6)
Weighted labour	0.11	0.53	0.46	0.12	0.80	0.62
input*	(0.9)	(77.9)	(26.7)	(0.7)	(8.9)	(5.7)
TFP growth**	3.45	-1.13	-0.96	-5.95	6.21	-0.41
	(28.2)	(-166.2)	(-55.8)	(-35)	(69)	(-3.7)

Notes: Following Nishimizu and Robinson (1984), industries are classified as either export-oriented industries (EOIs) which export more than 10 per cent of total production, or import-substituting industries (ISIs) which import more than 10 per cent of total domestic supply (imports plus domestic production minus exports).

*The percentage contributions of material inputs, capital, labour and TFP changes to output growth are given in parentheses.

**The most appropriate price indices for TFP growth analysis are the wholesale price indices (WPI). However, in the absence of WPI and the manufacturing GDP deflator in Nepal, the manufacturing price index (1992/93=100) was used, derived from the CPI.

Source: Central Bureau of Statistics (various years).

A marginal improvement in overall manufacturing productivity following a liberalisation program was detected (see Table 2). TFP improved from minus 0.96 per cent a year in the pre-liberalisation period to minus 0.41 per cent a year in the post-liberalisation period, providing some support for the notion that liberalisation results in productivity growth.[2] In the pre-liberalisation period, TFP growth was higher in EOIs than in ISIs, seemingly because of the latter's difficulties in obtaining imported inputs and slow growth in domestic demand, leading to excessive unused capacity. This was not a problem for EOIs as they were given import licenses on the ground that they earn foreign exchange. However, in the post-liberalisation period EOIs experienced a fall in productivity growth from 3.45 per cent a year in the earlier period to minus 5.95 per cent a year in the latter period, despite an increase in output. Meanwhile, the productivity performance of ISIs improved from minus 1.13 per cent a year to 6.21 per cent. This could be ascribed to enhanced access to imported inputs, leading to an improvement in capacity utilisation. However, capacity utilisation is still under 60 per cent in manufacturing, mainly because of shortages in electricity supply.[3]

In the post-liberalisation period, productivity improvements have occurred among both EOIs and ISIs. Productivity growth was higher in those ISIs that were least protected in the earlier period, with the exception of distillery and fruit canning. These ISIs comprised vegetable fats, grain mills, bakery products, animal feed, distilled products, bidi, wooden furniture, paper and paper products, printing, drugs and medicine, rubber products, structural clay and non-machinery fabricated metal. However, productivity declined in those ISIs that were highly protected, including the public-sector dominated sugar, dairy, textile, cigarettes and cement industries. Among the public sector dominated ISIs, only the drug and medicine industry, which had been less protected in the pre-reform period, recorded an improvement in productivity in the post-reform period. Furthermore, productivity improved by 7 per cent a year in the privatised footwear industry, which in the earlier period had been a loss-making public enterprise due to overstaffing and lack of competitiveness. This provides some support for the hypothesis that government intervention and high protection could lead to poor TFP growth in developing economies. Kajiwara (1994) finds similar results in the post-reform period for the Philippines.

Among EOIs, only knitting, leather and leather products, and jewellery recorded productivity growth in the post-reform period. The traditional garment and carpet EOIs, which contribute over 80 per cent of manufactured exports, experienced an absolute fall in productivity, apparently because of a shortage of skilled

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[2] Regime (1994) obtains similar results for the Nepalese manufacturing sector during 1972/73 and 1986/87. He observed the average annual growth of minus 1.68 per cent in TFP during this period. However, his estimates are based on the value-added production function and on the Indian WPI, which may have caused a small upward bias in his estimates.

[3] This is one of the problems currently faced by the manufacturing sector. As liberalisation occurred, demand for electricity increased as new industries came into operation and existing industries improved their capacity utilisation. But electricity supply is lagging behind the rising demand.

labour. This finding is similar to that of Okuda (1994), who finds negative TFP growth in Taiwan's clothing sector following liberalisation. Jute manufacturing also experienced a decline in TFP in the post-reform period.

Table 2 shows that capital input explains a major part of output growth in the overall manufacturing in the earlier period. This reflects the facts that industrialisation was supported in the form of subsidised credit and that import licences were often granted on the basis of installed capacity, creating an incentive for capital accumulation. Thus, capital input explains about 126 per cent of growth. The contribution of intermediate inputs was only about 3 per cent, which seems to be due to excessive restrictions in the imports of inputs. Labour input contributed about 27 per cent to growth, while the contribution of TFP growth was minus 56 per cent. However, this pattern has slightly changed in the latter period. Intermediate inputs explain about 65 per cent of output growth, which appears to reflect increased access to imported inputs following liberalisation. The contributions of capital and labour input to output growth had fallen to about 33 per cent and 6 per cent respectively. The declining share of labour input could be explained by the lower level of human capital and stringent labour legislation which made workplace dismissals more difficult. Furthermore, real wages have increased in recent years: the minimum real wages of unskilled, semi-skilled, skilled and highly skilled labour rose by 93 per cent, 75 per cent, 52 per cent and 29 per cent respectively between 1985 and 1992. Together, these factors seem to have contributed to a fall in the contribution of labour input to output growth. In a labour-abundant country like Nepal, however, it seems unlikely that output growth can be increased in the long term if the contribution of labour remains at around 6 per cent.

Conclusions

Although Nepal's overall manufacturing TFP declined both before and after the economic reforms of the mid-1980s, the smaller decline in the latter period provides some support for the claim that liberalisation may lead to higher TFP growth. However, its continued fall suggests that liberalisation is not a sufficient condition for rapid productivity growth in developing economies. Further labour market reforms, improvement in the level of human capital through aggressive training programs, and the provision of reliable infrastructure, such as electricity supply, may improve productivity growth. Nepal's lesson for low-income developing countries seems to be, then, that emphasis should be placed on infrastructure investment as well as on liberalisation. Without basic infrastructure, rapid productivity growth is unlikely to be achieved.

The reforms of the mid-1980s have had little impact on the macroeconomic front. The current account and budget deficits continue to deteriorate, while some improvements have occurred in international reserves and the ratio of exports to GDP. But these improvements have not come about as a result of a substantial improvement in manufacturing productivity growth. The rise in the ratio of exports to GDP ratio appears to be due to lucrative export incentives such as the generalised system of preferences, under which Nepalese exporters are given preferential

tariff treatment by developed nations. This is, however, not a reliable incentive and can be suspended at any time by the countries that implement it. Without a substantial improvement in manufacturing productivity, it is unlikely that Nepal would be able to maintain even a 7 per cent ratio of exports to GDP in the long run.

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REVIEW ARTICLES

The 'New Economics' of the Minimum Wage? Evidence from New Zealand

Tim Maloney

*David Card and Alan B. Krueger, **Myth and Measurement: The New Economics of the Minimum Wage**, Princeton University Press, Princeton, 1995*

THE publication of *Myth and Measurement: The New Economics of the Minimum Wage* has generated considerable interest among policy-makers. It was cited by supporters of the amendment to the US Fair Labor Standards Act raising the US minimum wage from US$4.25 an hour to $5.15 from April 1997. Equally, it has caused considerable consternation among many labour economists. For years, economists seemed to agree on at least one thing: that a rise in the minimum wage reduces employment among low-wage workers, particularly teenagers. This 'consensus view' has been contrasted with the results of public opinion surveys that often reveal support for increases in the minimum wage. Card and Krueger suggest that this favourable public sentiment may be warranted because a higher minimum wage could *increase* employment. So rather than condemning the public and politicians for their economic illiteracy, we should be chastising the economics profession for its overly simplistic theoretical models, its poor empirical methodology and its failure to evaluate honestly and objectively the empirical evidence in this area.

This article summarises and assesses Card and Krueger's analysis.[1] It should be noted at the outset that their work is almost entirely based on empirical findings from the United States. To bring more international evidence to bear on this topic, I present some econometric results from analysis of the adult and recently introduced teenage minimum wage in New Zealand. Both domestic and overseas research on the effects of the minimum wage has recently received considerable attention in New Zealand because of the 10 per cent increase in the adult minimum wage that came into effect on 1 March 1997.

[1] Readers are alerted to two sets of reviews of this book: by Ehrenberg et al. (1995) and Kennan (1995). See also Sloan (1996).

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'Myth'

The title of the book suggests that the economists' 'conventional wisdom' that the minimum wage reduces the employment of low-wage workers is a myth. Although this characterisation of the discipline's earlier research findings is technically correct, it is something of a red herring. Earlier research did show fairly consistent evidence of a 'disemployment' effect from the minimum wage. But the *magnitude* of this effect is relatively small. For example, Brown et al. (1982) conclude that a 10 per cent increase in the minimum wage reduces teenage employment by between 1 and 3 per cent, most probably in the lower part of this range. This is not a big employment effect, especially when the focus is on groups most likely to be directly affected by this legislation.[2]

Why are the employment effects of the minimum wage so small? The usual explanations cite three factors: incomplete coverage, tradeoffs in non-wage compensation, and non-compliance. In every economy, some workers are exempt from the minimum wage, such as those in industries or workplaces not covered by the federal minimum wage in the US, and small employers or the self-employed in all countries. In either case, workers displaced by a higher minimum in the 'covered' sector can find employment in the 'uncovered' sector; and the decline in aggregate employment is lessened if displaced workers are willing to work for lower wages in the uncovered sector. In addition, employers faced with a higher minimum wage may be able to contain their labour costs by reducing fringe benefits and other non-wage costs; any change in the composition of labour costs would curb any reduction in employment. Finally, the monitoring and enforcement of minimum wage laws has always been an issue. If some employers fail to comply with this legal requirement, the disemployment effect is weakened. So although the earlier literature suggests that the minimum wage reduces employment, this effect is relatively modest in size and pertains to only a small proportion of workers.

'Measurement'

Distributional effects. The strength of Card and Krueger's analysis lies in their use of a wide variety of data sources and estimation techniques to distinguish the different effects of the minimum wage in the labour market. Although the key to this work is new estimates on the employment effects, the authors also examine the impact of the minimum wage on earnings and income distributions and poverty rates in Chapter 9, and firm profits in Chapter 10. The results from these two chapters can be quickly summarised.

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[2] For example, suppose the recent 20 per cent increase in the US minimum wage reduces the employment of teenagers by between 2 and 6 per cent, as the earlier literature suggests. If there is no net impact of the minimum wage on adult employment, and teenagers comprise only 5 per cent of the workforce, this relatively large increase in the minimum wage reduces aggregate employment by between 0.1 and 0.3 per cent. This is easily within the margin of error of some sample statistics on aggregate employment.

Gramlich (1976) wrote the classic paper on the distributional effects of the minimum wage. Card and Krueger essentially update this earlier work with data through the early 1990s. They find results that are similar in spirit to those reported by Gramlich: an increase in the minimum compresses the overall wage distribution. What is interesting about these later results is that the 1990 and 1991 increases in the federal minimum wage reversed at least some of the rising wage inequality in the US during the 1980s. Of course, the effects of the minimum wage on family income and poverty are more tenuous, because not all low-wage workers live in low-income families and a large proportion of poor families have no labour market earnings. Card and Krueger admit that their results at best point to a 'modest poverty-reducing effect of the minimum wage' (p. 307). Even if there were no negative employment effects from the 1990 and 1991 increases in the federal minimum, at most 0.2 per cent of aggregate earnings would have been transferred to low-wage workers (p. 277). This work reinforces the image of the minimum wage as a relatively ineffective anti-poverty program.

Card and Krueger correctly state that most of the emphasis in the minimum wage literature has been on workers rather then firms. Yet increases in the minimum wage might reduce profits, which would presumably represent a transfer of wealth from stockholders to low-wage workers. The authors examined changes in the share values of firms that hire large numbers of workers directly affected by the minimum wage, seeking evidence of stock-market reaction to 'news' about impending changes in minimum-wage legislation. The results of this analysis are inconclusive: only weak evidence was found of small declines in shareholder wealth associated with reports about possible changes in the minimum wage. Although this approach is potentially useful, the authors struggle to convince the reader that they have identified the events that would constitute substantial shifts in the market's expectations about changes in the minimum wage. This is particularly problematic in the US, where the nature of the political system means that such expectations are likely to evolve slowly over time. Perhaps the parliamentary systems of Australia and New Zealand, where possible changes in similar legislation might not involve the same extended public discussions, could provide a better testing ground for these hypotheses.

Employment effects. The bulk of the book and the key to its success or failure consists of the evidence on the employment effects of the US minimum wage presented in Chapters 2 through 7. The idea the authors employ is a good one. Although one can find fault with almost any single approach, it is much more difficult to dismiss the results of a multitude of data sets and estimation techniques that point to the same basic conclusion. The authors seek to overwhelm the reader with evidence from various directions that points to the absence of a negative, and perhaps even the presence of a positive, employment effect from the minimum wage. The first results, the most important set of empirical findings in the book, are de-

rived from what the authors refer to as 'natural experiments' involving both state and federal increases in the minimum wage in New Jersey, Texas and California.[3]

The real value of the federal minimum fell steadily with inflation during the 1980s. In November 1989 Congress and President Bush agreed to raise this minimum wage from US$3.35 to $3.80 an hour on 1 April 1990, and again to $4.25 on 1 April 1991. The state of New Jersey increased its state-specific minimum to $5.05 on 1 April 1992. But the minimum wage in the neighbouring state of Pennsylvania remained at $4.25 in April 1992. Card and Krueger judged that this offered an excellent opportunity to study the effects of the minimum wage, with Pennsylvania serving as a 'control group' in their analysis.

Telephone surveys were conducted of 331 fast-food restaurants in New Jersey and 79 similar establishments in Pennsylvania. Managers in these restaurants were first interviewed in late February and early March 1992 (approximately one month before the implementation of the New Jersey law), and again in November and December 1992 (approximately eight months after). The 'conventional wisdom' would predict that the increase in the New Jersey minimum wage would reduce employment in this low-wage industry *relative* to that of Pennsylvania. Yet the authors found relatively weak statistical evidence in their regression analysis of the opposite effect: full-time equivalent employment in the New Jersey restaurants increased relative to their Pennsylvania counterparts.

This research has been subjected to essentially two lines of criticism, both of which are represented in the symposium by Ehrenberg et al. (1995). First, Finis Welch attacked the quality of the data. The survey instruments were poorly designed in some respects. Apparently, little thought was given to providing instructions and training to interviewers. The questions in the survey were somewhat confusing, and failed to solicit information on actual hours worked by employees. Managers were asked about their current 'full-time' and 'part-time' employees, although these terms were never defined. Since Card and Krueger had made the raw data available on the Internet, Welch was able to conduct his own analysis of the data. He found evidence of substantial measurement error in both the employment and the wage variables. Simple descriptive statistics like the extraordinary amount of variation across the nine-month period in the average establishment's employment level cast considerable doubt on the quality of these data and on the conclusions that can be drawn from them.

Second, Daniel Hamermesh took exception to the claim that the New Jersey study constituted any kind of 'natural experiment'. The legislation raising the minimum wage in New Jersey was passed in 1990, well before the 'baseline interviews' in early 1992. This first wave of interviews occurred so close to the implementation of this legislation that it would not be unreasonable to expect that New Jersey restaurants may have already reacted to the impending wage increase by this time. Moreover, the follow-up interviews were held only eight months after this rise

[3] Not all workers in the US are covered by the federal minimum wage. The remainder fall under state legislation. The state minimum wage takes precedence when it is above the federal minimum.

in the minimum wage. Insufficient time may have elapsed to observe any longer-run adjusts to this legislation. Finally, and most important, Pennsylvania was *not* an adequate control. Card and Krueger attribute *all* of the relative difference in employment growth between fast-food restaurants over this period to a single factor: differences in the effective minimum wage between the states. This is equivalent to saying that, in the absence of the rise in the New Jersey minimum, employment growth in this industry would have been identical in the two states. Although Card and Krueger make some attempt to control for regional effects within the states, they admit that localised demand shocks are exceptionally difficult to quantify. Proof of the importance of this issue might be gained by looking at differences in employment growth in this industry between neighbouring states that had the same minimum over the observation period. Who would expect not to find examples of large differences in employment growth in such a sample?

A second study was conducted using data on fast-food restaurants in Texas around the time of the April 1991 increase in the federal minimum wage. Card and Krueger found weak evidence of a positive employment effect in this study too. Restaurants that had to increase their starting wages by the largest amounts to meet the higher minimum wage experienced the largest increases in employment. The 'controls' in this natural experiment were the restaurants that paid starting wages that were initially above the new federal minimum. To a large extent, this work can be criticised for the same reasons given above for the New Jersey study. In particular, the relatively high rate of attrition (33 per cent) of restaurants between the baseline and follow-up surveys is troublesome. Again, key concepts, like 'starting wage', were never defined. The baseline survey (December 1990) occurred more than a year after the passage of the federal legislation. It is also strange that no attempts were made to understand why starting wages varied initially across restaurants. The source of this variation is the key to their analysis.

A third study involved the increase in California's state minimum wage on 1 July 1988 from US$3.35 to $4.25 an hour. This occurred nearly three years before the same increase in the federal minimum. Arizona, Florida, New Mexico and the Dallas-Fort Worth metropolitan area were used as controls. Card and Krueger found that the employment of California teenagers increased between 1987 and 1989 relative to that of the control group. Since the US economy was growing steadily during this period, it is again hard to say whether this result can be attributed to the minimum wage or the economic expansion. Moreover, when the authors focus on retail trade, where many low-wage workers are located, they find evidence of a negative employment effect. In the end, they conclude that the positive and negative employment effects cancel each other out. 'On balance, we believe that the evidence from California shows that the increase in the state minimum wage had ... no large or systematic effect on employment' (p. 110).

Chapter 4 uses cross-state variations in the effective minimum wage to isolate its employment effects. The idea is simple. The 1990 and 1991 increases in the federal minimum wage were more likely to reduce employment in low-wage states. No conclusive evidence was found of any effect of the federal minimum wage on teen-

age employment. The authors admit that they 'cannot rule out the possibility that the increase in the minimum wage had a small negative employment effect on teenagers' (p. 137).

Finally, Card and Krueger re-estimated earlier time series regressions in Chapter 6 with data through 1993. This time-series evidence was primarily responsible for the conventional wisdom that the minimum wage caused small employment losses. First, the authors discuss numerous methodological issues that confront this econometric work. They correctly state that the specification of the regression equation is somewhat arbitrary, and the results are often sensitive to the choice of both specification and estimation techniques. Second, they conclude that, since the statistical significance of the negative employment effects has not increased over time (as it should when sample size increases), this is evidence of 'publication bias': in other words, researchers and journals have chosen to report and publish results that are consistent with prior expectations that the minimum wage reduces employment. Third, the re-estimation of earlier regressions with more recent data shows disemployment effects that are smaller than those from past studies, and now statistically insignificant.

There is a simple alternative explanation for these last two conclusions. The effective minimum wage declined during the 1980s as it fell relative to the average wage. This by itself would mitigate any negative employment effects, and weaken the historical link between the minimum wage and employment. This is exactly what most labour economists would have predicted over this period. It also explains why the statistical significance of these results did not increase with sample size. In the end, it is not necessary to attribute this finding to publication bias. Even if researchers and journals had honestly reported their best estimates of these effects, the declining absolute values of these estimated coefficients may have more than offset the falling standard errors in these longer time series.

In summary, recent time-series and cross-state evidence is *not* inconsistent with a small negative employment effect from the minimum wage. Only the results from the 'natural experiments' suggest that the minimum wage might increase employment. Given the various concerns about this analysis, it would be reasonable to conclude from the totality of the evidence that the negative employment effects of the minimum wage might now be slightly smaller than we thought. This finding, however, is entirely consistent with a decline in the effective minimum wage during the 1980s.

The 'New Economics'

When I first scanned the Table of Contents of *Myth and Measurement*, I was struck by fact that the theory section appeared *after* the empirical evidence. The usual approach is to use theory to form a set of hypotheses that can be tested empirically. Instead, Chapter 11 offers an alternative theoretical framework as a sort of post-mortem on the failure of earlier empirical work to reveal evidence of the employment-reducing effects of the minimum wage.

Although this might seem surprising to those who have not read a labour economics textbook, theoretical models that predict positive employment effects from the minimum wage already exist. These involve 'direct productivity', 'shock' or 'monopsony' effects. The first model says that raising the minimum wage can increase both worker productivity and labour demand, thereby increasing employment. Such an effect is believed to be more relevant in less developed economies, where a higher minimum wage could lead to better nutritional and health standards. Card and Krueger link this idea to more recent efficiency-wage models that suggest that a worker's effort might increase with the wage he or she receives. Unfortunately, this has little to do with a universal rise in the minimum wage that doesn't create unemployment. The efficiency-wage argument rests on the notion that workers expend more effort if they receive a wage above what other employers are willing to offer. This is the 'penalty' associated with losing their current job.

The second traditional model involves the 'shock' to management when faced with an increase in the minimum wage. The idea is that there may be considerable slack in the organisation. When the minimum wage increases, the firm is forced to utilise its workforce more efficiently. If this shock effect is large enough, employment might increase. Although this model might better explain why the disemployment effects are relatively small, it has attracted little interest because it relies on firms forgoing potential profits without adequately explaining why this should occur.

Card and Krueger place most emphasis on the presence of monopsony effects. In the traditional 'static monopsony', there is a single employer in the local labour market. The firm knows that it has to pay higher wages to attract more workers. As a result, it operates 'inside' its labour demand curve. Since the firm can exploit its monopsony power to restrict both wages and employment, a minimum wage has the potential to increase employment. For lower levels of employment, the firm now does not have to pay higher wages to attract more workers. The minimum wage can nullify this monopsony power and force the employer to operate on its demand curve. Economists have generally argued that monopsonies are unlikely to be pervasive because of competitive pressures from a number of directions. The authors instead concentrate on a new 'dynamic monopsony' model. Due to imperfect information, all firms have some discretion over the wages they pay. Employers can reduce quits and increase hires by raising wages, but they will generally be reluctant to do this. An imposed minimum wage, on the other hand, allows them to fill their existing 'stock of vacancies' (p. 378). The result is an increase in employment for small increases in the minimum wage.

This dynamic monopsony model has not drawn a very favourable reaction from reviewers Kennan (1995) and Hamermesh and Welch (both in Ehrenberg et al., 1995). Nobody would dispute the fact that firms can have an impact on turnover by altering the wages they pay. However, these monopsony effects have to be underpinned by 'power' in the labour market. Thus, we come back to the traditional theory of static monopsony. Employment gains from an increase in the minimum wage should occur among employers who face very little competition from other employers.

This theoretical framework does have implications for the earlier empirical analysis in this book. If monopsonies are responsible for the positive employment effects of the minimum wage in the fast-food industry, this suggests where we should be looking for these effects. If the authors could show that their results are largely confined to small communities where teenage employment is concentrated among a few large employers, they would go a long way toward convincing the sceptical reader that they really have broken new ground. More important, the theory implies that 'causality' in this regression could be reversed. Card and Krueger interpret their results as establishing that firms that *must* raise their starting wages by the largest amount to meet the increase in the minimum wage hire more workers. Yet their theory says that employers could *voluntarily* raise starting wages when they want to hire more workers. Perhaps the theory section should have preceded the empirical analysis after all.

Recent Evidence from New Zealand

Chapter 8, on international evidence of the employment effects of the minimum wage, is one of the most disappointing in the book. The empirical results are largely confined to Puerto Rico, along with a couple of studies from Canada and Great Britain. Card and Krueger ignore a study by Gregory and Duncan (1991) on the small employment effects of comparable-worth legislation in Australia.

To add some additional weight to this international evidence, I provide some recent econometric results on the employment effects of the minimum wage in New Zealand. This is an extension of earlier work in this area (Maloney, 1995). New Zealand's minimum wage qualifies as a kind of 'natural experiment'. Until March 1994, the minimum wage covered only adults of age 20 or more. Exempt teenagers between the ages of 15 and 19 are used as the 'control group' in this analysis. Young adults between the ages of 20 and 24 serve as the 'experimental group'. We want to know whether increases in the effective minimum wage reduce the employment of young adults relative to that of teenagers.

Using quarterly data from 1985-93, Maloney (1995) found that a 10 per cent increase in the adult minimum wage reduced the employment of young adults by 3.5 per cent, and increased their unemployment rate by 3.5 percentage points. Even larger effects were found among young adults without school or post-school qualifications. The same increase in the minimum wage caused their employment to decline by 5.7 per cent and their unemployment rate to increase by 6.5 percentage points. In addition to this evidence of a direct, negative employment effect of the minimum wage on young adults, there was weak evidence of an indirect, positive employment effect on exempt teenagers. A 10 per cent increase in the adult minimum wage *increased* teenage employment by 6.9 per cent, and *reduced* their unemployment rate by 3 percentage points. Thus, there is at least some evidence that employers substitute relatively less expensive teenagers for young adults when the adult minimum rises.

One reason for this earlier study was the suspicion that the minimum wage may have increasingly important policy implications in the newly deregulated New Zea-

land labour market. Even though minimum wages have existed in New Zealand since the 19th century, they may have played a minor role compared with other wage floors established through a centralised wage-setting system. The Employment Contracts Act 1991 made compulsory unionism illegal and eliminated the awards system. Previous empirical evidence on the employment effects of the minimum wage has been largely confined to the highly decentralised US labour market.[4]

The econometric results reported here extend the earlier research in three ways. First, the data set is updated to include observations through the second quarter of 1996. Second, the specification of the earlier regressions are modified to address some of the concerns raised by Card and Krueger in Chapter 6.[5] Third, we allow for the implementation of a lower minimum wage for teenagers beginning in March 1994. This means that our 'control group' is now directly affected by this legislation by the end of our sample period. Since the teenage minimum was set at approximately 60 per cent of the adult minimum, we simply introduce a dummy variable for this change in policy.

Table 1

Changes in New Zealand's nominal and effective minimum wages, 1985-96

Date of legislated change	*Nominal adult minimum wage (NZ$/hour)*	*Ratio of adult minimum to aggregate mean wage*	*Nominal teen-age minimum wage (NZ$/hour)*	*Ratio of teenage minimum to aggregate mean wage*
Feb 1985	2.50	.313	-	-
Sept 1985	4.25	.502	-	-
Feb 1987	5.25	.482	-	-
Feb 1988	5.625	.467	-	-
May 1989	5.825	.448	-	-
Sept 1990	6.125	.430	-	-
March 1994	6.125	.408	3.68	.245
March 1995	6.25	.408	3.75	.245
March 1996	6.375	.403	3.825	.242

Sources: NZ Department of Labour; Statistics New Zealand, *Quarterly Employment Survey.*

[4] It is worth noting that the employment and unemployment effects of the minimum wage reported in Maloney (1995) were found to be nearly identical in the pre and post-ECA periods.

[5] Specifically, three changes were made to the specification of the employment equations in this new study. First, the dependent variables are now the natural logarithms of the employment-to-population ratios of the relevant age group. The earlier study had divided these employment propensities by those of older adults (aged 25 and over) as a control for unmeasured determinants of this behaviour. Second, both regressions are corrected for first-order autocorrelation. Third, age-specific educational enrolment levels are dropped from the list of regressors. Card and Krueger argue that enrolment rates are endogenous, and likely to be affected by the minimum wage.

Separate employment regressions were estimated for teenagers and young adults using quarterly data from 1985(4) through 1996(2). The dependent variables are the natural logs of the employment-to-population ratios for the two age groups. Our hypotheses are that the adult minimum wage should reduce the employment of young adults, and increase the employment of teenagers. The introduction of the teenage minimum wage should have a negative employment effect on this age group.

Table 2

Estimated determinants of age-specific employment propensities 1985:4-1996:2

Independent Variables	*Teenagers*	*Young adults*
Constant	-1.279	1.295**
	(1.190)	(.371)
Log of effective adult minimum wage	.245	-.377**
	(.311)	(.097)
Dummy for introduction of the teenage minimum wage	.008	---
	(.036)	
Aggregate unemployment rate	-.040**	-.024**
	(.006)	(.001)
Time trend	-.011*	-.007**
	(.007)	(.001)
Dummy for first quarter	-.016	-.000
	(.011)	(.005)
Dummy for second quarter	-.071**	-.023*
	(.012)	(.005)
Dummy for third quarter	-.079**	-.032**
	(.011)	(.005)
Number of quarters	42	42
R^2	.947	.964

Notes: ** Significant at a 1% level, two-tailed test. *Significant at a 10% level, two-tailed test.

Standard errors are in parentheses. Dependent variables are the natural logarithms of teenage and young adult employment-to-population ratios. The estimated coefficient on the log of the effective minimum wage is the cumulative effect from a second-order polynomial with three lags. The nominal minimum wage is divided by average wage from the *Quarterly Employment Survey.* Since the disturbances may be contemporaneously correlated, a seemingly unrelated regression estimation technique was used to improve the efficiency of the coefficient estimates. Both regressions were corrected for first-order autocorrelation. The nominal minimum wage was divided by the mean wage in the economy during that quarter, and the log of this effective minimum was used so that the coefficients can be interpreted as elasticities. The minimum wage was divided by the mean wage because it is believed that the 'relative' minimum wage affects employment. The alternative would be to deflate this nominal minimum wage by the CPI. The use of this alternative regressor does not affect the qualitative findings from these regressions.

The results from this estimation are reported in Table 2. The estimated impact of the adult minimum wage is negative and significant at greater than a 1 per cent level in the youth employment equation. This says that a 10 per cent increase in the

minimum wage now reduces the employment of young adults by almost 3.8 per cent. This effect is slightly larger than the one estimated in the previous study. There is no evidence of a similar negative effect of the adult minimum on our control group of teenagers. In fact, this estimated effect is positive, although insignificant at a 10 per cent level. Unlike the previous study, there is no statistical evidence here of any indirect effect of the adult minimum wage on teenage employment.

No evidence was found of any impact of the introduction of the teenage minimum wage on the employment of this age group. The estimated coefficient is positive, but insignificant. There are a couple of reasons why one might have anticipated this result. First, only nine quarters of data are currently available following the introduction of this teenage minimum. Not enough time has elapsed to identify any employment effect if it does exist. Second, this teenage minimum was set so low relative to the average wage that no such employment effect may exist at all. Table 1 shows this teenage minimum wage was slightly less than 25 per cent of the average wage in the economy. This is considerably lower than the effective minimum wage for teenagers in the US, which has ranged between 36 and 47 per cent of the average wage since the early 1980s.

As Card and Krueger and others have noted, the specification of the time series regressions is fairly arbitrary. There is no agreement about how the dependent and independent variables should be measured, or which explanatory variables should be included in these regressions. The issue here is one of 'robustness'. How sensitive are these basic results to different specifications of these equations? In other words, can the negative employment effects of the minimum wage for young adults be reproduced in a variety of settings?

Although the estimated coefficients on the minimum wage are somewhat volatile, their relative values are meaningful. In regression results not reported, various alternative specifications were used. The estimated effect of the adult minimum on youth employment ranged from around minus 0.1 to minus 0.4. At the low end of this range, the effect was no longer statistically significant. The estimated effect of the adult minimum wage on the employment of teenagers was even more unstable ranging from 0.4 to minus 0.1, but never statistically significant in any regression. Thus, if one chooses any single specification it is possible to produce results that would show no impact of the minimum wage on New Zealand employment. However, the *difference* between the employment effects for these age groups does show consistent evidence across specifications that the adult minimum wages reduces the employment of young adults *relative* to that of teenagers.

Conclusions

New Zealand provides a 'natural experiment' for estimating the employment effects of the minimum wage. Although the results reported above are far from conclusive, they suggest that increases in the minimum wage reduce the employment of the age group most likely to be directly affected by this legislation. Moreover, results reported in Maloney (1995) indicate that these disemployment effects are concen-

trated among the most disadvantaged within this age group, young adults with no school or post-school qualifications.

Myth and Measurement is ambitious in the sheer volume of evidence that it uses to isolate the effects of the minimum wage in the labour market. It demonstrates the potential advantages of using quasi-experimental data to answer these important policy questions. After careful examination, however, it fails to deliver sufficient evidence to overturn the cumulative results from past studies that point to the minimum wage having a small negative employment effect among low-wage workers. It certainly does not provide convincing evidence of a positive employment effect.

Moreover, the title of this book is misleading in purporting to offer a new theoretical framework from which the effects of the minimum wage might be viewed and its positive employment effects anticipated. Even worse, it attacks the credibility of recent labour market research. Yet the authors succumb to the ailments they claim to diagnose in the earlier literature. In the end, their empirical evidence does not support their most provocative conclusions.

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Irrational Expectations? John Quiggin's Critique of Microeconomic Policy in Australia

Fred Gruen

John Quiggin, Great Expectations: Microeconomic Reform and Australia, Allen & Unwin, Sydney, 1996

THIS is an important book. Its critique of microeconomic policy is rooted fairly and squarely in mainstream economic theory. This distinguishes it from a great many tirades against so-called 'economic rationalism'. It is also the first attempt by an able and informed economist to challenge the current conventional wisdom in the Australian economic policy debate about the desirability of microeconomic reform. Many Australian economists have studied individual issues associated with such reforms. But their contributions are mostly scattered. Quiggin's book provides the first overview of many key issues in the professional economic debate. Quiggin, a professor of economics at James Cook University, does not argue in a political vacuum: as he writes, 'it is, perhaps, impossible to undertake policy analysis in a way that is completely free of ideological preconceptions' (p. 64).

Quiggin's particular view is that 'the policy elite displays a clear consensus that microeconomic reform is both urgently needed and beneficial' (p. viii); 'the problem with the current Australian policy debate is not an excessive reliance on economics but the substitution of dogmatic precommitment for objective analysis' (p. ix)'. Primarily, 'Economic policy is based on a combination of *a priori* theory and an emotional rejection of the policies of the 1950s and 1960s' (p. 5). Quiggin tries to differentiate his critique from the considerable amount of root-and-branch criticisms of current economic policies that has been proffered by sociologists, political scientists and other social scientists: 'much criticism of current economic policy is based on nostalgia for the "good old days" of full employment and rapid growth without any clear analysis of what made those "good old days" possible' (p. 5).

My contention here will be that Quiggin is not wholly successful in differentiating himself from this literature; that he himself does not succeed in providing a convincing analysis of what made those good old days possible, how we could re-

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turn to them, or whether they truly existed.[1] On the other hand, I argue that Quiggin scores some telling points in his critique of the current policy consensus.

An Overview of *Great Expectations*

The first third of the book provides an historical discussion of microeconomic reform in Australia and internationally, an outline of the theoretical economic issues the author regards as relevant, and a discussion of the changing theories of government among mainstream economists: in particular, the move from the 'public interest' to the 'private interest' approach to government.

This is followed by the main section of the book. Eight chapters discuss various types of microeconomic reform, and deal with financial deregulation, airline deregulation, telecommunications, tariff reform, privatisation and private infrastructure, competitive tendering and contracting, and (relatively briefly) the Hilmer reforms.

The two concluding chapters occupy about one-eighth of the total space. They attempt to assess the benefits and costs of microeconomic reform, and make some final observations regarding competitiveness, choice, the intensification of work and the outlook for the future.

As Quiggin recognises, the most obvious omissions are labour market deregulation (which, he suggests, would require a different author) and changes in tax and welfare arrangements. Nevertheless, Quiggin is justified in arguing that he has given us an overview of some of the most important issues which arise in assessing microeconomic reform.

What Is the Counterfactual?

To assess the effects of microeconomic reform, we have to attempt to ascertain what would happen in its absence. Even where microeconomic reform has already taken place, it is often not possible to provide a conclusive assessment of its effects. Quiggin provides a schematic example of what we should be measuring or assessing (p. 203), reproduced here as Figure 1.

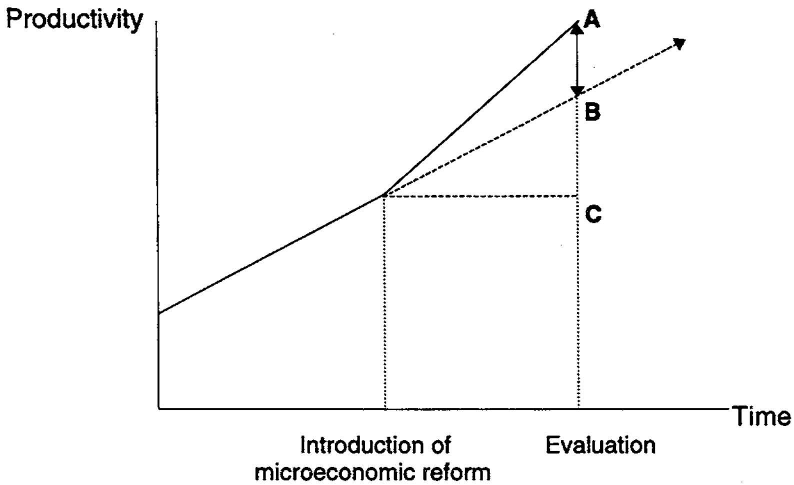
If there has been a steady increase in productivity before the introduction of microeconomic reform, the productivity gains attributed to the reform should be equal to AB. But occasionally gains equal to AC are attributed to the reform, as they are by the Industry Commission in its assessment of the benefits of microeconomic reform of the postal system, and by AUSTEL in its ascribing all price reductions in telecommunications to the benefits of competition, even though such reductions were frequent before any competition was introduced into the telecommunications industry.[2]

[1] One of the commentators on an earlier draft suggested that they were not in fact such 'good old days' since productivity growth was well below OECD norms for most of the post-war period.

[2] For references to these studies see Quiggin (pp. 203-4).

Figure 1

Counterfactuals and the evaluation of microeconomic reform



In fact, the real world is usually not so simple that one can project past productivity (or price) trends and argue that this is what would have happened in the absence of some type of institutional reform. After all, mechanical projection of past trends is basically an admission of ignorance.

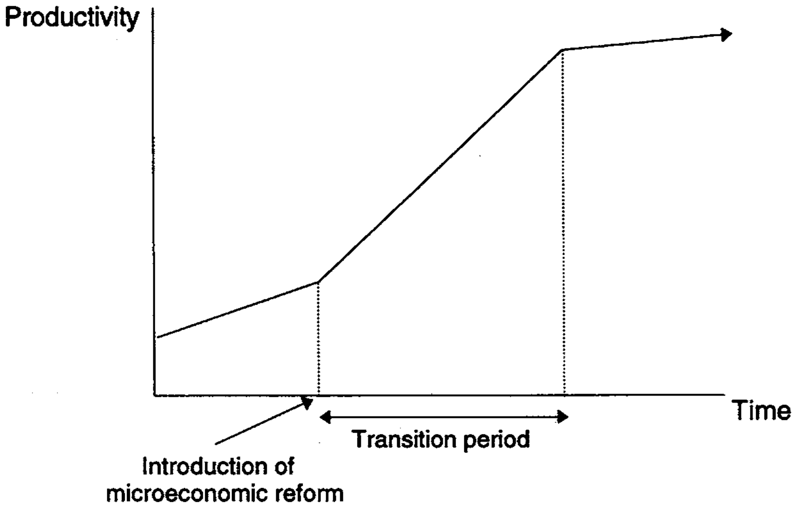
This is not to deny the validity of Quiggin's basic point: namely, that it is necessary to examine what would have happened in the absence of some institutional change in order to assess what the likely effects of the institutional change under consideration are likely to be. Past changes in prices and/or productivity are obviously relevant; on the other hand, so is other suggestive evidence (such as international comparisons). On the whole, Quiggin seems reluctant to use international comparisons and tends towards too mechanical a use of projection of past trends.[3] In most cases it will not be possible to arrive at completely clear-cut quantitative assessments of the effects of an institutional change such as the introduction of microeconomic reform. We cannot usually conduct controlled experiments in the social sciences to settle such matters beyond reasonable doubt.

However, it would have been useful if Quiggin had made a couple of other important distinctions. Under what conditions would one expect institutional changes to have primarily level effects with little or no effect on the longer-term growth rate (as shown in Figure 2)?

[3] There is also relatively little reference to the work on international benchmarking by the old Bureau of Industry Economics (BIE). This was quite a distinctive and useful contribution which may suffer from the dismantling of the BIE and its incorporation in the new Productivity Commission.

Figure 2

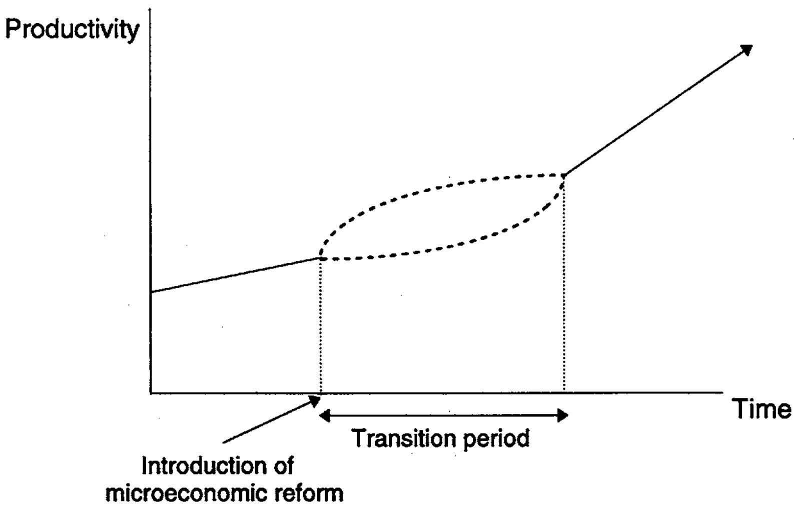
Microeconomic reform and the level of economic output



Thus, one would expect the Hawke Labor Government's attempt to remove excess labour from the Australian waterfront in 1989 to have had primarily such level effects. As suggested later, those who regard trade liberalisation as primarily a resource allocation issue (as does Quiggin) should also believe that it primarily has level and not long-run growth effects.

Figure 3

Microeconomic reform and the transition period



Again, after the introduction of microeconomic reform, there is often a period of heightened uncertainty and increased and unsustainable competitive pressure before those in the industry become familiar with the new rules and with what is now practical and profitable. For example, after financial deregulation and airline deregulation (especially in the US) quite some time elapsed before the longer-term effects of microeconomic reform became clearer.

This heightened uncertainty is shown in Figure 3 by the oval dotted line for the transition period. For this period it is difficult, if not impossible, to forecast productivity developments. After the transition period, the productivity growth rate can be expected to rise above the previous rate. Ideally, an assessment of the impact of microeconomic reform should consist of an examination of both the transition and the longer-term effects.

Shonky Quantification

The quantification of the benefits of microeconomic reform got off to a bad start when the first systematic program for microeconomic reform in Australia was presented in *Australia at the Crossroads: Our Choices to the Year 2000* by Kasper et al. (1980). These authors contrasted alternative paths which they called 'mercantilist' and 'libertarian'. The mercantilist path would produce a per capita GDP growth rate of 1.7 per cent a year over the period 1973-2000, while the libertarian path could be expected to more than double this to 3.8 per cent a year, implying a cumulative gain of 77 per cent relative to the base scenario. These figures were picked out of thin air, using selective international comparisons. Quiggin is kinder in saying they were based 'on judgement rather than formal modelling' (p. 200).

Since then, a plethora of models of the effects of microeconomic reform has appeared, often using ORANI or other general equilibrium models. One problem with these models is that they require a large number of guesstimates of the numerical values of the many parameters which are used to grind out final numerical results of the effects of particular types of microeconomic reform. The most professional outside review of ORANI concluded, a decade ago, that 'the likely variation in parameter values is such that ORANI should always be subjected to some sensitivity analysis' (Pagan & Shannon, 1987).

To the best of my knowledge, no sensitivity analysis using ORANI has been published by the many agencies cited by Quiggin who have used ORANI to examine the effects of microeconomic reform (such as the Bureau of Industry Economics, the Business Council of Australia or the Industry Commission).[4] This is despite the fact that the Industry Commission, at least, has drawn attention, in its 1989 study on the electricity supply industry, to 'the limitations of the model and the un-

[4] However, the EPAC study of the economic effects of microeconomic reform, which used the then recently developed AEM-CGE model, employed sensitivity analysis for some impact parameters (Filmer & Dao, 1994).

certainties of the data base' on one occasion when ORANI results clashed with its *a priori* expectations (quoted in Quiggin, p. 209).

As a result, the estimated benefits from different types of microeconomic reform are subject to a very wide margin of error. For instance, the Industry Commission estimates the direct and final benefits of the Hilmer reforms at 2.3 and 5.5 per cent of GDP, while Quiggin's estimates are around a third and a tenth of those respective gains (p. 214). I am not in a position to adjudicate between these widely different estimates, but I suspect that the two estimates might represent upper and lower bounds.

One reason why I am inclined to treat Quiggin's estimates of the benefits of microeconomic reforms as lower-bound estimates concerns his treatment of the gains from lowering tariffs and border protection generally. Here, Quiggin relies on Harberger triangle estimates which suggest that a 40 per cent tariff is associated with a decline in GDP of around 1–3 per cent (p. 134).[5] If tariff reduction is associated with an increased dispersion of rates (as it was in Australia from the mid-1970s to the early 1990s), tariff declines on average can even be associated with *declines* in GDP (p. 137).

From the late 1950s to the 1970s, a variety of relatively new perspectives came to suggest that the allocative efficiencies at the heart of traditional economic analysis were only a part — and possibly quite a small part — of the productive benefits of market competition and trade. These perspectives raised the prospect that the greatest gains from trade liberalisation might come from X-efficiencies, scale economies, lower rent-seeking expenditure and dynamic economies associated with knowledge creation through learning by doing and research and development (Abramovitz, 1956; Solow, 1957; Arrow, 1962; Leibenstein, 1966; Vernon, 1966; Krueger, 1974).[6]

While Quiggin mentions the thesis that there may be both dynamic and X-efficiency[7] gains associated with the move to free trade, he tends to dismiss both (pp. 128-30); but, later, he is concerned that 'the extent of intra-industry trade remains a puzzle for trade theorists, and there is no general agreement on how it should be modelled' (p. 138). Intra-industry trade is particularly relevant to the assessment of trade liberalisation, since it expands greatly when trade restrictions are removed and may hold the key to the typical adjustment process of an industry subjected to reduced protection.

[5] Dani Rodrik (1996:14) recently argued, 'In traditional economic theory trade restrictions have *level* effects but no growth effects. That is a 20 per cent tariff may reduce real income by, say, 0.5 per cent of GDP (permanently), but it will not affect the economy's long run growth rate'. Rodrik qualifies this statement with respect to endogenous growth theory. To my mind, another important qualification is that, after trade liberalisation, governments generally cease to cushion industries that find themselves under stress. That, after all, was originally a major rationale for 'made-to-measure' protection.

[6] I am indebted to Nicholas Gruen for making this point in one of his unpublished papers.

[7] X-efficiency theory presents a line of reasoning differing from standard economic theory by relaxing the maximising behaviour assumption, as a result of either inertia, discretion or incomplete contracts. See Leibenstein (1966).

Finally, Quiggin falls back on casual empiricism of a kind which might even be labelled 'shonky quantification': 'Experience since the move to free trade has done little to support optimistic predictions of large dynamic gains' (p. 138). A recent EPAC (1996) study, published perhaps too late to be considered fully in Quiggin's book, uses cross-country regressions with 14 OECD countries and suggests that Australia's previous and announced tariff reductions could be expected to increase GDP by around 15 per cent by 2020: nearly 0.5 per cent in annual per capita GDP over the period 1990-2020. As with most empirical work of this kind, one can find reasons for dismissing the numerical estimates. The point to be made here is that such empirical estimates are as suggestive as is theoretical reasoning based on comparative static models: models which we know to be incomplete in explaining the real world. Needless to say, even if the EPAC (1996) estimates are near the mark, they could still be swamped by other changes in economic performance and would thus not be noticeable if one adopts the type of casual empiricism which Quiggin displays in the above quotation.

Quiggin is, however, on firmer ground when he disputes the widely cited Prices Surveillance Authority estimate that the real cost of air travel has declined by some 24 per cent since airline deregulation. While this is what has happened to the average revenue per passenger kilometre, that measure is not a normal price index like the CPI or the GDP deflator. According to Quiggin, what has happened is that discount fares have fallen substantially (by 18 per cent), and now account for some 70 per cent of all tickets sold (compared with 45 per cent before deregulation), while normal economy and premium fares have risen by some 10 per cent in real terms. Averaging all this out suggests that average real airline prices have changed only modestly since airline deregulation.[8] But, with the large growth in discounting, the choices of those flying have greatly increased, though hardly anyone in the Australian microeconomic debate evaluates these policies in terms of the increased freedom they can produce. As Quiggin maintains elsewhere,

> The advocates of microeconomic reform have shown surprisingly little concern with designing reform in a manner that maximises the benefits in terms of consumer choice ... For example the deregulation of shopping hours and liquor licensing over the past 20 years has greatly expanded the freedom of choice available to consumers. Yet it has taken place largely independently of the microeconomic reform movement. (An exception is Hogbin, 1983.) (pp. 225-6)

Microeconomic Reform, Income Distribution and Employment

Economists used to attempt to avoid interpersonal comparisons. The literature told us to advocate policies only in cases where one could make Pareto improvements:

[8] Using the Laspeyers price index, Quiggin suggests an increase of 2 per cent; using the Paasche index, it becomes a 4.5 per cent decrease.

that is, changes which made at least one person better off and no one worse off. Unfortunately, few, if any, policy changes could be advocated under such a severe constraint. The Kaldor-Hicks criterion advanced in the 1930s argued, plausibly in my view, that economists should also recommend policies which produced *potential* Pareto improvements — policies which raised aggregate real incomes sufficiently so that gainers could potentially be made to compensate losers with something left over.

At least until the early 1970s, this seemed a sensible criterion. During the long post-World War II boom, most Western countries enjoyed full employment, and income differentials were generally declining. While no attempt was made to compensate everyone for any government action which might have affected them adversely, most people's real incomes were increasing fairly steadily; even if, occasionally, some were adversely affected by particular government policies (such as the lifting of import restrictions in the early 1960s).

Quiggin objects to the exclusive concentration on efficiency in the microeconomic reform literature and to the corresponding neglect of equity (and employment) considerations. Such concentration has been broadly justified on two grounds: (i) that equity is difficult to define (and, one might add, it is often defined in such contradictory ways that it is impossible to meet the various conflicting criteria at the same time); and (ii) that greater efficiency, once achieved, implies a greater capacity to do more about social justice, poverty, community objectives, and so forth. 'In practice, advocates of microeconomic reform undertaking analysis of any policy issue tend to assume that equity will be dealt with "somewhere else"' (p. 45).

Redistribution 'somewhere else' in practice means through the tax and welfare systems. Given that such redistribution is costly, Quiggin makes the eminently valid point that 'redistribution through pricing [for example, in telecommunications] should be pursued up to the point where the marginal cost, in terms of efficiency losses, is equal to the marginal efficiency cost of pursuing redistribution through the tax-welfare system' (pp. 120-1). In other words, once it is accepted that redistribution is not costless, the complete separation between efficiency and distributional criteria cannot be justified. Again, in a world where there is a good deal of unemployment and underemployment and where there is evidence that such slack labour markets are not wholly the result of labour market rigidities (Cross, 1995; Ball, 1996), microeconomic reform measures leading to more short-run unemployment should not be evaluated purely on the basis of any efficiency improvements which have been achieved. Evaluations in terms of efficiency alone implicitly assume that workers displaced during microeconomic reforms are able to obtain alternative jobs. Quiggin cites a 1993 ABS survey originally provided in evidence to an Industry Commission inquiry to the effect that some 50 per cent of Victorian workers made redundant by reform were still unemployed three years later. As labour's share of output in the economy as a whole is around 70 per cent, this suggests that 35 per cent of the total productivity gains from microeconomic reform will be lost as a result of labour force withdrawal (p. 213).

Privatisation and the Equity Premium Argument

Quiggin argues against privatisation on a number of grounds, but

> by far the most important ... is the equity premium. Because the rate of return demanded by holders of equity is well above the government's cost of funds, a sale at full market value will, other things being equal, leave the public worse off. (p. 159)

The equity premium argument has been around at least since a seminal paper by Mehra and Prescott (1985) suggested that the average real rate of return on American equities (over a period of some nine decades) has been 6 percentage points higher than the risk-free average real return on bonds.[9] The equity premium is too big to be explained by plausible levels of risk aversion, suggesting that private capital markets are unable to diversify risks efficiently.

This does not seem a valid argument against the privatisation of the Australian National Line, the Commonwealth Bank, Telstra or other government agencies. First of all, there are other, important, considerations dealing with the relative virtues of public versus private ownership which seem of major importance in deciding this issue. Thus, some commentators have reluctantly qualified their support for public enterprise because of endemic and chronic problems of overstaffing and unprofitability in many cases (see for example Rowthorn, 1989). Second, there is still a good deal of argument about the statistical validity of the equity premium argument across the world's major equity markets — even though it may be true for US equity markets. Third, even if the argument is sound, does it follow that governments should hold equities in the proportion in which a particular government has inherited them? If there is a general equity premium, it is an argument for governments selling bonds and investing the proceeds in a fairly wide spread of equities, rather than concentrating equity holdings in some very specialised equities which history (or certain political leaders such as King O'Malley) has bequeathed to these governments. Again, if there is a general equity premium, it may be sensible for central banks to hold some part of a country's external reserves in the form of equities rather than either foreign exchange and/or foreign fixed-interest securities.

The privatisation of infrastructure raises further issues over and above those arising from the privatisation of such government enterprises as the Commonwealth Bank. In particular, infrastructure projects such as roads often form part of a network. In such cases, as Quiggin points out, 'The risk associated with many infrastrucure projects depends more on public policy decisions than on the management skill of the operator ... [as a result] ... [t]he private operator must either demand a large risk premium in addition to the usual equity premium, or must demand guarantees of favourable treatment' (p. 166). It appears that both the Sydney Harbour tunnel and the Melbourne CityLink road are examples of private operators receiving such favourable treatment. It is difficult not to agree with Quiggin that

[9] For a recent summary of the debate, see Kocherlakota (1996).

'many current proposals for private sector involvement in infrastructure provision appear to be generated by the inappropriate incentives associated with global borrowing limits' (p. 171) rather than by an in-principle decision that private-sector ownership and operation of a given infrastructure project is socially optimal.

Where Does Quiggin Stand?

Enough has been said to give a broad flavour of Quiggin's critique. This account might lead the reader to believe that Quiggin is opposed to most microeconomic reform. But this is not the case.

Quiggin is opposed to turning the clock back and abandoning microeconomic reform:

> ... it is difficult to sustain the view, implicit in much criticism of 'economic rationalism', that microeconomic reform has caused large reductions in social welfare. *The major economic factors reducing social welfare over the past 20 years have been the slowdown in productivity growth and the rise in large scale unemployment. These developments have been common to the majority of OECD countries, including those that have undertaken no systematic program of microeconomic reform.*
>
> The primary contributions of microeconomic reform to higher unemployment in Australia have been indirect ... *although the benefits of microeconomic reform have been systematically overstated, they are still positive and significant in many, perhaps most, cases.* (p. 222, emphasis added)

Given that the benefits of many, perhaps most, examples of microeconomic reform are 'still positive and significant', one might puzzle about Quiggin's earlier statement that the Australia's policy debate has substituted 'dogmatic precommitment for objective analysis'. On the other hand, it is hard not to agree with Quiggin that, in the case of natural monopolies in such areas as road and telecommunications networks and other infrastructure services, the pendulum has now swung too far against government and in favour of simplistic *laissez faire* remedies. As Krugman (1994:181) puts it, 'markets are not magical. They can work well when conditions are right, but leaving a natural monopoly free to do its worst is blind ideology'.

Quiggin rightly draws our attention to some examples of waste currently incurred in the name of microeconomic reform. Prominent among these is the duplication of networks by the present telecommunications duopolists, Telstra and Optus. According to *The Australian Financial Review* (23 November 1996, p.13) some $4 billion has been spent on this virtual duplication exercise with a good deal more to come in capital cities such as Adelaide, not to mention further duplication of existing networks in Sydney, Melbourne and Brisbane. One of the main findings of King and Maddock (1996:3) is that 'national competition policy does not eliminate the desirability of some regulatory controls over infrastructure industries; access to essential infrastructure does not guarantee and, by itself, is unlikely to achieve any significant improvement in economic efficiency; reliance on access

terms which are negotiated privately ... cannot be expected to produce any significant improvement in the wellbeing of final consumers'. In other words, while microeconomic reform is a useful tool in our armoury, it is neither a cure for all our microeconomic problems, nor can we be sure that what is simplistically promulgated as 'microeconomic reform' will always live up to its name.

Yet I am not convinced by Quiggin's claim, quoted earlier, that current economic policy is based primarily on a combination of *a priori* theory and an emotional rejection of the policies of the 1950s and 1960s. There were some good reasons why economists in the later 1960s and early 1970s started to doubt that stimulatory macroeconomic policies could always be relied on to solve growing unemployment. In most OECD countries, the Phillips curve trade-off between inflation and unemployment seemed to become more and more unfavourable. It was the experience of these years which convinced the economic policy establishment to take microeconomic issues and 'supply-side economics' more seriously. After all, the committed anti-Keynesians of their day (such as Milton Friedman and Friedrich Hayek) had begun to propagate their message a couple of decades earlier — with relatively little effect on the policy establishment.

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Measuring Economic Freedom and Assessing its Benefits

David Henderson

James Gwartney, Robert Lawson and Walter Block, ***Economic Freedom of the World, 1975-1995****, The Fraser Institute, Vancouver, 1996*

THOMAS CARLYLE, in a memorable and much-quoted phrase, once described economics as 'the dismal science'; and this is indeed an appropriate label, in so far as the subject places a good deal of emphasis on scarcity — on the limitations of economic systems, and hence the inescapability of hard choices. But in another respect economics can be described as a heartening subject, since another of its distinctive messages is that two widely accepted values, prosperity and individual liberty, are not only compatible but mutually reinforcing. This has been part of the representative economist's view of the world ever since Adam Smith advanced so brilliantly the thesis that the wealth of nations would be furthered by what he termed 'the system of natural liberty'.

Within the economic sphere, individual liberty has several aspects. It includes the freedom of people to spend their money as they wish, and to choose their lifestyles, occupations and places of work. For both individuals and business enterprises, it involves freedom to decide how to invest their resources, and which products and services to offer for sale and on what terms. Further and not least, it embraces the right of people and businesses to move freely within national boundaries, and to choose where to live and to operate; and this latter freedom holds good even when, as in federations, there are politically significant geographical divisions. All this enters into the conception both of a free society and of a well-functioning market economy: the two go together. Freedom of action makes it possible for market initiatives to be taken and responses to be made, while these in turn provide the means through which freely chosen and freely exercised preferences can be given effect.

The Economic Freedom Index

This broad conjunction of economic freedom and material prosperity is one of the twin themes of the study under review, which presents, in readable and accessible form, the fruits of an ambitious long-term collaborative research venture. The first

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and principal theme of the book is an exercise in systematic measurement of the changing estimated extent of economic freedom across the world over a period of two decades. For 102 countries, and (where possible) for five separate years over the period 1975-95, various measures are developed to show the prevailing extent of economic freedom. These are brought together, in three different illustrative systems of weighting, so as to establish for each country, for as many of the five years as the data permit, an overall Economic Freedom Index. The countries are drawn from all regions of the world, though two notable absentees from the list, because of data limitations, are China and Russia.

Seventeen separate indicators of economic freedom were chosen (though for three of them data were available only for recent years). These are grouped under four headings: money and inflation ('Protection of money as a store of value and a medium of exchange'); government operations and regulations ('Freedom to decide what is produced and consumed'); takings and discriminatory taxation ('Freedom to keep what you earn'); and restraints on international exchange ('Freedom of exchange with foreigners'). In the particular weighting system which the authors prefer, the respective weights under the four headings, expressed as percentages, are 15.7, 34.6, 27.2 and 22.5.

The introduction and the first three chapters of the book, some 90 pages in all, are devoted to explaining the Economic Freedom Index and presenting the main results, while the final (fifth) chapter, of 118 pages in all, gives useful two-page summaries for 58 of the 102 countries (I would have preferred a wider coverage here). Two appendices, amounting together to a further 80 pages, give further details of the underlying data that were used. In the midst of this statistical evidence and commentary for particular countries, and drawing on the results, is Chapter 4, which is just over 20 pages long. This develops the second main theme of the study, namely, the links between the level of economic freedom attained and changes in this level on the one hand, and the past and current growth of output per head in these countries on the other. It thus reviews the connection between freedom and prosperity, as evidenced by what comes out of the main exercise.

Although the final responsibility for the text rests with the three coauthors, they were able to draw on a substantial team effort which goes back several years. The study is described as 'an outgrowth of a series of six conferences jointly sponsored by the Fraser Institute of Vancouver, British Columbia and the Liberty Fund of Indianapolis, Indiana' (p. xiii). A list is given of 62 participants in this series of conferences, drawn from (on my count) 13 different countries, though with a strong preponderance of Americans (42) and Canadians (8). (There is no one in the list from either Australia or New Zealand.) Final publication was by the Fraser Institute, but ten other market-oriented private research institutes around the world, including the Institute of Public Affairs in Australia, are listed as copublishers. The back page quotes tributes to the book from three Nobel prizewinners in economics: Gary Becker, Douglass North, and Milton Friedman who has been an active participant in the whole program and receives a special acknowledgement in the authors' preface.

As one would expect from the list of participating individuals and institutions, the viewpoint of the book, and its treatment of policy issues, is that of classical liberalism: progress is seen in terms of curbing the interventionist activities of governments. Now and then, chiefly in the brief comments on individual countries, the tone becomes rather trying — 'The sooner Bolivian policy makers understand this point and begin to act accordingly, the brighter the future for this troubled economy' (p. 121) — but this hortatory aspect is incidental only. The book is best seen and judged as a contribution to recent quantitative economic history.

Despite the important place which it implicitly holds in the characteristic economists' view of the world, the notion of economic freedom has been given surprisingly little explicit and systematic attention. The program of work that has led up to the publication of this book, as also the book itself and the analysis that it offers, are therefore to be welcomed. Not surprisingly, however, there is room for doubt over both the approach that is taken here and the actual results of the exercise.

The Australian and New Zealand Cases

Some of the reasons for doubt can be illustrated by looking at the numerical results in the particular cases of Australia and New Zealand. For both countries, the overall Economic Freedom Index, taking the weighting system which the authors prefer, is higher for 1995 than for 1975, with the increase for New Zealand (from 4.3 in 1975, out of a maximum of 10, to 8.0 in 1995) being substantially greater than for Australia (from 5.0 in 1975 to 6.8 in 1995). This broadly conforms to what one would expect, since in both countries there have been significant market-oriented changes in policy, which generally speaking have been more far-reaching in New Zealand. However, a closer look at the two series brings out some surprising and questionable features.

For Australia, the timing of the changes in the Economic Freedom Index looks strange. Along with other observers of the Australian scene, my version of events holds that the most notable moves towards liberalisation on the part of federal governments dated from the mid- to late 1980s. The main developments were the floating of the exchange rate at the end of 1983, the radical freeing up of financial markets which accompanied and followed this, the tax reforms of 1986, the substantial deregulation of direct foreign investment in general over these years, the decision of 1988 to set in train a progressive reduction of tariffs, and the readiness as from 1987 to engage in asset sales and privatisation of government-owned enterprises. All these embodied significant changes in the orientation of economic policy. (This view of the past is sketched out further in Henderson, 1995). As compared with this Hawke-Keating period, both the Fraser period from 1975-83 and the first half of the 1990s appear as phases in which the impetus to economic reform was weaker. It is therefore odd to find that the evolution of the index for Australia goes as follows: 5.0 for 1975; 5.5 for 1980; 5.9 for 1985; 6.0 for 1990; and 6.8 for 1995. Of the total increase in the rating of 1.8 points between 1975 and 1995, 1.3 points are thus attributed to 1975-80 and 1990-95, compared with only 0.5 points for the decade of the 1980s, almost all of it attributable to the first five years.

Detailed study of the figures renders the differences between these two views of past events clearer. For one thing, in Australia (and New Zealand too) the authors' rating for 1995 is raised by the inclusion of three new items, two of which do not previously appear while the third is included only from 1990. Hence the overall index as quoted is not consistent over time, and because of this the improvement for 1990-95 may well be overstated. Second, the decision to evaluate policies only in terms of measurable outcomes means that policy changes as such, even when they appear historically significant, do not count. A good instance is the New Zealand Fiscal Responsibility Act 1994, which does not enter into the rating here; and in Australia, the rating for 'taxes on international trade' stays the same for 1980, 1985 and 1990, even though the orientation of trade policies changed markedly. Third, the Fraser Government gets credit for 1980, as compared with 1975, for (i) reducing the variability of inflation, and still more for (ii) apparently establishing, in the period 1978-80, 'freedom from government policies and regulations that cause negative real interest rates'. By contrast, Australia loses marks, as between 1985 and 1990, for a higher rate of growth in the money supply. Fourth, throughout the period, from 1975 onwards, Australia is awarded 10 out of 10 for (allegedly) permitting freely both the ownership of foreign currency and the ownership of a bank account abroad; but as these freedoms effectively date from the abolition of exchange control after the end of 1983, the sequence of ratings here is misleading.

In the case of New Zealand, it is surprising to see that the rating in respect of 'government enterprises' stays the same (at 6 out of 10) for the whole period 1975-90, despite the reforms of state enterprises following the Act of 1986 and the subsequent privatisations (which, however, probably explain the improvement to 8 out of 10 in 1995). More worryingly, there seems to be no allowance in the index for the passage of the Employment Contracts Act 1991, which is arguably the most significant liberalisation to be carried out with respect to labour markets in any country of the world during these two decades.

Three related general morals can be drawn from these specific instances. The first and most mundane is that a lot more work needs to be done on individual countries, with a view to getting facts, figures and history more clearly established. Despite the time and effort put into arriving at the measures presented here, major questions of accuracy, relevance and interpretation remain. To deal with these effectively would mean extending the range of expertise, impressive though it is, that is to be found in the individuals and institutions that have produced the present study. A closer look needs to be taken at particular cases, preferably with the participation of national and international officials as well as people in universities and research institutes, and with a wider geographical spread of first-hand knowledge.

Second, the question of what should enter into an index of this kind remains debatable. One issue, as noted above, is how exclusively the index should reflect actual developments that can be measured, as distinct from statements of policy and intention, or changes that are not easily mirrored in official statistics. A further issue, not surprisingly, is coverage: the present list of indicators makes no explicit reference to freedom of contract in labour markets, or to freedom of choice and the extent of

competition with respect to purchases of health and education services. For these and other reasons there is scope for devising and trying out alternative measures.

Third, the questions of measurement and definition are themselves linked to the more fundamental issue of how economic freedom is to be viewed and defined. In the project of which this book forms part, a good deal of time and thought has gone into exploring these matters, most notably in a number of essays by Alvin Rabushka (Block, 1991). But in my view the whole subject area needs to be treated more fully, with a stronger contribution from both historical and philosophical thinking.

One aspect of clarifying further the notion of economic freedom is to examine more closely some borderline issues and cases, where informed observers who broadly share the same point of view may find themselves in disagreement. Examples of such issues are anti-trust action and merger control, legal protection for patents, insider trading on financial markets, and collective action to improve environmental outcomes. The Fraser Institute program has not, I think, been able to go into such debatable areas, and indeed it is not clear from the present volume how a country would qualify to earn and keep a rating of 10 out of 10 for its Economic Freedom Index.

In the same way, the discussion in Chapter 4 of this book, of the relation between economic freedom and the level and growth rates of income per head, deals with general aspects to the exclusion of more debatable cases and episodes. So far as it goes, the analysis is sound and well presented. The evidence from the country measurements is marshalled so as to bring out two relationships in particular: (i) persistently high freedom ratings go with prosperity, and persistently low ratings with low levels of income per head; and (ii) increases in the Index have been linked to good or improved growth performance, as contrasted with bad or worsening performance in countries where the Index has fallen back.

In a fuller treatment, which it would be unfair to have expected from this study, attention could also be given to differences in growth performance, whether over time or between countries, which may not fit this framework too well. Examples include: the falling away of productivity growth in the OECD countries, as between the period 1950-73 and thereafter; the contrast between growth rates of output per head in the UK and Japan in the decades following World War II; and the sustained high growth rates of South Korea and Taiwan, which at least in the earlier stages — before 1975, the initial date for this study — were achieved in economic systems which in some respects were highly regulated. Also under this heading, it remains to be seen how far the economic reforms of recent years will serve to raise the underlying growth performance of the many countries across the world in which they have been made.

Absolute vs Proportionate Change

Possibly the most useful single feature of the present study is that it enables this process of reform to be presented in comparative and quantitative terms across countries. Since ratings are provided for a series of separate years, a dual presentation can be made for each country: first, of the extent to which reform has been taken during some stage of the period 1975-95; and second, of how far this measure of reform

compares with what could have been realised — the apparent potential for reform — given the initial 'pre-reform' situation of each economy. Both these measures of change, the absolute and the relative, are of interest. By using the second, it is possible to allow for differences in the scope for liberalisation, arising from the fact that at the beginning of their respective reform processes some economies were freer than others. Both measures are therefore shown in Table 1, in which I have drawn on the results of the study to present a picture of my own in which 32 countries are included.

Table 1

Changes in economic freedom rating for 32 countries, 1975-90, ranked in order of proportionate change

Country	*Rating*		*Change*	
	Initial (year)	*1990s*	*Absolute*	*Proportionate (%)*
New Zealand	4.1 (1985)	8.0	3.9	*66*
Argentina	2.5 (1985)	6.3	3.8	*51*
Ireland	3.9 (1975)	6.7	2.8	*46*
South Korea	4.0 (1980)	6.7	2.7	*45*
UK	4.5 (1980)	7.0	2.5	*45*
Singapore	6.8 (1975)	8.2	1.4	*44*
Chile	2.8 (1975)	5.8	3.0	*42*
USA	6.0 (1975)	7.7	1.7	*43*
Thailand	4.9 (1975)	7.0	2.1	*41*
France	3.4 (1985)	6.0	2.6	*39*
Malaysia	5.1 (1975)	7.0	1.9	*39*
Australia	5.0 (1975)	6.8	1.8	*36*
Japan	5.2 (1975)	6.9	1.7	*35*
Czech Republic	2.4 (1985)	4.9	2.5	*33*
Poland	2.2 (1985)	4.8	2.6	*33*
Taiwan	4.9 (1975)	6.6	1.7	*33*
Ghana	2.3 (1980)	4.8	2.5	*32*
Mexico	3.8 (1980)	5.8	2.0	*32*
Sweden	3.4 (1980)	5.5	2.1	*32*
Italy	3.6 (1985)	5.6	2.0	*31*
Turkey	2.3 (1980)	4.2	1.9	*25*
Canada	5.9 (1985)	6.9	1.0	*24*
Indonesia	5.0 (1980)	61	1.1	*22*
Netherlands	5.4 (1980)	6.4	1.0	*22*
Egypt	2.4 (1980)	4.0	1.6	*21*
India	3.3 (1975)	4.5	1.2	*18*
Kenya	3.4 (1975)	4.5	1.1	*17*
South Africa	3.9 (1975)	4.9	1.0	*16*
Switzerland	7.1 (1980)	7.5	0.4	*14*
Brazil	2.3 (1985)	3.3	1.0	*13*
Nigeria	2.8 (1980)	3.7	0.9	*13*
Germany	5.9 (1975)	6.4	0.5	*12*

The first column of the table shows the Economic Freedom Index — again taking the authors' preferred weighting system — for a 'pre-reform' year which can be 1975, 1980 or 1985: in each case, the year that I have chosen is the one in which the country's rating was lowest, and is indicated in the column. The second column shows the rating for the latest year available in the 1990s, and the third column the difference between the two, which is an absolute measure of the estimated extent of reform for the period concerned.

The final column gives the improvement in economic freedom as a percentage of the difference between the initial pre-reform rating and a rating of 10. This allows us to rank the changes in the different countries as a proportion of the level of unrealised economic freedom (according to the Index) prior to the reforms being undertaken. It indicates the achievement as against the potential. Hence in the case of Australia the absolute change in the rating is 1.8; this is divided by 5.0, which is the estimated potential for reform in the initial year of 1975. The result is a figure of 36 per cent.

The main points that emerge from the table are as follows:

- For all 32 countries, the 1990s ratings are higher than those in the first column, in some cases substantially higher: all these countries have taken the path of liberalisation, though in some cases the extent of reform appears as quite modest.[1]

- In the final year, Singapore has the highest rating,[2] closely followed by New Zealand, and with the US and Switzerland third and fourth respectively. Australia appears as tenth.

- In absolute terms, New Zealand appears as the leading reformer, closely followed by Argentina — in both cases despite the fact that the 'pre-reform' year is the relatively recent one of 1985. Other leading countries are Chile, Ireland, South Korea and France. The lowest absolute extent of reform is shown for Switzerland and Germany, though in both these countries the initial rating was a high one. Australia emerges as 17th in this list, right in the middle of the group.

- Generally speaking, and as might be expected, reforms have been taken furthest in those economies that were initially more regulated, so that the ratings for the 1990s, in the second column, show less divergence than those in the first. However, some countries in which the economic system has long been closely regu-

[1] In a small number of the 70 countries not included in the table, the freedom rating was appreciably lower for the most recent year than for any of the earlier years for which a figure is shown. The list here includes Cameroon, Honduras, Iran, Venezuela and Zaire.

[2] For all the years and with each of the three weighting systems offered, Hong Kong is given the highest rating of all 102 countries covered in the study. Taking the average of all three measures for the most recent year, the leading countries and their ratings are: Hong Kong, 9.0; New Zealand, 8.5; Singapore, 8.2; the US, 8.0; and Switzerland, 7.9. In this listing Australia comes eighth equal, with a rating of 7.4.

lated, such as India, Brazil, South Africa and Nigeria, have so far made only modest moves in the direction of reform.

- In the final column, where differences in the initial situation are allowed for, New Zealand emerges as clearly the leading country, with Argentina an unchallenged though not a close second. New Zealand's lead would appear even greater if account were taken of reforming measures which are not reflected in the Economic Freedom Index, including the Employment Contracts Act and the Fiscal Responsibility Act. Australia's ranking in this final column is twelfth.

Concluding Comments

For reasons that have been touched on above, too much weight should not be placed on particular figures in this table: there is a lot of scope for debate, rethinking and improvement. Among other aspects, it is possible that the choice of indicators here gives too little weight to areas — such as labour markets, environmental measures, and health and safety regulations — in which the trend of recent policies in some countries may well have been towards, rather than away from, interventionism. In such cases, the extent to which reform has been taken may be overstated. Nevertheless, the picture conveyed in the table seems accurate in general outline, so that the results of the study throw further light on the trend to market-oriented reform which has been such a notable (and largely unexpected) feature of the past 15 to 20 years. In this respect as in others, *Economic Freedom of the World, 1975-1995* makes a contribution to the understanding and interpretation of recent history.

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Agenda, Volume 4, Number 2, 1997, pages 217-236

NOTES AND TOPICS

The *Wik* Decision: Judicial Activism or Conventional Ruling?

Pamela O'Connor

FEW judicial decisions in Australia's history have evoked such intense reactions as the High Court's recent judgment in *The Wik Peoples v Queensland*.[1] In that case the Court reaffirmed the common law doctrine of native title first laid down in *Mabo v Queensland [No 2]*,[2] and decided by a narrow majority that the grant of certain Queensland pastoral leases did not extinguish the applicants' native title (if any) to the leased lands. Many people in government and industry believed the decision was inconsistent with prior understandings as to the legal effect of Crown leases upon native title rights. Some State and Territory premiers, the National Party and industry groups demanded that the Commonwealth parliament legislate for the wholesale extinguishment of native title on pastoral leases. Indigenous groups warned that any attempt to reverse the decision by legislation would violate the principles of racial equality, imperil the reconciliation process and invite international opprobrium.

Public debate revealed a considerable polarisation of opinion, as well as a degree of confusion about the making of the decision and its implications. Correspondents to newspapers asked how it came about that a question of such national importance was decided by the Court rather than by parliament. How could they have any confidence in the legal correctness of a decision that commanded the support of a bare majority of the Court (4 to 3)? And why was the outcome of the case not anticipated by State and Commonwealth governments, which had confidently maintained that it was clear from the *Mabo* decision that the grant of a pastoral lease extinguished native title? It was tempting to assume that the High Court had engaged in judicial activism, deciding according to what it thought the law ought to be instead of applying existing principles, and arrogating to itself the role of legislator.

Yet the legal principles and methods used by the Court to reach its decision were quite conventional. In its earlier *Mabo* decision, in contrast, the Court boldly

[1] (1996) 71 ALJR 173.

[2] (1992) 175 CLR 1 (hereafter '*Mabo*').

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rewrote the common law of Australia, invoking policy considerations in justification. It expressly overturned a long-held assumption of property law that native title did not survive the annexation of the Australian colonies to the British Crown. Such a doctrine could no longer be supported, the Court said, based as it was on the 'unjust and discriminatory' notion that Australia was *terra nullius* (practically unoccupied) at the date of acquisition by the Crown.[3] As Justice Kirby has conceded, the *Mabo* decision 'sits on the fine line which separates a truly legislative act from the exercise of a truly judicial function' (1994:70).

Paradoxically, the *Wik* decision evoked a much more swift and hostile reaction than the *Mabo* decision itself. This was because government and industry groups had relied on legal opinions that failed correctly to predict the Court's decision on the pastoral lease question. The Queensland government, acting on legal advice that native title could not subsist on pastoral leases, had been granting mining titles over land subject to a pastoral lease without complying with the procedures laid down in the Native Title Act (Wilson, 1997:50). The validity of those titles depended upon the correctness of the government's view of the law.

More than any other statute, the Native Title Act was negotiated legislation. Some of the industry groups who were party to the negotiations insist that their support for the Act depended on government assurances that native title was extinct in all lands held under pastoral leases. They cited the preamble to the Native Title Act as evidence that the Act was passed on the strength of that understanding. The preamble includes a recital that the High Court in *Mabo* decided that native title was extinguished by the valid grant of freehold *or leasehold* titles.[4]

The Pastoral Leases Question After *Mabo*

Although the High Court in *Mabo* had not considered the effect upon native title of the grant of a pastoral lease, the government's legal advice assumed that pastoral leases were not relevantly different from traditional common law leases. The majority judges in *Mabo* had said that native title is extinguished where the Crown grants to a third party an interest that is inconsistent with a continuing right to enjoy native title. Six of the judges in that case considered the effect of two leases granted over land in the Murray Islands for the purposes of a sardine factory. Brennan J (with whom Mason CJ and McHugh J concurred) were of the view that the grant of a lease extinguishes native title, even in the case of the sardine factory leases which expressly reserved the access rights of the Islanders.[5] Deane and Gaudron JJ

[3] *Ibid* at 42 per Brennan J.

[4] The *Wik* decision can be reconciled with that statement. The Court affirmed that the grant of a Crown lease is inconsistent with native title and extinguishes it. The pastoral leases in question did not have that effect because, according to the majority, they were not true leases.

[5] *Mabo* (1992) 175 CLR 1 at 71-3. Dawson J agreed (p. 158), but this was subsumed by his larger view that native title could not survive the acquisition of sovereignty by the Crown: a view rejected by the other six judges.

thought that native title might survive the grant of the lease, but found it unnecessary to reach a concluded view.[6] It was common to all the judges who considered the lease question that native title was extinguished by the grant of a lease that conferred exclusive possession and contained no reservation in favour of indigenous people.

It was not necessary for the Court in *Mabo* to rule upon the effect of leases on native title. It follows that the judges' views on this point, though of high authority, were not binding. There was a divergence of opinion, and none of the views expressed commanded majority support. Another reason for caution in interpreting the observations in *Mabo* was that the judges were not discussing pastoral leases specifically. Brennan J had said that while the grant of a lease would extinguish native title, the grant of lesser interests (for example, mineral exploration permits) would not do so.[7] Long before the *Wik* decision, several legal writers had canvassed the argument that pastoral leases might fall into the category of lesser interests which had no extinguishing effect.[8] In an article based on a conference paper delivered in June 1994, Peter van Hattem (1994:200) foreshadowed the argument:

> It is arguable, having regard to the limited rights and tenure conferred by a pastoral lease, the degree of concurrent use of the land permitted to others, and the limitation on usage by pastoralists, that a pastoral lease confers little more than a non-exclusive licence ... to use and occupy Crown land for pastoral purposes.

The Native Title Act did not solve the pastoral lease question. Provision was made to validate pastoral leases in force as at 1 January 1994 that might have been invalid by reason of the operation of s.10 of the Racial Discrimination Act 1974. Once validated, these leases extinguished native title, and compensation was payable to the former holders of native title. Otherwise, the effect of pastoral leases on native title was left for the courts to resolve. Pastoralists were pressing for wholesale extinguishment of native title on all their lease-holdings. The government was reluctant to accede, mindful of the compensation implications.[9] It chose to stay its legislative hand in the expectation that the High Court would solve the problem by ruling that native title on pastoral leases was already extinct. No question of compensation for the extinguishment would then arise.

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6 *Ibid* at 116-7.

7 *Mabo* (1992) 175 CLR 1 at 69.

8 For example, Stephenson (1993:109); van Hattem (1994:199-201); Durack et al. (1992:7); Amankwah (1993:14). It has been reported that a submission to federal cabinet as early as April 1996 anticipated the outcome in *Wik* (Tingle, 1997). Henry Reynolds (1996) has opined that there was an element of wishful thinking in the government's understanding of what was decided in *Mabo*.

9 Under s.51(31) of the Constitution, the Commonwealth must give just terms if the extinguishment amounts to an expropriation of property.

The *Wik* Decision

And so it came about that a matter of such great national importance was left to be decided by the High Court rather than by the Commonwealth parliament. Much was at stake in the outcome of the *Wik* case. The Court was told that pastoral leases cover some 40 per cent of the total land area of Australia. Many pastoral leases cover marginal lands in remote areas, where grazing activities do not involve an intensive use of land. These are the areas where Aboriginal people are most likely to have maintained their traditional associations with the land. If the High Court had accepted the argument that the grant of a pastoral lease necessarily extinguished native title, any lands that had ever been under pastoral lease would be put for ever out of reach of native title claims. A victory for the Wik peoples on this point would consolidate the gains represented by *Mabo* and the Native Title Act, while a loss would marginalise their significance.

The Wik peoples claimed native title over an area of land and waters in northern Queensland. The lands claimed included two large areas that had been subject to pastoral leases. One of the two holdings had been the subject of leases granted in 1915 and 1919, but so marginal was the land that no lease holder had ever gone into possession. Since 1922, after the second lease was terminated, the land had been reserved by an Order in Council for the use of Aboriginal inhabitants.

The Wik peoples' claim was met with the argument that their rights had been automatically extinguished when the land was first leased to pastoralists. The Queensland government argued that the grant by the Crown of any pastoral lease necessarily extinguished native title, even if the lease holders never set foot on the land. The High Court in *Mabo* had laid down two prerequisites for a finding that native title exists on a parcel of land: the Aboriginal claimants must have maintained their traditional association with the land, and their title must not have been extinguished by an act of the Crown inconsistent with the continued enjoyment of native title rights. This means that even if the Aboriginal people have continued to occupy the lands, their title might still be extinct in consequence of a past grant.

The High Court was asked to determine two main issues: did the pastoral leases confer exclusive possession on the grantee, and did the grant of the pastoral lease necessarily extinguish native title to the land? The majority answered both questions in the negative, the second question subsumed by the negative answer to the first.

The 'Lease' that Wasn't

The defining characteristics of a lease are that it holds for a certain duration and that it confers on the lease holder a right to exclusive possession. Exclusive possession means that, subject to reservations in the lease, the lease holder can turn everyone else off the land, including the landlord. The right to exclude others may be subject to the property rights of third parties, such as an easement of right of way.

The minority judges agreed with Brennan CJ that if parliament uses the term 'lease' to describe a title that the Crown may grant under statute, it is presumed to

mean a lease in the sense understood at common law. If parliament calls the grant a 'lease', then a lease it is — and a lease by the usual definition confers exclusive possession. The grant is therefore inconsistent with the continued enjoyment of native title.

The majority judges approached the matter from the opposite direction: the grant is a lease only if it confers exclusive possession. If it does not, then it is something other than a lease. Courts have long insisted that the question of whether a transaction creates a lease or a licence is determined not by the nomenclature but by the substance of the rights conferred.[10] The controversy in *Wik* was about what should be inferred from the terminology used in the statute. Was the statute deeming this limited tenure to be a lease, or did it simply use the word 'lease' as a convenient misnomer for a tenure that was entirely its own creation?

The majority said that the pastoral leases in question were not leases in the common law sense, but were special interests created by statute. These 'leases', the majority said, were subject to so many reservations of rights of entry in favour of the Crown's agents and other authorised persons that it could not be said that they conferred upon the holder a right to exclusive possession. Historical evidence of the origins of the pastoral lease indicated that this form of tenure was never intended to authorise pastoralists to displace the Aborigines.[11] The majority concluded that the pastoralists' rights were not exclusive of the rights of the native title holders, but were capable of being enjoyed concurrently. Since the rights could coexist, the grant of the pastoral leases did not extinguish native title.

Living with the *Wik* Decision

The *Wik* decision did not deliver what the government and industry groups had hoped for: a simple and universal answer to the pastoral leases question. Assessment of whether a particular lease can be regarded as conferring exclusive possession — thereby extinguishing native title — requires a judgment of degree. That a lease document and its authorising statute limit land use and reserve rights of entry does not necessarily destroy the characteristic of exclusive possession, but they will have that effect if the restrictions are judged to be too extensive. As a result of Australia's federal structure, there is substantial variation in the terms of pastoral leases and their authorising statutes in operation at various times in different parts of the country. It is difficult to predict which of these may be found to confer exclusive possession on the grantee.

Other aspects of the decision also raise the spectre of case-by-case adjudication of many claims across Australia. There is the absence of any clear test for determining the effect of non-extinguishing pastoral leases on the rights of native title

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[10] *Radaich v Smith* (1959) 101 CLR 209; *Street v Mountford* [1985] AC 809. The principle was often invoked during the postwar housing shortage to thwart attempts by landlords to avoid rent control legislation by signing tenants up to 'licence' agreements.

[11] For an account of the historical origins of pastoral leases, see Reynolds (1992:14).

holders. With the support of the other majority judges, Toohey J stressed that in the event of any inconsistency between the rights, then the rights of the native title holders must 'yield' to those of the pastoral lease holder.[12] The application of this priority principle in cases of conflict will require a detailed assessment of the circumstances. It will be necessary to identify the rights granted to the pastoralists by examining the terms of the lease and the statute under which it was issued. The specific content of the native title holders' rights will also have to be determined, in order to assess whether and to what extent these are inconsistent with the rights granted to the lease holder (Farley, 1997:3).

The notion that different interests can coexist in the one parcel of land is quite unexceptional in property law (Tehan, 1997). For example, different persons may hold freehold, leasehold and mining titles over the land, while another has an easement of right of way. There is nothing extraordinary in the Court's ruling that native title can coexist with the rights of a pastoral lessee. The difference is that, in the case of the long-established interests mentioned above, the law has developed rules for resolving conflicts about priority and enjoyment.

Given time and a sufficient volume of cases, the courts could work out a regime for regulating the coexistence of native title and pastoral leases. But it would be far preferable for parliament to step in and provide a scheme. Regulating the coexistence of proprietary interests is an entirely familiar subject matter for legislation. It has not proved to be beyond the ingenuity of legislators to draft laws governing commercial and residential tenancies, coownership, strata and cluster titles and life tenancies. There is nothing insuperable about the novel problems presented by the coexistence of native title and pastoral leases.

In a speech titled 'Wik: What Do We Do Now?' delivered on 22 January 1997, Justice French, the President of the National Native Title Tribunal, suggested certain steps to develop a model for coexistence, including codes of practice for the parties governing access to and use of leased land, enforcement and dispute resolution mechanisms, and processes for consultation with native title holders concerning proposed improvements and new uses of the land. Other possible responses include statutory codification of the access and usage rights of native title holders on pastoral land.

Pastoralists had assumed before *Wik* that their rights were the equivalent of those enjoyed by the holders of a true lease. If they hold only lesser statutory interests, there is a need to clarify the content of their rights and update the statutes to take account of the range of land-use activities that comprise modern pastoral practices (Love, 1997:6-8).

It is really no valid criticism of the *Wik* decision that it laid down the broad principle of coexistence, leaving the myriad details to be worked out by legislation. It is for parliament, not the Court, to elaborate a detailed scheme for the accommodation of competing interests, just as parliament acted to implement the principles of *Mabo* by legislating for the adjudication of native title claims. The scope of

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[12] *Wik* (1996) 71 ALJR 173 at 215.

what the Court could decide was in any event confined by the way the matter came before it in the form of an itemised list of questions reserved for its consideration.

Negotiating a regime for coexistence of native title and pastoralists' interests will be a complex and contentious process, but no more so than the multilateral negotiations that produced the Native Title Act. It is only through the process of negotiation and compromise that an enduring settlement can be reached. The extinguishment of native title on pastoral leases is not the 'quick fix' solution its proponents represent it to be, but would lead to resentment, litigation and international opprobrium. The search for a just resolution must involve indigenous and industry groups working constructively with government for the best possible negotiated solution.

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How Land Titling Promotes Prosperity in Developing Countries

Ray Trewin

MANY developing countries are facing rapidly increasing demands on their scarce resources, especially land. Such demands are imposing associated pressures on traditional or informal titles to land, and highlighting the need for stronger property rights. Land titling and registration, in conjunction with an appropriate legal, institutional and social environment, can help meet this demand.

Land is the main productive asset in many developing countries. Whereas property rights in land represent 40 per cent of family assets in the United States, in developing countries they represent around 70 per cent (de Soto, 1993). Land titling and registration helps secure property rights and could offer associated public benefits such as an apparatus for better planning as well as an essential basis for the development of an efficient land market. It could also provide to land holders, including poor land holders, greater private land security, investment collateral, potentially higher incomes and land values.

If the benefits of land titling and registration are potentially so great, why does a large amount of land in developing countries remain unregistered under formal title? For example, it has been estimated that only 20 per cent of Indonesia's, and a similar percentage of Peru's, land is registered under formal title (Grant, 1996; de Soto, 1993). Does land titling and registration add anything to workable informal arrangements? An economist would naturally seek to answer these questions by searching for failures in the land titling market. Are the private benefits of land titling and registration too small relative to the public benefits? Are the private costs, in both money and time, of registering a land title through current public monopolies too large relative to the private benefits obtained? Are the benefits, both public and private, of registering a land title well understood? Is land titling and registration effective in the absence of the legal, institutional and social environment needed to enforce the property rights encompassed in land titles (this is especially likely to be true of communal land, which is still widespread in many developing countries)? These issues need to be understood if the benefits of land titling and registration are to be captured and maximised.

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What Is Land Titling?

This note follows the standard practice of referring to land titling for the separate land titling and registration components of an overall system of land ownership. 'Land titling' denotes the legal recognition of ownership or of an interest in a parcel of land (International Federation of Surveyors, 1995). More precisely, land titling is concerned with the rights, restrictions and responsibilities associated with forms of ownership and use of a parcel of land, often geometrically described in the title. It includes, as well as rights to the use of the land and its yields, rights to transfer, mortgage or leasing.

'Land registration' denotes the official recording of the title. This record can become the primary evidence of ownership. It is a more advanced system than having the title as the primary evidence of ownership, and requires greater investment; but it provides better security and reliability, and hence lower transaction costs, thus promoting a more efficient land market. An appropriate land registration system is necessary if the full benefits of land titling are to be realised.

Many systems of land titling are in operation, reflecting the way boundaries are delimited and recorded; the Torrens system that is used in Australia is one example. A country's optimal system of land titling depends on its resources, its social, political, legal and administrative environment, and so forth. Systems of land titling need not be uniform within countries, whether over time as the country develops or across all areas; for example, some indigenous groups within a country may wish to register as a community rather than as individuals.

The Potential Benefits of Land Titling

A framework for land titling and related projects is set out in the International Federation of Surveyors (1995) and the United Nations Interregional Meeting of Experts on the Cadastre (1996). This framework has underpinned many World Bank and other projects aimed at increasing the level of land titling. It predicts that introducing more efficient and transparent land transactions will result in less risky private land-related investment, greater overall investment through the use of more secure land as collateral, and incentives for longer-term investment towards more sustainable land use, leading to changes in input use, productivity, incomes, land prices, and so on.

Land titling has traditionally been undertaken by public utilities. Many of the more obvious benefits have been public ones: for example, a comprehensive register of land titles provides a basis for government land taxes as well as a potentially low-cost apparatus for assessing land resources and planning their appropriate use. Moreover, land titling provides an essential basis for an efficient land market where land is allocated to its potentially highest value use, including social values, through secure transfers of ownership or possession. Land titling also supplies indirect public benefits, including the incentive through the provision of stronger property rights for owners to take better care of their land. But it can have negative effects as well. For example, land titling could, if not properly implemented, exacerbate economic inequality, environmental stress and political instability.

Evidence of the Impact of Land Titling

Much of the evidence that is emerging of the impacts of land titling is described in a recent paper by Feder and Nishio (1996).

Feder (1987) and Feder et al. (1988) show that farmers with legal title gained access to 52–521 per cent more institutional credit (depending on the province) than farmers without legal title, both because titled land was available as collateral and because it was 25–132.6 per cent more valuable than untitled land. Moreover, titled farmers invested more in land, and used more inputs and produced more output, than untitled farmers, resulting in 14.5–20.8 per cent higher revenues (agricultural and non-agricultural). As well, three to four years after the issuance of titles, titled land in project areas stimulated 35–205 per cent more land transactions than land in non-project areas (Onchan & Aungsumalin, 1993).

Similar results have been observed in urban areas. Dowall and Leaf (1990) found, after taking into account the level of infrastructure and distance from the city centre, that residential land prices in Jakarta were strongly positively correlated with the degree of tenure security (as certified by registration and tax receipts).

More recently, evidence of the impact of land titling has been available from Latin America. Lopez (1996) shows that titled farmers in Honduras had greater access to credit, both in terms of numbers receiving credit and (more significantly) the average amount of credit received; they also invested more than twice as much as untitled farmers, especially in land-related investments. Moreover, with farms that were similar in 1983, titling led to significantly different yields by 1993. The rate of return from land titling was estimated at 17 per cent, which is significantly higher than the real lending rate in Honduras. Carter and Olinto (1996) find similar results for Paraguay farmers with land-related investment and credit provision. De Soto (1993) found that investment in property increased ninefold when squatters in Perù formalised their property titles. The IDB (1986) reported that land titling increased squatters' incomes by 200 per cent in Brazil and doubled farmers' incomes in Ecuador. The World Bank (1992) presents some of the broader impacts of land titling, such as reduced forest damage in Thailand, a tripling of household investment in sanitation facilities in Bandung, Indonesia, reduced soil erosion in Kenya, and improved land management in Burkina Faso.

Overcoming Market Failure

In view of the apparent net social benefits of land titling, why is the practice not more widespread? A key potential reason is institutional failure, primarily the absence of an appropriate legal, institutional and social framework to support the property rights encompassed in land titling. Another reason is the absence of net private benefits from land titling, which may result in the loss of potential net social benefits.

Different approaches to land titling and registration that address market failure have been developed. For example, in many developing countries, such as The Philippines, Thailand, Indonesia, and those in sub-Saharan Africa, the World Bank

has been involved in 'systematic registration', which involves surveying and adjudicating all eligible parcels of land in a contiguous area during the one phase. It is intended as an improvement on traditional, sporadic registration practices in which individual landowners apply to register their parcels of land without the benefit of supporting processes such as comprehensive and integrated surveying. It has been estimated that at the current rate of sporadic registration it would take 90 years to register all current parcels in Indonesia; yet such parcels are growing at more than one million a year (*Inside Indonesia*, 1996).

Systematic registration addresses a number of market and other failures by extending the current legal framework through separate adjudications, cheaper processes, greater public awareness, as well as increased community and private sector involvement. A good example of the approach is the Indonesian Land Administration Project (ILAP), which builds on earlier projects in Thailand and the Philippines (see Grant, 1996), although the specific institutions, customs, and so forth are different. The ILAP is being undertaken by the government of Indonesia with World Bank funding and Australian technical assistance. It has three main objectives: to assist the national land agency in accelerating land titling and registration; to improve the institutional framework for sustainable land administration; and to help the Indonesian government develop sustainable land management policies. The first two objectives are designed to foster efficient and equitable land markets, and to alleviate conflict over land from development pressures. The third objective addresses longer-term inter-agency and cross-sectoral issues.

Privatisation has also been adopted to overcome market and other failures in land titling. In Peru, obtaining a title used to involve over 200 bureaucratic steps in nearly 50 government offices, and took, on average, over two and a half years to compete at the cost of a fifth of the official minimal annual wage. More recently, some South American countries have tried low-cost, decentralised privatisation based on a computerised register with important links to credit provision that specifically targeted the poor (*The Economist*, 9 December 1995). This last aspect could be particularly important in South America, where land holdings tend to be larger, and in the hands of wealthier owners, than in Asia.

A third approach is the 'evolutionary' one. Many so-called traditional systems have in reality evolved as a result of various social, economic and political pressures. In Africa, indigenous land rights have evolved away from a system of communal control towards individualised rights in response to increased commercial and population pressures (Migot-Adholla et al., 1991). Similar observations have been made in the Pacific (Crocombe, 1987). In fact, most of the titled land systems in the world's developed countries have evolved from communal land systems. Such systems survive in the form of strata titles with general boundaries and administrative arrangements for individual properties and common areas similar to those in some traditional communities. In fact, 20 per cent of Australian titles are of this form (Williamson, 1997). As agriculture intensifies as a result of increased commercialisation and population pressures, landholders themselves often demand stronger private land rights. Communal control often involves market failures such

as 'free rider' problems and also high transaction costs in dealings with outsiders. Many of the informal institutions that have evolved within the communal land systems have been the result of attempts to reduce such transaction costs.

The Impact on the Poor

It has been argued that the poor are better off without land titling (*Inside Indonesia*, 1996). Allegedly, more information on land ownership disadvantages the poor both because it increases inequalities of access to information, and because, by encouraging development, it could result in the poor being thrown off their land. Lakau (1995) argues that traditional land ownership provides a kind of social safety net. However, governments could provide more information to potentially disadvantaged groups and also supply appropriate safety nets. As well, the poor are often disadvantaged by old land systems under which their land can be confiscated without compensation.

Cases have recently been reported of the poor in South America seizing unused land and other property. In fact, in many developing countries the landless poor often establish themselves on unused land ranging from abandoned railway yards to virgin forest lands. Such informal property rights could become a cause of future conflict; but land titling can legitimise them by recognising established occupancy and in this respect give priority to the poor.

A further way to help the poor is to legislate for covenants on land use, as already happens for environmental reasons. Other approaches include land committees and other organisations charged with overseeing the bona fides of land transactions. Such trade-offs between efficiency and equity could protect the rights of needy minorities without unduly constraining development opportunities.

Conclusion

Appropriate land titling, in conjunction with a relevant legal, institutional and social environment, can promote prosperity in developing countries by providing a more efficient land market with secure property rights, investment collateral, sustainable land use, income opportunities, and so on, as well as a good framework for public land use planning. It does this by addressing failures in current systems, including a paucity of information on the benefits of land titling and high transaction costs. There is a spectrum of land titling systems, both public and private, with the most appropriate system for a country depending on the available resources, and the specific legal, administrative, social and political environment, as well as how well the system addresses the failures. The poor have been badly disadvantaged by the pressures on current informal systems and can be targeted to benefit more within new systems that can make miscarriages of justice more transparent and any compensation fairer.

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Deadweight Loss and the Cost of Public Funds in Australia

Harry Campbell

RECENT studies of productivity and economic growth have stressed the importance of infrastructure such as transport and education facilities in promoting growth. Facilities of this kind are termed 'public goods', that is, goods that we share to some extent as opposed to goods that are subject to exclusive private use. According to Otto and Voss (1994), a 10 per cent increase in the public capital stock increases total factor productivity in the private sector by 4 per cent. While infrastructure investment can be undertaken by the private sector, it is generally recognised that some level of government investment is required if the appropriate amounts of public goods are to be provided.

In 1994-95 Australian Commonwealth government outlays totalled $128 billion, of which $97 billion consisted of transfer payments of various kinds, including interest payments, provision of social security benefits, and grants to the States. The balance was devoted to expenditures on provision of goods and services, including $6 billion on goods classified as capital in nature (ABS, 1994/95). The latter sum underestimates the amount of investment undertaken by the Commonwealth, since a proportion of current outlays on areas such as education and health contributes to augmenting the stock of human capital. General government outlays in Australia constituted 37 per cent of Gross Domestic Product as compared with the OECD average of 41 per cent (OECD, 1996: Annex Table 28).

In deciding which goods and services to provide, governments have to take account of the benefits and costs generated by each type of expenditure. Public expenditure can be funded either by taxation or by borrowing, but in the latter case tax revenues are required to meet interest on, and repayment of, loans. Ultimately, the cost of public projects is represented by the costs imposed by raising tax revenues. These costs comprise mainly collection costs, compliance costs and deadweight loss. Collection costs are incurred by the private and public sectors in the battle over the amount of tax due; compliance costs arise from account-keeping and form-filling; and deadweight loss reflects changes in economic behaviour induced by the structure of the tax system (Diewert & Lawrence, 1995:28). Arguably, while collection and compliance costs may be substantial, they do not increase significantly with an increase in tax rates, whereas the size of the deadweight loss does.

This note is concerned with the deadweight loss associated with raising an additional amount of tax revenue to fund an additional public project in Australia.

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The cost of the project would be funded by the revenues raised as a result of the tax increase. However, raising this amount of tax revenue imposes an additional cost on the economy in the form of a deadweight loss. This means that the overall cost of the tax increase, and hence the overall cost of the proposed project to the economy, is higher than the revenue raised to fund the project.

The overall cost to the economy of the tax increase expressed as a ratio of the additional tax revenues available to fund a public project is known as the marginal cost of public funds. If we ignore additional compliance and collection costs, the benefits of the proposed project per dollar of cost would need to be at least as large as the marginal cost of public funds to make the project worthwhile. This means that the project would have to provide a return sufficient to cover both a normal rate of return on the funds employed and the marginal deadweight loss.

Campbell and Bond (1997) find that the deadweight loss associated with raising additional tax revenue is 19 per cent, implying that the marginal cost of public funds is around 1.2. This figure is similar to the estimated deadweight loss of 18 per cent that Diewert and Lawrence (1995) find for New Zealand and is within a fairly wide range of estimates that Freebairn (1995) finds for Australia. But while the results of these two studies are not inconsistent with those obtained by Campbell and Bond, the methods of analysis differ. A more direct comparison is provided by Findlay and Jones (1982), who, using a similar approach to that of Campbell and Bond, estimate that the marginal deadweight loss associated with raising and spending tax revenues in Australia lies within the range 23-65 per cent. The difference between the two findings may be partly attributable to changes in the tax system since 1978-79, and particularly to the lowering of marginal tax rates in high income-tax brackets. However, it is interesting to note that whereas deadweight loss appears to have fallen in Australia, Diewert and Lawrence find an increase in deadweight loss in New Zealand over the period 1972-91. They attribute much of the increase to the greater flexibility of the New Zealand economy, which offers taxpayers more opportunity for changing behaviour in response to tax changes.

The Nature of Deadweight Loss

Deadweight loss is the cost of changes in incentives to work or invest caused by changes in the level or structure of taxes. Measuring the effects of tax changes on capital flows is very difficult; and most analysis to date has concentrated on the effects of a tax increase on work incentives.

An increase in the tax rate lowers the after-tax wage (the cost of leisure) and makes additional leisure relatively more attractive. However, the lower after-tax wage also reduces disposable income and makes additional leisure less affordable. While these two effects work in opposite directions, it is likely that a reduction in the after-tax wage will increase the amount of leisure, thereby reducing the amount of labour supplied.

To understand the importance of the labour supply response in determining the amount of deadweight loss resulting from an increase in the tax on earnings, consider first the case in which the level of labour supply is unaffected by the tax increase. If the supply of labour remains constant, the value of goods and services produced by

the economy remains constant. What happens is that economic activity is redistributed between the private and the public sectors. Since take-home pay falls by the amount of the increase in tax revenues, households reduce their demand for goods and services; this reduction in demand is matched by the government's increased demand for the goods and services required to undertake the additional public project. Since the cost to the household sector is exactly offset by the market value of the additional public project, no net or 'deadweight' loss is imposed on the economy. Of course, this leaves aside the question of whether the value of the output of the public project is sufficient to compensate the household sector for its loss. This is a separate issue, and is considered in the cost-benefit analysis of the proposed project.

Now consider the case in which the quantity of labour supplied falls as a result of the tax increase. The resulting decline in the value of goods and services produced by the economy is measured by the value of the fall in before-tax earnings. However, this decline is partly offset by the value households place on the additional leisure they have chosen to enjoy. Since additional leisure is valued at the after-tax wage, there is a net loss to the economy consisting of the difference between the before-tax and the after-tax value of the reduction in labour supply. This net loss to the economy is termed a deadweight loss.

The cost of the deadweight loss resulting from the reduction in the quantity of labour supplied falls on both government and households. The government loses the tax revenues which would have been paid on the labour which is no longer supplied; and households lose the after-tax income which that labour would have earned (though this is partially offset by the value placed on the extra leisure time which is enjoyed). In addition to the loss resulting from the reduction in labour supply, the household sector also suffers a loss in the form of increased taxes payable on the new level of labour supply.[1]

Estimating Deadweight Loss

The aim of undertaking an additional public project is to make the household sector better off. This is accomplished if the value of the benefits of the project exceeds the cost imposed on households by the tax increase. However, we have seen that the cost imposed on households exceeds the additional revenue available to fund the project. This means that the nominal cost of the project — the cost of the goods and services purchased by the additional tax revenues and used to construct and operate the project — is less than the cost imposed on households. This in turn implies that the value of the project's benefits has to exceed the nominal cost of the project if

[1] The marginal cost of public funds, which reflects the amount of deadweight loss imposed on the economy by the tax increase, can be expressed in two equivalent ways: as the ratio of the cost imposed on households by the tax increase to the extra amount of tax revenue available to fund the public project; and as one plus the ratio of the deadweight loss to the additional amount of tax revenue collected by the government. These two ways of calculating the marginal cost of public funds are equivalent because the extra tax revenues collected plus the deadweight loss equals the cost of the tax increase to the household sector.

households are to be made better off. In fact, the ratio of the value of the project's benefits to nominal cost has to be at least as high as the cost of public funds. This is why the concept of the cost of public funds is so important in the evaluation of public projects.

Information about labour supply and tax rates makes it possible to estimate the cost of public funds. Campbell and Bond (1997) have estimated effective rates of tax for workers in the average household in each of the household gross-income deciles in Australia in the 1988-89 tax year. The effective marginal tax rates (EMTRs) on labour income are 20 per cent in the lowest decile, rising to 67 per cent in the fourth decile and then falling to 44 per cent in the tenth decile. The average EMTR is 47 per cent. These rates may seem surprisingly high, but they incorporate both direct and indirect taxes and include the effects of benefit programs as well as taxation: the EMTR is the increase in tax paid minus benefit received when household income rises by a dollar. In effect, the household is penalised twice when income rises as a result of additional work: it pays more tax and it experiences a reduction in those government benefits which are related to income level.

The EMTR can be expressed as the marginal tax rate (MTR) minus the marginal benefit rate (MBR). The MBR is negative, since benefits received tend to fall as household income rises. A rise in the MTR, involving some mix of direct and indirect taxes, raises the EMTR, thereby tending to cause a decline in household labour supply. Campbell and Bond (1997) assume that additional public funds are obtained by raising the MTR for the average household in each gross income decile by 1 per cent of its original value. Since the MBR is unaffected, this results in non-proportional increases in EMTRs across households.

A rise in the tax rate in order to fund an additional public project causes a decline in the quantity of labour supplied, thereby reducing before-tax incomes and making some households eligible to receive increased benefit levels. How should these increased benefits be financed? It can be argued that the additional tax revenues should be sufficient to fund the additional public project *and* to pay any additional benefits required under current welfare programs because of the tax increase. In the analysis by Campbell and Bond (1997), this requirement is imposed on the funding of an additional public project.

The size of the reduction in labour supply depends upon the responsiveness of the labour supply to a change in the after-tax wage. Campbell and Bond use estimates for the Australian labour market which indicate that, while households in different income deciles would respond differently to a tax increase, the average household would reduce labour supply by 6 per cent in response to a 10 per cent fall in its after-tax wage. Using a simple model of labour supply incorporating this assumption, they calculate the fall in the amount of labour supplied by the average household in each income decile as a result of a 1 per cent increase in its MTR. Aggregate deadweight loss and aggregate additional tax revenues are calculated by summing across households, and their ratio is used to calculate the deadweight loss per dollar of additional tax revenue available to fund additional public expenditure. A value of

$0.19 is obtained, implying that the cost of public funds is $1.19 per dollar of tax revenue.

The Effect of Public Good Provision on Labour Supply

The labour supply may be affected, not only by the tax increase, but also by the public project itself. For example, a new road could decrease labour supply by making it easier to get to the beach, or increase it by making it easier to get to work. Furthermore, having access to an additional quantity of a public good increases households' economic well-being, thereby making leisure seem more affordable (this sort of reaction is termed an 'income effect'). The net effect of the output of the public project will vary from case to case, but will probably tend to be in the direction of reduced labour supply, thus causing a further reduction in tax revenues.

Little empirical work has been undertaken on the effects of public good provision on labour supply. However, when the value of a public project's benefits is of a similar dimension to its costs (including the deadweight loss), it may be reasonable to assume that the income effects of the public expenditure are roughly equal, although opposite in direction, to the income effects of the tax increase. This assumption can be incorporated in the analysis of the marginal cost of public funds by eliminating the income effect of the tax increase from the calculation. Since the income effect of the tax increase tends to work in the direction of a higher supply of labour, removing it from the calculation tends to raise the marginal cost of public funds.

Campbell and Bond (1997) find that leaving out the income effect of the tax change increases the estimate of deadweight loss by 5 per cent, bringing the estimate of the marginal cost of public funds up to $1.24 per dollar of additional tax revenue to be used to fund an additional public project. This value is directly comparable with Findlay and Jones's (1982) results, since it incorporates both the revenue and the expenditure effects of the tax increase. However, the EMTRs that Campbell and Bond estimate for higher-income households in the late 1980s are significantly lower than those estimated by Findlay and Jones for the late 1970s, and this results in a lower estimate of deadweight loss.

Conclusion

Unless it has particularly desirable income distributional effects, an additional Commonwealth government project should have a benefit/nominal cost ratio of at least 1.24 before being undertaken. The benefits and costs of the project should be measured in the usual way, except that the benefit measure should be adjusted to add (subtract) the value of any increase (decrease) in tax revenues generated as a result of the nature of the project's output as a substitute for (complement to) leisure. This change in tax revenues should be valued at the marginal cost of public funds. In practice, little is known about the substitution or complementarity effects of public expenditure on labour supply; and it will be difficult to account for them in public project evaluation. Where these effects are localised, they may be insignificant in comparison with the overall cost of the project.

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REVIEWS

In Search of the True Republic

***Patrick O'Brien, The People's Case: Democratic and Anti-Democratic Ideas in Australia's Constitutional Debate**, Constitutional Press, Perth, 1996*

*Reviewed by **Rudolf Plehwe***

THE Australian constitutional debate, says Patrick O'Brien, has been diverted from the issues that matter on to the largely irrelevant choice between a royal and a non-royal head of state. The task that desperately needs tackling is to tame the executive government, which, having inherited the undiminished powers of the Crown, now also controls the legislature and is not in practice accountable to anyone. O'Brien, a political scientist at the University of Western Australia, argues for a 'true' republic, characterised by an explicit constitutional recognition of the political supremacy of the people, which would be safeguarded by an effective separation of powers, checks and balances and effective controls on all governmental authorities. Such a polity could be headed by a president or a constitutional monarch. But if the choice *were* to be one between the 'Keating-Turnbull axis' on the one hand and Australians for Constitutional Monarchy and the Samuel Griffith Society on the other, democrats would have to side with the latter. The so-called 'minimalist' republican proposals are meant only as the first step in implementing a hidden agenda and would in any case abolish even the inadequate checks on executive power provided by the Crown and its representatives.

Unchecked executive power is favoured, or unthinkingly accepted, by much of Australia's political elite, including many on what is considered the conservative side. It is justified by arguments derived from positivism, utilitarianism and socialism, which particularly appeal to those who aspire to remake society according to some truth revealed to themselves and not yet understood by the people (who must be educated, cajoled or, if necessary, coerced into compliance). These self-anointed saviours hanker after a unitary state with an omnicompetent, unicameral parliament through which they and their party can rule unchecked, with the people reduced to passing judgment at election time, when governmental secrecy and widespread use of patronage and the pork barrel will ensure a favourable verdict.

The People's Case was published before the 1996 federal election, and the author devotes a lot of space to what he calls Keating's culture war: the attempt by the former Prime Minister and his disciples to impose their own version of Australia's national identity. In the best (or rather worst) traditions of 19th-century European nationalism, this is accompanied by a tendentious and selective use of history designed to appropriate the past for partisan ends. Since politicians will not act to enforce governmental accountability, we must agitate for a convention elected by the

people to formulate reforms. The people must be, and be seen to be, the source of a new constitution that enshrines their supremacy and limits the powers of all lesser authorities. The author supplies a list of desirable measures to be adopted in time for the centenary of federation.

True to form, Professor O'Brien has given us a vigorous polemic against some of the worst features of contemporary Australian politics. What he calls 'partocracy', or the virtually uncontrolled exercise of both executive and legislative power by party elites concerned to evade all scrutiny, is a serious evil. He rightly draws attention to the acquiescence of 'conservatives' in executive domination. It is also true, as he says, that many who battle for economic freedom show no great concern for those institutions that protect freedom generally by limiting the powers of government. It is worth remembering that both the Thatcher Government in Britain and the Kennett Government in Victoria increased the dominance of the central government over subordinate authorities (such as, in the Victorian case, local councils and the Director of Public Prosecutions).

The People's Case is also valuable in setting the record straight on some historical matters, such as the part played by racism in Australian nationalism and the way many Labor Party and trade union leaders fought against the admission of boat people after the communist takeover of Vietnam. Of course, the author had to be selective, and much more could be written about the vagaries of Australian traditions, past and present. I personally treasure Jack Lang's account of how he and his mates used appeals to White Australia to defeat conscription in World War I, and the almost admirable flexibility of nationalists who denounce the (largely mythical) cultural cringe while trying to make Australia's variant of the Westminster system conform to the even more centralised British version.

The book thus has very considerable merits. But it is a tract for the times, even a call to arms, rather than a detailed and nuanced analysis of the issues. Probably some leading republicans have hidden agendas, but there do seem to be important disagreements among them which O'Brien does not explore. John Hirst, for example, has often fought the very distortions of history that O'Brien deplores. There is an implicit threat to federalism in the current republican program, but it may be due to muddle. It results from the almost total lack of discussion by republicans of future arrangements in the States. The 'official' republican position is that the matter should be settled in each State. But recent discussions of the Governor's role in New South Wales and Victoria suggest that some leading republicans expect the office to disappear. In any case, the general silence implies that the issue does not matter. But if the role of the head of state and the reserve powers are important at the Commonwealth level, they must be significant in the States. Moreover, State Governors in their sphere represent the Crown and carry out its duties (to govern the people according to law) as directly and fully as the Governor-General does in his. If, as republicans and monarchists agree, symbols matter, any change in this arrangement may affect the position of the States in the federation.

Professor O'Brien points out that the term 'republic' has been used in many ways and often has no precise meaning. But he invokes 'democracy' and

'government by the people', which have been used and misused even more. True, he usually argues for 'liberal democracy' or 'constitutional democracy'; but many of the British and American writers and statesmen he admires were wary of the term 'democracy', which to them suggested direct democracy and the constant danger of mob rule. Abraham Lincoln's 'government by the people' is a powerful slogan but is totally impracticable and sits as uneasily with the realities of American government as with the views of the authors of *The Federalist* and Professor O'Brien's own admirable concern for limited powers and the protection of individual rights. The 'sovereignty of the people' has been frequently invoked by the social engineers whom O'Brien scorns, beginning with the French revolutionaries who tried to replace all honorifics by the title of 'citizen'.

The proposals for action are the least satisfactory part of the book. The plan of a people's convention on the Constitution raises many practical problems, as the Howard Government seems to have discovered. The version finally announced, with half the members to be appointed rather than elected, is hardly likely to satisfy O'Brien, and from his point of view the whole exercise presumably became futile when it was announced that the convention would deal only with the question of the head of state. A fundamental problem is that a convention that includes practising politicians is likely to be dominated by them, while one that excludes this group may well be seduced by hare-brained schemes. In any case, even if, as O'Brien demands, parliament binds itself to submit all a convention's recommendations to a referendum, any measure opposed by a substantial section of the political class is likely to fail.

The author presents 21 'proposals for constitutional renewal' which, he claims, 'contain no utopian panaceas' but are 'down-to-earth and practical measures' (p. 133). Some, like a stronger system of parliamentary committees and a re-examination of Commonwealth-State relations, are hardy perennials, though not necessarily any the worse for that. Others would be radical innovations in the Australian context: for example, 'the sole right of the people to directly elect their heads of state and government' (p. 135), the outlawing of all pledges by members of parliament to accept party discipline, and 'recall and/or dismissal of members of all three branches of government through citizen-initiated referendums' (p. 137). In some cases the author's meaning is unclear. Does 'the supremacy of the electorate over the legislature' add anything to other points such as the constitutional limitation of legislative powers or the possibility of recall by referendum? How exactly is impeachment (of members of the executive and the judiciary by parliament or members of any of the three branches by referendum) to work? Impeachment, unlike recall, is a judicial process. Does Professor O'Brien want to apply the American and the now obsolete British systems, where the lower house prosecutes and the upper house acts as a court? As for impeachment by referendum, this is a frightening prospect, whatever it means precisely.

More generally, Professor O'Brien advocates a number of devices that have been tried in the United States, at either federal or state level, without considering the problems they have caused. 'Partocracy' is a great evil, but extreme fragmenta-

tion of power can produce gridlock, where entrenched special interests are almost unassailable and corruption and pork-barrelling are the only ways to get anything done. The point is not that Professor O'Brien is necessarily wrong and that the sceptics are right, but rather that most of his proposals raise serious problems and at the very least need a lot of hard thought before they could be implemented.

But it would be misleading to end on a negative note. In this book, Professor O'Brien continues his distinguished career as a slayer of sacred cows, most of which deserve slaying, or at least a damned good scare. Long may he continue to 'speak truth to power'. And he is never dull.

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Anthropology on Trial

*Chris Kenny, **Women's Business**, Duffy & Snellgrove, Sydney, 1996*

Reviewed by ***Roger Sandall***

'IF men define situations as real, they are real in their consequences.' So said a long-forgotten sociologist, and one way of approaching the Hindmarsh Island bridge saga is to see it as a perverse attempt to 'define a situation as real' regardless of the awkward facts uncovered along the way, so that 'good' interests triumph and 'bad' interests fail.

The title of Kenny's book is taken from the memorable words of consultant anthropologist Lindy Warrell: 'it would be nice if there were some women's business'. Seldom can wishful thinking have had such dire results. In Chris Kenny's invaluably detailed account of the affair we see how the overwhelming desire to achieve certain 'real consequences', in this case the blocking of a developer's marina plans, meant that truth was sacrificed; how as a result of Warrell's provocative hint suitable ethnographic 'evidence' was fabricated; how in the struggle to define the situation a conspiratorial misrepresentation was endorsed at the level of former Prime Minister Keating's cabinet, anyone querying these events being denounced in parliament and the media as a racist redneck. The maze of interests, personnel, and activities here laid bare is dauntingly complicated. A good deal more than just a work of reportorial enquiry, the portrait of modern Australia to be found in *Women's Business* is as intriguing as its social analysis. We are all in Mr Kenny's debt.

Where did the fraud start? Not, certainly, with the Aborigines who were opportunistically recruited to the cause, many of whom acted in good faith, and some of whose lives were made a misery. Rather, it began in the late 1980s as the desire of a combination of New Class urbanites with secluded weekenders, along with resident retirees, to preserve the lifestyle they were accustomed to. In their view, a bridge would open up what had once been a privileged private reserve. Then, after three years of complicated financing and development applications and environmental impact statements, including an anthropological report to the effect that no surviving Aboriginal mythology even referred to Hindmarsh Island, and none of which drew Aboriginal objections, the South Australian parliament decided to go ahead and build the bridge. The opponents now faced a supreme challenge. Only the 'sacred site' gambit was left. So one of the Weekenders said to Davey Thomason, an organiser for the CFMEU (whose most exciting public exploit was the smashing in of the glass doors to the Commonwealth parliament in August 1996, followed by the bloodstained oration he gave on camera), 'Let's see if we can get some Aboriginals down from Murray Bridge' (p. 47); a conservationist named Sally Francis in the Adelaide Hills did just that; in March 1994 aforementioned consultant anthropologist Lindy Warrell momentously hinted that 'it would be nice if there was some women's business' (p. 71); and at a meeting in October Aboriginal leader Henry

Rankine raised a laugh from his audience when he said that, although he didn't know of any sites, 'I'm sure if we have a look around we can find something' (p. 51). But fraud requires unusually strong nerves and single-mindedness. Only when Doreen Kartinyeri was added to the plot in April 1995 were these available. In 1983 she had said that she 'didn't know much about the culture, customs and language' of the Ngarindjerri (p. 164). Yet by 1995 the media had transformed her into an authority on such matters. It was she who produced the required synthesis of pseudo-ethnographic elements: a tale involving uterine waters and birth passages and who knows what else, much of it dreamed up by men who had been gazing over-imaginatively at a map.

Kenny is commendably even-handed, especially considering the insult and intimidation he himself had to endure in the course of his inquiries. He gives Kartinyeri appropriate credit for the tracing of Aboriginal genealogies which brought her academic recognition. He describes what he calls 'the terrible legacy of dispossession' and its effects on Aboriginal life (p. 71). He maintains a proper distance from developers Tom and Wendy Chapman, whose marina plans were the original cause of the dispute. He leaves it an open question whether the claims of conservation or of development better serve the interests of the people of Hindmarsh Island, who were themselves divided on the matter. The unusual realignments of position on Hindmarsh Island which were to be seen in both the South Australian Liberal and Labor Parties — Labor and Bannon first advocating the bridge while the Liberals, including Ian McLachlan, opposed it — are clearly described, and McLachlan's later role in the famous 'envelopes affair' which led to his shadow ministerial resignation is portrayed as the imprudent thing it was. The author notes three occasions on which reports of public interest were not released (that by anthropologist Rod Lucas in 1990, and both the Jacobs and Draper reports of 1994) and includes material from Lucas providing an early warning that the marina development 'would provide a chance for the Aboriginal community to exert its identity and authority', and that 'the potential advantages to developers [would be] necessarily played off against the political interests of contemporary Aboriginal groups' (p. 31).

But there is no doubt where Kenny's sympathies lie: with the 14 women who told the truth in the face of threats and ostracism; with the two anthropologists who emerge with credit from the affair, Philip Clarke and Philip Jones of the Anthropology Division of the South Australian Museum; and with the tragic figure of Doug Milera, the Aboriginal man who approached Kenny and blew the whistle, who as a party to the plot confirmed evidence already painstakingly gathered from other sources, and who was afterwards brow-beaten into an ambivalent retraction of his confession, only to be portrayed in the media as 'a drunken Aboriginal who would sell out his friends for a few dollars' (p. 207). Finally, Kenny's sympathy is with Royal Commissioner Iris Stevens, without whose patient hearings the truth could hardly have come out, the 'definition of the situation' otherwise likely to prevail being a fiction strenuously created by a coalition of protest groups and their media friends — especially the ABC.

Chris Kenny is himself a well-known reporter for Channel Ten in Adelaide. Vilified by all and sundry for arranging and broadcasting the interview with the 'dissident women' which exposed what was going on, he notes that 'considered, expert opinions were never allowed to dominate the public perception' of the Royal Commission, and that 'it would have been difficult for those of the public who relied on [the ABC] to understand the Commission proceedings' (p. 226). The ABC distinguished itself by its usual one-sidedness, by refusing to have anything to do with the dissident women, and, when it did finally deign to show one on camera, it allowed a young Canadian reporter to inform her sharply that her testimony was turning Aboriginal traditions upside down. An ABC television program by Stuart Littlemore of 'unprecedented length and virulence' tried to destroy Kenny (p. 209). The entire ABC coverage was predictably slanted, the issue being reported as one of 'cash versus culture', in which a Royal Commission was heartlessly 'pursuing Christian truth, possibly at the expense of another culture' (p. 189). Though it seems that in the view of one prominent Catholic the truth was irrelevant: 'Even if the story is true', Dr Damien Mead said to Kenny, 'you shouldn't be doing it' (p. 228).

For its part, the Uniting Church declared that the Royal Commission and author Kenny were putting Aboriginal beliefs on trial: 'The dominant Western culture will now stand in judgement over Ngarrindjeri culture and belief' (p. 188). But the Church was wrong. It was anthropology and the credibility of anthropologists which were on trial, and neither looked good in court. When faced with questions of truth or falsehood, the discipline itself was seen to equivocate: reality lay 'somewhere in between'. Endless pages of incoherent anthropological testimony called in question not so much the intellectual integrity of the witnesses as their mental capacity. Then there were the revealing comments of Lindy Warren broadcast on the ABC. Finding that her innocently casual invitation to fraud ('it would be nice if there were some women's business') had been picked up by the media, she said 'I've made a party joke of it ever since' (p. 226). This perfectly catches the tone of flippancy, cynicism, and childish irresponsibility which prevails across wide stretches of anthropological social life. What's a few million dollars? Or the lives of those Aborigines who stood up to be counted in the face of what they knew was fraud? The best treatment of this topic is, however, Ron Brunton's 'The Hindmarsh Island Bridge and the Credibility of Australian Anthropology' (*Anthropology Today*, Vol. 12, No. 4, August 1996). He says at the outset that the bridge affair 'has become a turning point for Aboriginal heritage claims in Australia'. This is true. Anyone wishing to know how that turning point was reached should read Kenny's admirable case history.

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Eminence Green

*Bob Brown and Peter Singer, **The Greens**, The Text Publishing Company, Melbourne, 1996*

*Reviewed by **Cathy Buchanan***

THERE was a time when one could ignore books such as *The Greens.* In this work, Brown and Singer set forth the philosophy and platform of the Green Party of Australia. The Greens are, by their own admission, rather eccentric nature lovers who spurn middle-class values and culture in favour of low-tech living. Green ideas are not new, nor are they likely to become very popular. But since the Greens have obtained seats in the upper houses of several Australian parliaments, they are in a position to influence government policies.

Understanding the Green philosophy is more difficult than it first appears. *The Greens* contains so many inconsistencies that it is hard to know which assertions are meant to be taken seriously. Thus, the authors claim to be the champions of the ordinary working person and make frequent appeals to the importance of democracy and free choice. Yet they want to deprive working people of many things they enjoy, such as automobiles, televisions, dishwashers and microwave ovens. Brown and Singer maintain that working people have been brainwashed by huge transnational corporations into wanting things they do not need, luxury items such as videocassette players and clothes dryers.

Brown and Singer claim that the Greens are a grass-roots democratic party; every person's voice should be heard; local governments should be strengthened. Yet when the authors discuss enacting any significant legislation, they favour using the federal government to do it. For example, they argue that the federal government should use its powers to regulate trading companies to enforce protection of the environment. The federal government should also increase taxes on the rich and reintroduce death duties as a way of paying for generous social welfare plans. Everyone should be forced to work fewer hours per week and suffer reduced income, in order to ensure a 'fairer distribution of work' (p. 133). Presumably, this would have to be achieved through federal legislation, since if any individual State or local government attempted to pass legislation limiting the working week to 30 hours, it would soon find a mob of consumption-loving workaholic citizens heading for the border, along with companies eager to employ them.

When Brown and Singer discuss the importance of helping poor people in other countries, they note that 'there is no principle of fairness that can justify the gulf between the wealth of most Australians and the poverty of most inhabitants of, say, Bangladesh' (p. 154). Although the authors claim they want to help people in impoverished nations, they also want to increase tariffs on the goods produced by those nations. But this would ensure that the poor countries got poorer and, for good measure, that the average Australian got poorer, too. Prices for goods formerly imported would rise, and Australians would be enticed into less productive

jobs. If the Green philosophy prevails, we will impoverish ourselves while performing the same charitable act on our neighbours.

The most striking inconsistency in *The Greens* concerns the use of Australia's natural resources. After railing against consumerism, destruction of natural resources and failure to preserve the planet 'as we found it', Brown and Singer reassure us that Australia can implement a vast social welfare scheme since it is the richest country in the world. As they note, 'When the value of Australia's assets, including people, land, minerals, railways and water systems were divided by the size of our population, we all turned out to be millionaires, well ahead of our nearest rival, Canada, and almost twice as wealthy as the citizens of the United States' (p. 117). It would be magical indeed if the Greens could make Australians rich from mineral resources that were never taken out of the ground, forests that were never disturbed and land that remained as we found it.

When the Green philosophy is inconsistent, it is merely amusing. When the Green philosophy is coherent, it is truly disturbing. The cult of Mother Earth has returned, and we must worship and protect our goddess at all costs. Human life is nothing special, certainly no more special than that of a frog. While Singer's 1994 book *Rethinking Life and Death* was theoretical in nature, in this work we see an attempt to implement many of his frightening ideas.

Brown and Singer apparently aim to be Green philosopher-senators, helping the ignorant masses realise what they should not want. Understanding the 'paradox of hedonism' (p. 57) will cure people of the disease of consumerism; we will happily turn back the clock to the days before washing machines, stereos and televisions. While this scenario sounds ridiculous, it may yet be realised by Green policies that make us too poor to buy basic conveniences such as cars and white goods.

One can only wonder at Brown and Singer's disregard of the basic facts of economics. They justify their repudiation of economics on the grounds that 'economics is not a science, and most economic prediction is guesswork'. Instead of standard economics, Brown and Singer advocate 'green economics', a system in which the laws of supply and demand apparently do not apply, and the economy is controlled 'democratically' (p. 121).

Many simple and attractive arguments can be made against the radical policies of the Greens, including the obvious one that we are products of nature and thus anything we do is 'natural'. The tragedy of the anti-market approach of the Greens, however, is that environmental problems arise because there are too few markets rather than too many. Resources that are not owned are excessively exploited. The worst environmental problems in the developed world exist in the formerly socialist Eastern Europe. Most progress is being made in solving the 'tragedy of the common' by introducing markets for resources, such as clean air, clean water, fish and other wildlife, that formerly were not owned.

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Japan, The West and The Rest

*John P. Powelson, **Centuries of Economic Endeavor: Parallel Paths in Japan and Europe and Their Contrast with the Third World**, The University of Michigan Press, Ann Arbor, 1994*

*Reviewed by **Pierre van der Eng***

WHY did Japan and the West do so much better than the rest of the world in terms of long-term economic development? What hope do the reforming former communist countries and Asia's rapidly growing economies have of emulating Japan and the West? A substantial answer to these simple questions could unlock the shackles which keep the rest of the world underdeveloped.

John Powelson, Professor Emeritus in Economics at the University of Colorado, has an answer, which he gives at the beginning of his book. He argues that in Japan, Northwest Europe and the latter's 'cultural descendants' the 'institutions of economic development' (the methods, rules and instruments of policy and exchange) were fashioned at an early stage, primarily by bargaining among the involved parties (peasants, landowners, producers and traders, but also nobility and church). Thus, these parties 'built into their systems ways of holding each other accountable for performance and for efficient use of resources, both public and private' (p. 1). Participation in processes of political decision making, or democracy, is therefore part and parcel of these societies.

In other parts of the world, equivalent institutions of economic *under*development were fashioned by autocratic rulers, the military or the elites which ruled a weakened citizenry. Here, the absence of a balance of power among interest groups discouraged an efficient use of resources and ultimately entrenched a condition of underdevelopment. In short, Powelson argues that the explanation of development lies ultimately not in economic factors, but in politics: in the creation of institutions that facilitate the diffusion of power in societies, and in the commitment of all factions in society to sustaining these institutions, on the understanding that it is in their best interests to do so.

Having given his answer, the author sets out to underpin his thesis. He starts with Japan, perhaps to emphasise that the country did not emulate the West. Japan developed its own liberal institutions well before the Tokugawa era (1603-1868); these have evolved in parallel with those in Northwest Europe since the Middle Ages. Powelson notes that feudal relations in Japan and Europe represented 'contract feudalism', based on the mutual benefit they yielded for lords and peasants. The institutions that facilitated power diffusion (such as the monetary system, the legal framework, trading practices, and parliamentary democracy) evolved when guilds and peasant groups formed vertical alliances with factions of the nobility in order to manipulate the balance of power in their favour. Leaders were held accountable for their actions, a principle which was maintained when the bases of power later shifted away from military and religious elites towards economic and political institutions. But why only Ja-

pan and Northwest Europe? Powelson's tentative answer is that relatively high population density and the geographical unsuitability of long-distance trade forced landlords and peasants to cooperate, a condition not found elsewhere.

After six chapters on Japan and Northwest Europe, Powelson devotes 16 chapters to most of the rest of the world. These chapters discuss countries which seemed set for sustained economic growth, but which faltered because power-sharing arrangements akin to those in Japan and Northwest Europe did not emerge: as happened in Africa, India, China, Russia, Spain and Portugal, Latin America, the Middle East, European city states and the 'Four Dragons' in East Asia. In Germany, they emerged only at a later stage, because the periodically recurring forces of 'Easternness' kept the country from emulating the rest of Northwest Europe until after World War II.

The main implication of the book is that sustained development is not possible without the mechanisms of power diffusion. Colonial governments ventured to introduce them in Africa and India. Success depended on the cooperation of local rulers, whose power was confirmed or enhanced in return for their willingness to adopt some of the organisations — not 'institutions', in Powelson's terminology — from the colonising countries. These efforts failed because the 'institutions' were not the result of the careful crafting which would have made them 'respected, trusted and even demanded' (p. 6). There was no commitment to sustaining them.

In other countries, where economic growth did take place, Powelson contends that development eventually had to falter because of the absence of processes of power diffusion. For instance, Russia experienced 'command growth'. Spain and Portugal under (respectively) Franco and Salazar underwent 'reflected growth' by merely absorbing 'institutions of economic growth from neighbouring areas of related culture' (p. 243), but without developing native institutions to facilitate power sharing. The author is also pessimistic about the rapidly growing economies of Asia. Powelson maintains that China's economic achievement in recent years is due not to the government's success in managing economic development, but to the demise of the key role of the central government as economic development has compelled it to share its power, in particular with provincial governments. China too can look forward only to a bumpy ride ('crisis'), when its 'elites' will have to negotiate with 'lower interest groups' (p. 188) about further power diffusion.

Surprisingly, Powelson groups the 'Four Dragons' (Hong Kong, Singapore, South Korea and Taiwan) together with Novgorod in the later Middle Ages and the North Italian city states of the 15th century. He maintains that all these states experienced rapid development because their autocratic governments chose growth on the basis of free market conditions, not because their institutions were crafted through lengthy processes of compromise and negotiation. Although the author is cautious, his comparison implies that the 'Four Dragons' will eventually follow these European city states into oblivion unless they do not find ways of creating the institutions of power diffusion.

Looking ahead, Powelson postulates that the less developed countries which are now implementing structural reforms in order to achieve 'the beneficent objectives of liberalisation, privatisation, and a market economy' (p. 330) are doing so merely to

please international agencies. Unless such organisations are carefully crafted in a 'free market in institutions' (p. 339), he expects the reforms to fail eventually.

Although thought-provoking, Powelson's thesis smacks of historicism, an overt belief in immutable historical laws. This is due mainly to the author's use of an up-front model of the relation between economic and political change, which is followed by a selection of historical details arranged in support of the thesis. For this exercise to be successful, the thesis has to be conveniently vague enough to accommodate all such details. For instance, power diffusion is clearly a matter of degree, given that not one but a range of 'institutions of economic development' will have to develop to sustain economic growth. This raises the question whether there is a critical minimum degree of power diffusion without which no economic development occurs at all. There are also the questions of which institutions will have to develop first, and who should take the initiative in developing them. If the interaction of farmers, landlords and guilds is the necessary prerequisite in the model, there indeed is no role for other actors.

At the other end of the scale, it is possible to be less exhilarated about the development of power-sharing arrangements in developed countries. One may wonder whether there is a critical maximum of power diffusion, beyond which the costs involved in maintaining the relevant institutions will start to stifle development. Solving issues through parliamentary democracy or through the courts may produce compromises which appeases most parties, but reaching the compromises can be costly.

There is also the problem of gauging power diffusion to establish the critical minimum or maximum. For instance, modern Japan may display the trappings of democracy, but could it be regarded as a society in which people exercise their constitutional rights to the full, and in which in which power is entirely diffuse? Can elected Japanese ministers really stand up against bureaucratic ministries? Does the Japanese electorate really determine government?

Powelson provides no answers to these questions. By keeping the thesis vague, he is able to shoehorn most cases in his mould. The consequence of using an upfront model is that, in Powelson's view, the former communist countries and the less developed countries cannot, because of their pasts, hope to emulate Japan and the West. They can look forward only to extended (a matter of centuries rather than decades) strife and confusion, and possibly the accompanying economic set-back as parties with an interest in sustaining economic development eventually work out ways of holding each other responsible and thus create the mechanisms of power diffusion. Weak governments have to shape up, strong governments have to tone down. The practical questions remain: how and to what degree?

Despite these criticisms, the book is thought-provoking and deserves to be widely read, if only because Powelson dares to chastise his economist colleagues for treating economic development as 'a mathematical exercise' resulting in a 'plethora of growth models' (p. 4), thus neglecting other fields of study and the evidence which the past can yield to substantiate or disprove theoretical approaches.

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Agenda, Volume 4, Number 2, 1997, pages 249-252

CORRESPONDENCE

*From **Jill Walker and Luke Woodward***

IN her article 'Australia's Merger Policy and the Caltex/Ampol Merger Case' (*Agenda*, Volume 3, Number 3, 1996, pages 305-316), Sandra Navalli suggests that the administration of merger policy by the Australian Competition and Consumer Commission (ACCC) is inappropriate and that its analysis of the potential consequences of the Caltex/Ampol merger was flawed. These suggestions seem to be based on the Industry Commission's submission on the ACCC's Draft Merger Guidelines, and its general report in relation to the petroleum industry, rather than on any independent assessment. A number of points need to be made.

First, Navalli confuses the law with its administration. Section 50 of the Trade Practices Act (the Act) prohibits mergers and acquisitions which substantially lessen competition. This is a consumer welfare standard, not a total welfare or efficiency standard. Some may consider that an efficiency standard is more appropriate, but this is not the law and it would be inappropriate for the ACCC to administer it as if it were. Australia is not alone in adopting a consumer welfare standard for merger law: it is the norm around the world. Adoption of the alternative total welfare standard is not as clearly preferable as might appear. Recent hearings before the Federal Trade Commission (FTC) in the United States indicate the complexity of the issues:[1] for example, whether efficiencies are otherwise achievable, whether efficiencies are real or pecuniary, whether efficiencies are likely to be sustained, and the impact of a lessening of competition on dynamic efficiency generally. Indeed, one submission to the FTC suggested that the Australian law is more advanced than other countries' in its consideration of efficiencies due to the availability of the authorisation provisions and the 'public benefit' test (see Griffin & Sharp, 1996).

Second, Navalli suggests that the legislative factors in s.50(3) are similar to those considered by the Tribunal in determining cases under the 'dominance' test. The reference is to *Re Queensland Co-operative Milling Association Ltd*, but this case was in fact considered under the 'substantial lessening of competition' test during its previous life. In relation to the ACCC's application of the statutory factors in its Merger Guidelines, a more critical review of the Office of Regulation Review's work would have revealed a highly selective and inaccurate reading of the relevant literature in relation to critical concentration ratios. This is discussed further in Anderson et al. (1996).

Third, in relation to the Caltex/Ampol merger, Navalli states that 'How the ACCC applied the five-step approach to this merger is unclear' (p. 309). It is unfor-

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[1] See a report by the FTC staff, *Anticipating the 21st Century: Competition Policy in the New High-Tech, Global Marketplace*, Antitrust & Trade Regulation Report Special Supplement, Vol. 70, No. 1765, 6 June 1996.

tunate that Navalli did not read Walker and Woodward's (1996) analysis of the merger and the role of enforceable undertakings in its resolution. She states that 'Few commentators expected that the proposed rationalisation would breach the "substantial lessening of competition" test or that the IC (1994) report confirming the competitiveness of the petroleum industry would apparently be ignored' (p. 309). Any commentator who did not consider such a likelihood could not have looked at the ACCC Merger Guidelines. It was quite clear that the proposed merger exceeded the concentration thresholds and that, at the very least, there would be a strong argument that import competition was not an effective discipline on the market and that barriers to new entry were substantial. Any such merger must run a very high risk of breaching the merger law. In addition, conditions in the industry were such that the proposed merger would increase the likelihood of successful coordinated conduct between the remaining four major players after the merger. It is not sufficient simply to dismiss these factors one by one, as Navalli does. Rather, one must consider an integrated analysis of the likely extent of competition in the market pre- and post-merger. The ACCC did not ignore the IC's report. It was a general report on the industry, not an analysis of the impact of a particular merger on competition. However, some of the market characteristics discussed were relevant to the ACCC's analysis: for example, lack of excess capacity and inelastic demand.

Finally, contrary to what Navalli claims, the ACCC cannot require merger parties to give enforceable undertakings under s.87B of the Act. Undertakings must be offered by the parties. As such, undertakings provide an alternative flexible solution to potentially anti-competitive mergers. In this case, the undertakings offered by the parties allowed them to preserve the efficiency benefits of the merger while maintaining competitive pressures in the market, so ensuring that consumers did not suffer higher prices and that efficiency gains are more likely to be sustained.

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Walker, J. & L. Woodward (1996), 'The Ampol/Caltex Australia Merger: Trade Practices Issues', *Trade Practices Law Journal* 4(1): 21-48.

Sandra Navalli responds:

WALKER and Woodward's first point is that consumer welfare is the aim of s.50 of the Trade Practices Act. This conflicts with the arguments of the Australian Competition and Consumer Commission (ACCC) for strengthening the merger laws. The ACCC relied heavily on Michael Porter's arguments that industry would be the prime beneficiary with the creation of internationally competitive companies through strong domestic competition. Little emphasis was placed on consumer welfare. As well, the then Attorney General, Michael Duffy, said when introducing the amendments to s.50:

> Part IV, which contains the restrictive trade practices provisions, is designed to facilitate and promote competition. This is based on the premise that competition will yield the best allocation of economic resources, the lowest prices to consumers, the highest quality of goods and services and the greatest national progress.[2]

Thus, if competition is a means to achieve a number of goals, the question arises as to why the ACCC has decided to focus mainly on consumer welfare. Arguably, the test in s.50 is vague, and, given the non-exhaustive list of factors in s.50(3), a number of factors could be taken into account. The ACCC does give consideration to efficiency arguments if companies apply for authorisation; but how is this weighed against consumer welfare? Normative arguments to the effect that efficiency (and hence total welfare) should be the goal are relevant.

Second, although *Re Queensland Co-operative Milling Association Ltd* was decided under the 'substantial lessening of competition' test, it is generally regarded as the first Australian case to discuss the factors that were subsequently applied under the dominance test in other cases, and adopted into legislation. The essential point is that these factors have remained the same under both tests and hence do not provide guidance as to how the two tests differ.

Third, my claim that it is unclear how the ACCC applied the five-step approach was based on the information released by the ACCC at the announcement of its merger decision, and was intended to highlight the lack of clear and broad indicators that the business community can rely on. No one is able to foretell whether the ACCC will block a particular merger by applying the guidelines, unless the ACCC indicates to the media its approach to particular industries such as banking. Walker and Woodward say that the ACCC's reasons are spelt out in their article. Does this mean that we must always wait for the ACCC's official reasons to be explained at a later date? They also object to the factor analysis used in my paper; but what they describe as an 'integrated analysis' could also be interpreted as vague reasoning, unsupported by any specific facts.

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2 Second Reading Speech, Australia, House of Representatives 1992, *Debates*, vol. HR103, p. 2405.

Finally, Walker and Woodward say that the ACCC cannot require parties to give undertakings. Not legally perhaps, but if the ACCC threatens to block the merger, parties have little choice. Legal proceedings are time-consuming and costly. Parties have to satisfy the ACCC in this informal negotiation process. These tactics force the parties to offer undertakings.

Agenda, Volume 4, Number 2, 1997, pages 253-263

NON-AGENDA

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

—— *Jeremy Bentham* (c.1801)

Does Australia Really Need the ABC?

Ross Jones

IN July 1996, the federal Minister for Communications and the Arts, Senator Richard Alston, announced a review of the role and functions of the Australian Broadcasting Corporation (ABC), the first major review since the 1982 Dix Report. The review, conducted by Mr Bob Mansfield, released its report, *The Challenge of a Better ABC,* in December 1996. By concentrating on financial issues, however, the review ignored the most important issue: whether there is any need for a publicly funded broadcaster such as the ABC.

Arguments for Public Broadcasting

The ABC, which receives about $500m annually from taxpayers, has five major official objectives. They are:

1. to be distinctly Australian, developing and enriching a sense of Australian culture;

2. to be an effective and distinctive alternative to other broadcasters by providing a wide range of high quality and innovative services to rural and remote Australia, to the cities and to specialist and minority audiences;

3. to provide Australians with independent coverage and analysis of contemporary issues and events;

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4. to achieve the most cost-effective use of its resources; and

5. to employ and develop new technologies and techniques that will improve service and efficiency (DTC, 1992).

These objectives reflect the widespread beliefs that only tax-financed public broadcasting is capable of providing quality programs, and that, without it, consumers would face a limited choice of programs. In particular, it is believed in many English-speaking countries that popular broadcasting by advertiser-financed commercial channels must inevitably be dominated by American products at the expense of local culture and to the detriment of national identity. The argument goes that commercial broadcasters provide programs free to consumers and are therefore unable to measure the intensity of demand for particular types of programs by consumers' willingness to pay. Consequently, they always give priority to maximising their audience and so tend to produce the same types of programs (such as news and current affairs and sport) and to show them at the same times. Correspondingly, they have little incentive to provide programs which attract minority audiences, thus failing to meet audience demands for a greater diversity of programming.

Such market failure can allegedly be corrected by the diverse range of programming made available by public broadcasters, a range far beyond that provided by private broadcasters. This diversity also promotes the preservation and enhancement of a national culture and identity. Although commercial broadcasters may provide news, current affairs, sport and quiz show programs with a strong domestic content, they are less likely to provide indigenous drama programming given its relatively high cost and the low price of imported, especially American, drama. Hence, it is argued, taxpayer-funded public broadcasting is justified on cultural as well as economic grounds.

Does the Market Fail?

But does the broadcasting market fail in this way? And, if so, why?

It seems plausible to argue that Australia's three commercial television networks do not provide as diverse a range of programming as may be demanded. As their critics point out, they provide similar types of broadcasting and schedule them at similar times. Yet a very diverse range of commercial radio programs is available in Australia. This difference between radio and television in terms of content diversity reflects different degrees of market competition: whereas many commercial radio channels exist, there are only three commercial television broadcasters, each of which has to try to achieve the maximum audience size by providing programs that appeal to the majority. In this sense, the provision of more diversified services by a public broadcaster may be justified.

However, the oligopolistic market structure of Australian commercial television is a consequence of government regulation. It is more than 30 years since the third commercial network (Ten) was licensed to operate in Australia's major cities. Few

other industries have received such protection from governments against new competition. Yet in many cities around the world with markets the size of Sydney's and Melbourne's, many competing commercial broadcasters exist, both free-to-air and, more recently, pay TV. But in Australia, the three existing commercial networks have for many years successfully lobbied governments to prevent new free-to-air and pay TV services.

The introduction of pay TV and new digital technology is likely to have profound effects on both commercial television stations and public broadcasters. Already pay TV is providing a diverse range of channels, with dedicated movie, sport, children's and documentary channels. Internationally, a vast range of minority interest channels is available and is likely to become available in Australia in the next few years. Some of these channels may be little more than repackaged library material from foreign production companies; yet consumers appear to value them sufficiently to pay for them. While some critics of pay TV have claimed that it provides '57 channels and nothin' on' (to quote Bruce Springsteen, 1992), such claims merely reflect the bias of these critics rather than providing a justification for the public provision of 'quality' programming.

Digitalisation may make possible the entry of more free-to-air broadcasters if the government refuses the demands of the existing commercial networks to be allocated the additional spectrum freed up by digitalisation. As the number of channels increases, diversity will expand rapidly. Consequently, the argument that a public broadcaster such as the ABC is necessary to provide diversity will become increasingly irrelevant as commercial channels compete against each other by offering a greater range of program choices.

High-Quality Services

Arguments that the ABC is necessary to provide 'quality' are similarly undermined by the greater available choice. The claim that a public broadcaster should provide 'superior' programs to those that viewers might otherwise choose is patronising and elitist. The most effective way to encourage consumers to widen their programming tastes is to provide a wide range of choice, something subscription television can do more effectively than a single-channel public broadcaster. The wide range of cuisines now available in Australian restaurants is evidence of way in which unrestricted competition encourages experimentation and diversity.

A related argument is that public broadcasting is needed because consumers have insufficient information about program content and quality to make informed choices. But many entertainment services suffer from an 'information failure' problem. Consumers are typically not fully aware of the quality of a movie or a play or a concert before they buy the service; but the suppliers survive without subsidies such as those given to public television.

In numerous other information and entertainment industries, competitive private companies provide quality and diversity. For example, it is rare to hear the claim that Australia needs publicly funded newspapers and magazines to ensure quality. Australia also has a number of quality newspapers which do not need pub-

lic funding and ownership to survive. Indeed, publicly funded broadcasters such as the ABC may hinder the development of quality and diversity. The provision of broadcast services at no direct cost to the viewer may be a major barrier to the entry of new competing commercial services. Just as a publicly funded quality newspaper would put in doubt the viability of a number of Australia's quality newspapers, the 'free' ABC will probably inhibit the development of wide range of quality television channels in the future.

As well, the diversity offered by public broadcasters may not necessarily reflect consumer demand. Just as in a centrally planned economy the planners often make inaccurate demand and supply forecasts, so may public broadcasters. Their programs may reflect the interests and opinions of those who spend the public money rather than of the taxpayers and viewers who supply it. And while public broadcasters may provide greater diversity than a small number of commercial free-to-air broadcasters can, they have neither the financial resources nor the channel capacity to provide the diverse range of programming available from subscription television.

One area where market failure may justify some form of intervention is children's programming. Children may not be aware of the benefits of education and the merit in consuming educational programs. Further, even if they were aware of benefit, they are unlikely to have the direct purchasing power to convey their demands for programs to producers and broadcasters. However, this consideration is insufficient to justify the existence of public broadcasters such as the ABC: quotas for children's programs on commercial networks together with subsidies for the production of programs with educational merit may be a more efficient mechanism.

Independent Coverage?

The claim that the ABC provides independent and unbiased coverage of news and current affairs is also open to debate. News and current affairs on public broadcasters may not be subject to the influence of a proprietor, but it may nevertheless reflect the views of its 'owner', in this instance the government, particularly when the government provides the public broadcaster with its income. On numerous occasions, the ABC has been accused of bias in its news reporting. But news reporting may often reflect the bias of the reporter rather than the media owner. The most effective way to counter any perceived bias is to ensure that a diverse range of information sources is available.

Given the prestige, influence and reputation for independence that is traditionally associated with national broadcasters, the possibility of bias in the news reporting of the ABC is of greater concern than in the case of private sector organisations. But the ability of new technology such as pay TV and digitalisation to provide a range of channels and consequently a range of reporter viewpoints may be the most effective answer to the problem. A number of such sources now provide a range of current affairs and business channels offering a range of views. While these sources are typically foreign rather than Australian, future expansion of pay TV channels may provide a greater range of domestic as well as foreign perspectives

on news and current affairs should consumers value such choices sufficiently to be prepared to pay for them.

Public Broadcasting Objectives Revisited

There is, then, little justification for continued taxpayer funding of public broadcasting on the grounds of market failure. But even if such justification did exist, the question remains whether Australia's public broadcasters meet their official objectives.

One of the ABC's stated objectives is to develop a sense of Australian culture. It appears to have had little success. The Mansfield Report (1997:36) notes that, in 1995 and the first half of 1996, no Australian drama or comedy program was among the 20 most popular ABC programs. By contrast, seven British drama and comedy programs were among the top 20. Audiences for ABC coproductions were found to be on average 25 per cent higher than for in-house productions. This suggests that the ABC was not particularly adept at producing Australian programs that Australians wanted to see. But if the ABC is to develop a sense of Australian culture, people at least need to be watching its programs.

Arguably, the commercial networks are better at meeting this cultural objective. The commercial networks are subject to rigorous Australian content requirements: the Australian Broadcasting Authority requires that 50 per cent of all programs broadcast between 6am and midnight must be Australian-made. The most popular Australian programs are broadcast by commercial stations. Perhaps the cultural objectives should be left to the commercial networks.

A recent analysis by the Bureau of Transport and Communications Economics (1996) of the community benefits of Australian television programming and regulation found that Australians were dissatisfied with the mix of Australian programming; substantial unmet demand existed, for example, for documentaries and children's programs, whereas drama series and serials were oversupplied. The ABC does not appear to be programming to meet such stated demands.

The commitment of the ABC to another of its objectives — regionalism in broadcasting — was also questioned by the Mansfield Report (Mansfield, 1997:24). The ABC has in recent years reduced State-based programming on television and (to a lesser extent) on radio. The Report notes that the ABC could not reflect the plurality of Australian views if it operated only from the capital cities.

Australia's other publicly funded broadcaster, Special Broadcasting Services (SBS), has similarly failed to meet its objectives. Launched in 1980, SBS television was designed to provide an 'ethnic' multicultural television service. However, SBS television, which several years ago started accepting advertising, now proclaims itself to advertisers as providing a unique marketing audience. 'They are the A-B audience, highly educated, very selective, very independent', according to the head of SBS marketing (*The Bulletin*, 8 October 1996). The average taxpayer, it appears, is subsidising the viewing habits of a wealthy section of the population: a damaging admission for a public broadcaster. The typical SBS audience would appear to be precisely that which should be served by a quality commercial subscription service.

The Future of Public Broadcasting

If the traditional arguments for public broadcasting ever had much weight, they certainly do not nowadays. Technological developments have led to an enormous expansion of capacity, and enable service providers to charge consumers directly for programming. Consequently, a huge range of programs can be supplied to consumers, and such programs will reflect consumer demand.

As subscription television grows, the demand for public broadcasting services is likely to decline. Faced with dwindling audience share, public broadcasters may become expensive marginal anachronisms. A logical response would be to move towards privatisation. SBS is an obvious and immediate candidate for privatisation. It would function successfully as a private subscription network. It already provides (with pay-TV partners) subscription television. There is also scope for the ABC to provide a range of subscription channels. The British Broadcasting Corporation has already launched similar ventures. Digitalisation of free-to-air broadcasting over the next few years could provide the ABC with the option of supplying subscription services which meet consumer demand.

However, taxpayers would not need to fund such services. The most important role for government in broadcasting is to enforce strong competition laws. The government should ensure that opportunities exist for new firms to enter the media markets, and that no firm can gain or maintain excessive market power. To this end, privatisation of SBS and ABC, new free-to-air licences for digital broadcasters, and an open-access regime for cable and satellite delivery would more effectively achieve the objectives of diversity and high quality in programming.

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Not Calling the Tune: Australian Taxpayer Subsidies to Parties' Election Campaigns

Ian Farrow

HOW many Australians are aware that when they cast their ballots at a Commonwealth general election they are also facilitating taxpayer contributions to the political parties?

Taxpayer funding of political parties was one of a number of significant changes to the electoral system introduced by the Hawke Government in 1983. The changes comprised:

- expanding the size of the federal parliament: the House of Representatives by 23 seats (to 148) and the Senate by 12 seats (to 76);
- establishing a system for the registration of political parties with the Australian Electoral Commission, enabling them to have their party name printed adjacent to their candidates on ballot papers;
- providing the registered political parties with access to the electoral roll in electronic format to facilitate direct mail operations: a privilege that is not available to other organisations or individuals;
- modifying the voting system for the Senate, so enabling party machines to control more tightly the flow of preferences through an 'above the line' group ticket voting system;
- requiring political parties to disclose campaign donations above a certain level; and
- introducing taxpayer funding of election campaigns.

In 1983/84 the first taxpayer funding scales were set at 66 cents (then equivalent to two postage stamps) for each first-preference House of Representatives vote and 33 cents for each first-preference Senate vote. Political parties were required to account for their expenditure. Although they were prohibited from receiving more funding than they had actually spent on their election campaigns, the major political parties easily outspent whatever they later received in taxpayer funding.

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The first Commonwealth election to which these changes applied occurred in 1984, and resulted in payments to the political parties of $7.5m. As the original funding scales were later indexed to the Consumer Price Index, by the time of the 1993 Commonwealth election subsidies amounted to one dollar for each House of Representatives first-preference vote and 50 cents for each Senate first-preference vote. Taxpayer subsidies to the political parties following the 1993 election amounted to approximately $15m.

Taxpayer Funding Doubled

Taxpayer funding of election campaigns was doubled in 1995 to more than $30 million (see Table 1), in time for the 1996 Commonwealth election.

The 1995 legislation increased taxpayer funding to $1.50 (indexed) for first-preference votes in both the House of Representatives and the Senate. By the time of the 1996 election, indexation had increased this amount to $1.57. The legislation also removed the requirement that taxpayer funding be limited to the amount declared as campaign expenditure, thus making it possible for subsidies to exceed campaign costs. No moves were made at the same time to restore the repealed subsection 329(2) of the Electoral Act that subjected political parties to the same standards that applied to the private sector requiring 'truth in advertising', even though the Dissenting Report of the Joint Standing Committee on Electoral Matters by Opposition parties after the 1993 election had asserted that

> ... if some of the misrepresentations which occur during election campaigns were to happen in the private sector, the perpetrators would find themselves liable to prosecution under the Trade Practices Act. (1994:164)

The legislative changes to the Electoral Act strongly suggested collusive behaviour between the major beneficiaries in the Australian Labor Party, the Liberal and National Parties and the Australian Democrats. The sole dissent to this arrangement came from the Western Australian Greens, with Senator Christabel Chamarette asserting that

> This is a disgraceful rort which the public has not had a chance to debate because the deal was kept behind closed doors until recently. Not even the Joint Standing Committee on Electoral Matters was consulted on the proposed changes. (*Sydney Morning Herald*, 21 April 1995)

At an estimated total cost of $100m, the 1996 Commonwealth election was the most expensive in Australian history (*Australian Financial Review*, 22 January 1996). Taxpayer funding provisions formed a significant component of the increased cost.

Table 1 suggests that some political parties made slight losses due to high levels of campaign expenditure. But taxpayer funding is in addition to the millions of dollars in campaign contributions solicited from other sources such as businesses

and trade unions. The Liberal Party, the Australian Labor Party, and the National Party reportedly received almost $39m, $30.4m and $5.5m respectively in campaign donations before the 1996 election (*Australian Financial Review*, 4 February 1997). The available data strongly suggest that some political parties made significant profits from the 1996 election through a combination of campaign contributions and taxpayer funding.

Table 1

1996 Commonwealth election: taxpayer funding of, and declared expenditure by, political parties (A$)

Political parties	*Taxpayer funding*	*Declared expenditure*
Liberal / National Parties	15,610,253	16,949,734
Australian Labor Party	12,856,383	13,806,144
Australian Democrats	2,968,965	1,615,648
Greens	447,748	397,527
Others	271,451	659,471
Total	**32,154,800**	**33,428,524**

Source: Australian Electoral Commission web site: http://www.aec.gov.au/funding.html

The 1996 Oxley Campaign

The 1996 campaign in the House of Representatives electorate of Oxley provided a good example of the enthusiasm with which the political parties pursue taxpayer funding. Although Pauline Hanson was disendorsed by the Liberal Party following her comments about Aborigines, she remained officially nominated by the Liberal Party, and on the ballot papers the word 'Liberal' remained adjacent to her name. Following the election, the Liberal Party received $55,000 from the Australian Electoral Commission in respect of votes cast for a disendorsed candidate. Mrs Hanson is taking legal action against the Liberal Party to recover this amount, in order to cover $12,000 of campaign expenditure (which the Liberal Party has offered her) and to contribute the balance towards the purchase of a new police car for the electorate (*Australian Financial Review*, 10 October 1996).

The Impact of Compulsory Voting

Australia is one of the few democracies to make voting compulsory. Since support for either the ALP or the Liberal-National Coalition rarely falls below 40 per cent,

the voter participation rate secured by compulsory voting combines with taxpayer funding effectively to provide the political parties with financial security.

The Dissenting Report (by members of the Liberal and National Parties in Opposition) of the Joint Standing Committee on Electoral Matters commented:

> Compulsory voting is not the democratic norm. No other English-speaking democracy has it, nor does any other major democracy. In principle it is contrary to the spirit of democracy, which is based on the right to vote (or not to vote). (1994:157)

Subsidising Television Stations

Taxpayer funding has been defended by the National Secretary of the Australian Labor Party, Gary Gray, as compensation for 'the service that we provide in connecting the political leadership to the grass roots' (Gray, 1996:53). In fact, this is code for extra television election advertising and the assembling of direct mail databases on Australian citizens. As Stephen Mills (1986:129) notes,

> By virtually guaranteeing the Parties a minimum reimbursement, public funding means they can spend other funds with greater ease than before. This means costs will continue rising. And by failing to place restrictions on the way Parties spend the public monies, the new rules ensure TV proprietors will continue to reap a good harvest every election time. ... Under the public funding rules the public is effectively being hood-winked. Public funding of election campaigns mainly means public funding of TV stations.

Mills further observes that television stations charge political clients more than they would charge normal commercial advertisers, both because of the sudden demand requirements by political parties to schedule advertising during the election campaign period and the use of standard advertising rates. If the television stations provided the political parties with discounts on their standard rates, as they might do for other high volume advertisers, the Electoral Act would require them to declare the discounts as *de facto* donations to the political parties.

Reforming the Electoral System

Taxpayer funding of election campaigns is a symptom of waning public involvement in political parties. All Australian political parties are experiencing a long-term membership decline, occasionally interrupted by frantic recruitment in safe electorates prior to party preselections. Taxpayer funding amounts to a substitute source of income for political parties; it also renders party members and supporters even less relevant to the electoral process.

The present electoral system is increasingly designed to serve the interests of the elected rather than the electors. It could be substantially reformed by abolishing

compulsory voting, rescinding the taxpayer funding of election campaigns and ensuring that the political parties are subject to the same advertising standards as those that apply to the private sector. It is, however, very unlikely that the Commonwealth parliament will undertake such reforms in the foreseeable future. In particular, it is unlikely to abolish the taxpayer funding of political parties, even in the interests of fiscal consolidation.

It used to be said in connection with donations to political parties that 'those who pay the piper call the tune'. If taxpayers at present have no choice but to continue funding political parties (which are private organisations), perhaps they could successfully demand greater control over how their taxes are spent. They could insist on two changes: that political parties adopt minimum standards for internal elections and procedures as a condition of entitlement to taxpayer funding; and that the Australian Electoral Commission publicise details of the operation of taxpayer funding in conjunction with the normal voter information campaign during Commonwealth elections. An electorate better informed about the present system would undoubtedly demand further change.

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