

Australia-USA Free Trade: Competitive Liberalisation at Work in 2003

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A little less than two years after its launch, the World Trade Organisation's latest round of multilateral trade negotiations, the 'Doha Development Agenda', has failed to live up to original expectations. The collapse of the Cancun Ministerial meeting in September, coming on top of missed negotiating deadlines earlier in 2003, has lowered expectations and made completing the round on schedule (before the end of 2004) problematic. Meanwhile, Australia and the United States, arguably two of the strongest supporters of the multilateral trading system are each working hard on a number of preferential trade arrangements (PTAs) — a term which will be used to refer to those bilateral and plurilateral trade agreements envisaged in the WTO GATT 1994 (Article XXIV) and GATS (Article V) Agreements. Although customs unions will be included by reference, the bulk of the discussion will be directed at free trade agreements that do not call for common external levels of protection. One of the more significant of these efforts is the negotiation of a bilateral Australia-US free trade agreement (AUSFTA) linking the two countries in what would be a combined market of over 300 million consumers.

This sounds impressive, but few economists argue that a bilateral preferential free trading arrangement like AUSFTA would produce greater gains than a successful WTO round. On top of what some argue is a distraction from a needed focus on the WTO talks, the negotiation of the bilateral agreement is consuming no small amount of scarce human and budgetary resources. The acceleration of the negotiating time frame (with an objective of finishing in 2003) has not made matters any easier. So why are Canberra and Washington expending considerable time and resources on AUSFTA when the WTO negotiations seem to be in a bad way?

The answer lies in part in the exercise of a policy of 'competitive liberalisation' embraced and espoused by politicians and negotiators in both the United States and Australia. AUSFTA and similar initiatives are designed to complement the negotiating effort in Geneva by putting additional external pressure on other players in the Doha process while at the same time producing tangible (and earlier) trade benefits for the business communities in Australia and the USA. There is also an undeniable (and undenied) political and security aspect to the AUSFTA negotiation that should not be ignored in any discussion of this ambitious initiative.

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Local debate relative to AUSFTA has moved on rapidly from its initial stages when one would find a plethora of newspaper articles and Op-Ed pieces arguing against the negotiation of this proposed agreement. For better or worse, the idea that AUSFTA will be a feature of Australia's economic and political future now seems to be a foregone conclusion. Commentators no longer discuss whether there will be an agreement, but what will be its eventual content and likely impact on Australia and on this country's trade and political interests with third parties. Of course, this does not mean that everyone is enthusiastic about the agreement.

The agreement that will emerge from the negotiations is likely to be a comprehensive agreement of a type that would pass muster under the relevant WTO provisions governing PTAs. AUSFTA is unlikely to result in any significant trade diversionary effects and will contribute to (not detract from) a successful WTO 'Doha Round'. Moreover, the evidence thus far on economic benefit suggests that the USA and Australia will both realise welfare gains from this agreement.

Multilateralism Versus Regionalism

Before analysing the AUSFTA-specific negotiation in any detail, we briefly review the 'multilateralism' versus 'regionalism' debate. As noted above, academic economists are in general agreement that both national and global economic welfare are better served by multilateral trade liberalisation under WTO than they are under PTAs. There is also a general appreciation for the idea that PTAs in certain circumstances can lead to economic effects (trade diversion and misallocation of investment) that actually produce losses in economic welfare. There are also those who seem to argue that there is no such thing as a 'good PTA' because any and every PTA inevitably incorporates discriminatory features that undermine the health of the inherently superior multilateral system. This group is also likely to add that the demonstration effects of PTAs encourage others to do likewise — exacerbating the seriousness of the attack on the MFN principle. For want of a better label, this group is referred to as the 'Bhagwati Camp' in acknowledgement of Professor Jagdish Bhagwati of Columbia University who is probably the person most closely associated with an ongoing effort in support of this view. Here in Australia, there are a number of adherents to the Bhagwati Camp, the most active of which seem to be associated with the Australian National University.

A variety of measures are used to estimate the number of PTAs in effect in 2003, but a fairly constant 'best guess' puts the number at around 175-180. This is a large number. It is also clear that the number of PTAs has been rising rapidly in recent years and has shown no signs of slowing in the post-1995 WTO era. Close to a hundred of these PTAs have been negotiated since the WTO entered into force and more than seventy are currently under negotiation. Those who are concerned about the threat posed to WTO by PTAs are alarmed by this steep rise. However, the authors of the World Trade Organisation's 'World Trade Report — 2003' note that one explanation for the apparent large increase in the number of

PTAs relates to the efforts of former COMECON members to re-establish trade links in the period following the collapse of the Soviet Union — with something like one-third of PTAs in the 1990's being concluded amongst Central and Eastern European 'transition economies'. Notwithstanding such qualifiers, PTAs are clearly in vogue. There are at last count 148 Member governments in the World Trade Organisation and a larger number (around 170) participating in the current Doha Round of multilateral trade negotiations.¹ According to the WTO's 2003 Report, the number of Members not party to any PTA stands at just four.² This has got to be cause for concern in the Bhagwati Camp.

All economists see value in multilateral liberalisation but not all think there is nothing good that can come out of PTAs. Some economists even see the possibility for PTAs to contribute to further liberalisation on a global level through the multilateral system of the WTO. A lot depends upon the nature of the PTA at issue, however, and later in this paper I plan to examine aspects of the likely result of the AUSFTA negotiations from the standpoint of whether it contributes or distracts from a WTO result and whether it contributes to the economic welfare of its participants.

For now, the question is whether or not — with the Doha Round in some trouble — it is a good idea to be negotiating a PTA between the United States and Australia. How PTAs and the WTO system interact is part of the subject taken up by Richard E. Baldwin (1997) in a thoughtful analysis of the causes of regionalism. His general conclusion is that there is no convincing evidence to support the notion that the negotiation of PTAs has hindered multilateral liberalisation or harmed the WTO system. Among other things, Baldwin points out that those countries and regional groupings that most pushed for multilateral liberalisation over the history of the GATT and WTO are the same ones that masterminded and extended liberalisation of trade on a PTA basis. This leads us right into the discussion of PTAs and multilateralism and the notion of a 'competitive liberalisation' linkage between the two approaches.

The term 'competitive liberalisation' may well have been coined by Fred Bergsten (1996) when he laid out his views on how preferential trade agreements had worked in the past to stimulate progress in negotiations on the multilateral front, and how a combination of multilateral and preferential efforts might be pursued in a strategy to achieve global free trade. In the very beginning, it was the formation of the European Communities (EC) that led the USA (which could not itself join the EC) to push for the Kennedy Round of multilateral GATT negotiations. Other notable past examples of preferential trading agreements contributing to constructive pressure on the multilateral system include the pre-

¹ The rules agreed for the current round of negotiations permit the participation of those non-Members in the WTO that are in the process of acceding to the Organisation.

² As of March 2003, WTO (2003:46) listed Hong Kong, China, Macao, China, Mongolia and Chinese Taipei, but noted that of these only Mongolia was not engaged in PTA negotiations. Since then, Hong Kong, China and China have concluded a 'Closer Economic Partnership' agreement.

Tokyo Round enlargement of the European Communities and developments in APEC and NAFTA's finalisation in the early 1990's at a time when the Uruguay Round was in real trouble. Bergsten also credits PTA negotiating efforts in the post-Uruguay Round period with keeping up the momentum for trade liberalisation. I would agree with this view. Given the disastrous situation of the WTO system in the 18 months following the 1999 meeting in Seattle, it is probably a very good thing that trade liberalisation efforts were not identified solely with the global system. Bergsten is clearly of the view that while the global multilateral system is the best approach, the 'competitive liberalisation' aspect to PTAs helps to get us where we want to be (global free trade) at the end of the game.

Back to Richard Baldwin's paper which should be required reading for anyone interested in this debate. Many others have argued that the rise in regionalism grew out of frustration with the cumbersome multilateral process and that the straw that broke the camel's back came when one of the system's main defenders, the USA, abandoned its preference for the multilateral system in favour of PTAs. Through his examination of a series of historical developments and the politics surrounding the negotiation and approval of trade agreements, Baldwin succeeds in refuting the argument that PTAs are pursued because they are 'easier' than multilateral negotiations under the WTO. He also counters the theory that the big increase in the number of PTAs in recent years can be traced to a conversion of the USA from a 'multilateralist' to a 'regionalist'. Baldwin (1997:884) concludes that:

'Rejecting the standard explanation is important since, if it is wrong, many fears concerning regionalism are misplaced. Regional liberalisation did not occur because regionalism was easier, so regional agreements are not necessarily substitutes for multilateral liberalisation. Moreover, since the U.S. was always prepared to pursue regional and global liberalisation in tandem, resurgent regionalism does not mean that the U.S. is disaffected with the WTO-centred system.'

What is even more interesting about Baldwin's analysis is the conclusions he reaches in respect of how PTA-based initiatives can be an important motor on a national level for multilateral liberalisation. Where exporters are the key pro-liberalisation force in a country and those who compete with imported goods and services are the key protectionists, he argues that any liberalisation (PTA as well as multilateral) that acts to increase exports and imports will tend to enhance the influence of exporters and weaken protectionists.

To illustrate the approach, consider how episodic GATT rounds started a liberalisation dynamic in industrialised nations. Announcement of a reciprocal trade talk multiplies the ranks of pro-trade forces by making exporters — normally indifferent to domestic protection — opponents of domestic import barriers. The same goes on in other nations, so the resulting political equilibrium involves liberalised domestic and foreign

markets. While the liberalisations are phased in, export interests get stronger as they expand output and employment. Import competitors get weaker as they scale back or shutdown. (p. 885)

Baldwin argues that each time this cycle is repeated, whether the impetus is bilateral or multilateral, pro-trade forces will be relatively stronger than protectionists at the start of the process. Of course, he also acknowledges that the direction of this dynamic depends upon the nature of the trade agreement. The argument would break down in the face of a negotiation designed to result in an agreement aimed at giving protective cover to import-substituting industries — as in Europe's CAP or certain South-South PTAs. But, in general — and for the purpose of this paper — Baldwin's arguments mean that we should expect that a comprehensive and genuinely liberalising accord such as the proposed AUSFTA will enhance the power of pro-trade groups in the USA and Australia. This increases the power of these positive groups in their subsequent arguments in favour of liberalisation through the WTO route, diminishing protectionists' chances of undermining the Doha Round's objectives, *inter alia*, in respect of improved treatment of goods from developing countries.

Not surprisingly, not everyone has read or agrees with Baldwin. One of the recent Australian-based economic examinations into the proposed AUSFTA clearly started from the premise of the Bhagwati Camp and concluded (with little background explanation) that the bilateral agreement would not only produce likely economic losses for Australia but would also work against the interests of Australia in seeing a successful conclusion to the WTO round (ACIL Consulting, 2003). This is a dubious proposition. Apart from the convincing arguments such as those advanced by Baldwin, it is obvious that officials at the highest levels in both Canberra and Washington recognise the limitations of the bilateral route. Progress in AUSFTA is seen as helping to advance a shared interest in the WTO round. US Trade Representative Bob Zoellick has said repeatedly that a necessary criterion to be fulfilled before the United States will enter into a PTA negotiation with another country is that the country in question must be prepared to cooperate with the USA toward a successful outcome in the WTO negotiations.

AUSFTA — A 'Third Wave' Agreement

Not only are there a great deal many more PTAs in 2003 than we saw just a decade ago, but the nature of these agreements is considerably different from bilateral and plurilateral agreements negotiated in the period prior to the establishment of the World Trade Organisation in 1995. The scope and coverage of modern PTAs go far beyond the preferential lowering of tariff barriers to include most if not all of the non-tariff aspects of the WTO system (for example, services, intellectual property rights, product standards, and government procurement.). Many PTAs also go beyond the coverage of the WTO in 'WTO-Plus' disciplines related to areas like competition policy, investment regulation, dispute settlement, and standards relative to protection of the environment and

rights of workers. In its May 2003 Staff Working Paper, the Australian Productivity Commission characterised such modern agreements as ‘Third Wave’ PTAs. No discussion of a PTA at this stage is complete without reference to tariffs and this is also necessary here due to its relevance to a later portion of this paper. But the primary focus will be on those aspects of the AUSFTA we can reasonably expect to be ‘Third Wave’ or ‘WTO-Plus’.

In its report, the Productivity Commission also implies the obvious: the changed nature of modern PTAs complicates the economic analysis of their costs and benefits. The predominance in modern PTAs of provisions liberalising non-tariff (and often ‘non-trade’) measures makes traditional economic modelling inadequate at best and misleading at the worst. More on this later.

Tariffs and ‘rules of origin’

Modern PTAs like AUSFTA — especially in cases like this where two developed countries are concerned — are not primarily about eliminating tariffs, even if tariff elimination is an understandable and necessary objective of the talks. One reason for this is the fact that tariffs (at MFN rates) are not, generally speaking, much of a problem in trade between the United States and Australia. In the United States, the average MFN tariff stands at just 5.4 per cent *ad valorem* and more than 30 per cent of MFN tariff rates are duty-free. (WTO 2002a:xxii and 25). The situation in Australia is not too much different: the average applied MFN tariff is just 4.3 per cent and almost half of all tariff lines (48.2 per cent) are duty-free for MFN trade. Only about 15 per cent of all Australian tariff lines qualify for the designation ‘tariff peaks’ (WTO 2002b:x and 30).

This relatively low incidence of tariffs has several important ramifications for the AUSFTA:

- With some obvious exceptions, tariffs are not a major impediment to US-Australian trade and therefore not the most problematic aspect of the negotiation.
- The large number of tariff lines allowing for trade between the two countries duty-free (and into the two countries from third countries at duty-free rates) reduces the significance of potential problems related to complexities in rules of origin.
- The low tariff levels applicable to MFN imports probably significantly reduce the probability of welfare-diminishing trade diversion (discussed later).

The impact of tariffs on significant amounts of trade reasonably likely to flow between the two countries — were it not for a genuinely protective effect of duties — is probably limited to imports into Australia from the United States of motor vehicles and parts. In the American market, the protective effect is felt in the cases of ‘out of quota’ beef, dairy and sugar agricultural exports as well as ‘light trucks’ (‘utes’ in Australia) falling under the 25 per cent duty dating from the Americans’ ‘Chicken War’ with Europe several decades ago. Of these sectors, it

is likely that only the beef, dairy and sugar tariffs are difficult issues in the negotiations and that (based on what happened in the USA-Chile Agreement) the issue there is not whether, but how fast, tariffs would be eliminated under the bilateral AUSFTA.

The impact of the low or duty-free tariffs is probably more significant in the rules of origin area. The Bhagwati Camp makes frequent use, in its criticisms of PTAs, of Bhagwati's 'spaghetti bowl' argument. The argument posits that differing and overlapping rules of origin resulting from PTAs can be so complex as to be trade-inhibiting in themselves. They will so complicate traders' lives as to actually contribute to higher costs of doing business under a PTA, as well as contributing to trade diversion pressures. But it seems that, on a practical level, in order for rules of origin to be a major issue in AUSFTA, tariff barriers between the USA and Australia and between both countries and third parties would need to be considerably more significant than at present. PTA rules of origin have no significance in the case of MFN duty-free trade and where MFN tariffs are very low, traders will not bother with the rules if compliance costs are high. Remember, average MFN rates in both countries across-the board are only about five per cent.

In addition, AUSFTA can reasonably be expected (under optimistic scenarios) to enter into force around 1 January 2005. The first cuts in tariffs (many of which will go immediately to duty free) of the Doha Round are likely to be made just 12 months later. The point is that the commercial need to spend a lot of time worrying about rules of origin due to the difference between MFN and preferential tariff rates in an AUSFTA context is not very apparent. Complex rules of origin make for a pretty good 'spaghetti bowl' speech, but where tariffs are relatively unimportant, the argument is not very compelling.

Third Wave Issues and Precedent

In April 2003, the Department of Foreign Affairs and Trade (DFAT) tabled a major submission to the Senate Foreign Affairs, Defence and Trade Committee, a substantial portion of which is addressed to aspects of the AUSFTA negotiations (DFAT, 2003). In Annex C of the submission, DFAT lays out nearly four pages of Australian objectives in the negotiations, with more than half of the text devoted to objectives in non-traditional 'third wave' areas.

In addition, both Australia and the United States have recently concluded PTAs with Singapore and it seems that both delegations to the AUSFTA talks have found these bilateral precedents useful in guiding their own discussions. Those who would doubt the 'third wave' nature of the AUSFTA exercise are well-advised to consult the results of the recent American negotiations with Singapore and Chile, both of which led to PTAs now approved by the U.S. Congress and due to enter into force in the not too distant future. Of course, AUSFTA is its own negotiation and it is a negotiation between two 'developed' countries with high standards and low levels of protection with respect to each others' trade, so there may be limits to which these earlier agreements might be seen as precedents in the

AUSFTA context. That said, who would imagine either side going back to Congress or the Parliament with a result that was not 'better' than that achieved with the developing country partner?

Investment

Investment is very much a 'WTO-Plus' or 'Third Wave' aspect to AUSFTA. DFAT (2003:66) states Australian objectives in respect of an enhanced framework to govern bilateral investment flows, the reduction of unnecessary regulatory impediments to Australian investors doing business in America and protecting aspects of Australia's own foreign investment review policy. While WTO GATT Article III has been interpreted as not permitting discrimination against imported products in a local content sense (the basis for the TRIMS Agreement) and the GATS provides for the possibility of 'Mode 3' commitments, there are no general investment-regulating provisions in the WTO today. In the Doha Round, the European Communities and Japan have pushed for negotiations aimed at a framework agreement for liberalising commitments in respect of rules governing foreign direct investment. India, together with a number of other developing countries, have strongly opposed the investment initiative in the WTO talks. Developing countries' refusal to agree to negotiations in this area contributed importantly to the collapse of the Cancun meeting.

Eleven pages of the Australia-Singapore agreement are devoted to investment. The USA-Singapore investment chapter runs to 42 pages and there are 37 pages in the US-Chile agreement on investment. National Treatment — defined as treatment no less favourable than that accorded, in like circumstances, to its own investors — is a key concept in any agreement addressed to trade and investment. The USA-Chile, USA-Singapore, and Australia-Singapore agreements state that investors from the other party will be given national treatment in relation to the establishment, acquisition, expansion, management, conduct, operation, sale or other disposition of investments in its territory. Both agreements also contain reservations to national treatment commitments for non-conforming measures at central or regional government levels, and provisions for investor-state dispute settlement that would appear to be channelled through the International Centre for Settlement of Investment Disputes (ICSID). The USA-Chile text goes into considerably more detail on the operation of the dispute process than does the Australia-Singapore agreement. One discernable difference between the two texts seems to be the provisions in the USA-Chile text providing detailed rules prohibiting or otherwise disciplining the use of 'performance requirements' associated with investment approvals.

Certainly, AUSFTA will contain a significant chapter on investment guarantees. Precedent indicates likely rules governing national treatment, most favoured nation, performance requirements, remittances restrictions, expropriations and compensation and some form of investor-state dispute resolution. This seems broadly consistent with DFAT's stated objectives and this

is what the business community (speaking through 'AUSTA') says it wants in this bilateral agreement.

Intellectual property rights

Intellectual property rights (IPR) is another important 'WTO-Plus' area for AUSFTA. Only two and a half pages of the Australia-Singapore FTA are concerned with Intellectual Property compared to twenty-seven pages of text in the USA-Singapore FTA Agreement. The American agreement with Chile is not much different. Protection of IPR through the WTO is currently constrained by what was on the books in 1993 (when the WTO Uruguay Round negotiations concluded). A lot has changed in the past ten years, both technologically and in terms of what has transpired in both the American and Australian markets.

The IPR area is likely to be contentious in the negotiations. The DFAT submission to the Senate appears to foreshadow this when it lists as an objective ensuring:

that Australia remains free to determine the appropriate legal regime for implementing internationally agreed intellectual property standards, maintaining a balance between the holders of intellectual property rights and the interests of users, consumers, communications carriers and distributors, and the education and research sectors.' (DFAT, 2003:66)

On the basis of what has happened in the American agreements with Chile and Singapore, Australia can expect substantial pressure to change certain of its approaches to copyright protection. This will include enhanced technical protection for digitised copyrighted materials as well as a likely demand from Washington for extension of post-author copyright protection for a period of seventy years (compared to 50 years for TRIPS). Specific practices in Australia that have been targeted by the USA for attention in AUSFTA include Australian policies in respect of parallel imports for CDs, books, DVDs, software and electronic games, and the possibility that Australia might allow 'spring-boarding' by generic pharmaceutical companies to allow immediate marketing approvals on expiration of patents held by others (US Trade Representative, 2003).

Trade in services

Trade in services has been a controversial area for AUSFTA and this is not surprising, given the long history of NGO attacks on the WTO GATS agreement. While Australia seeks enhanced access to the American market for trade in services, an effort is made to appease the NGOs through a promise by Canberra that 'the outcome of the negotiations [will not be allowed] to limit the ability of government to provide public services, such as health, education, law enforcement and social services' (DFAT, 2003:66). Australia has also been notably sensitive to the perceived interest of the USA in using this negotiation to get at restrictive measures such as Australian TV content regulations.

Although the GATS agreement at the WTO covers services trade, and many aspects of the bilateral negotiations are similar to those followed in Geneva (such as commitments that vary according to the modes of delivery), there are important fundamental differences between GATS and AUSFTA. Very significantly, the AUSFTA services negotiation will be a 'top-down' negotiation based on a negative list of exceptions to coverage as opposed to the GATS 'bottom-up' positive list approach. This means we start from the assumption that everything is covered — with full national treatment — unless exceptions and reservations are agreed to the contrary.

What does this mean for TV content quotas? Once again, previous agreements give us some guidance. In the Chilean agreement, 'culturally'-based restrictions in broadcasting were also at issue. The challenge is to find a way to satisfy both sides with a reasonable approach that recognises both national sensitivities and economic realities. In the Uruguay Round, the negotiations were threatened with failure at a certain point by continued US-EC argument over audiovisual services. In the end, the US decided to settle for an arrangement that more or less recognised the status quo and a tacit understanding that restrictions would not be tightened or extended to new areas (satellite or computer-based broadcasting).

Not much has changed in Hollywood's view. What we can expect in the Australian case is what we saw in the US-Chilean agreement. Australians will not be asked to roll-back existing TV-content requirements, but at the same time they will likely be asked not to maintain a wide-open 'anything goes' approach to the possibility of further restricting foreign content. The United States' position is not so accommodating on the question of possible restrictions on broadcasting over the Internet or through other newer technological means. Most likely, USTR will want an understanding that restrictive policies should not be extended to new technologies' dissemination of audiovisual content. In the case of Chile, the tacit understanding as to the status quo was reflected in an exchange of letters between the United States Trade Representative and the Chilean Minister for Foreign Relations. A similar approach should be possible in the AUSFTA context.

Labour and the environment

Whether provisions like those found in the Chilean and Singapore Agreements with the USA relative to trade and the environment or trade and labour qualify as 'WTO Plus' is a matter for individual appreciation. Nevertheless, it is clear that the Trade Promotion Authority (TPA) legislation in the United States that governs American participation in these PTA negotiations gives USTR little room for manoeuvre. There will need to be TPA-consistent provisions upholding labour and environment concerns even if it looks ridiculous for the USA to demand that Australia enforce its own labour laws on its own workforce. This is a 'make it or break it' part of the deal. What will be interesting to see is whether a 'good' TPA consistent outcome on trade and labour or trade and the environment will be

sufficient to ensure, for example, AFL-CIO or ACTU endorsement of an AUSFTA outcome.

Economic Analysis of AUSFTA

The economics of AUSFTA deserve further comment. This paper is being written in late October 2003, two years after the Centre for International Economics (2001) produced its initial study on the estimated effects for Australia and the United States of AUSFTA. Since that time, others have produced economic modelling studies designed to predict the impact of the agreement. There are at least four quantitative studies that purport to assess the economic welfare aspects of AUSFTA and they come to four very different conclusions. There are also divergent views as to the potential impact of this possible agreement on trade creation and trade diversion.

Trade creation or trade diversion

A trade agreement begets trade creation when a lowered or eliminated barrier to imports leads to a domestic supplier being displaced in its home market by imports from a more efficient, lower cost, overseas competitor that now can export into the market. Trade creation enhances economic welfare both in the importing country, where consumers get something at lower prices, and in the exporting country — which now has the possibility of greater production, exports and higher national income. Trade diversion, on the other hand, means that instead of buying from the lowest cost, most efficient supplier, buyers in the importing country are diverted from those optimal suppliers to higher cost, less-optimal producers from another source who have gained an artificial (but not real) advantage in the marketplace as a result of a discriminatory PTA. Trade diversion is immediately bad for the efficient exporter who now sees his product displaced and ultimately bad for the importers in the consuming country, who would be better off with the absolutely lowest price product — something that would theoretically be possible through multilateral liberalisation and non-discrimination.

The importance of non-tariff liberalisation in AUSFTA should be clear from the earlier discussion of expected ‘third wave’ elements to the agreement. An examination of the possible trade creation/trade diversion effects of AUSFTA requires us to focus, somewhat artificially, on the expected effects of tariff reductions or elimination.

Nearly all of the economic modelling which is possible today and which can be used to look at questions like trade creation and trade diversion relies heavily on estimations of demand elasticities and likely changes in trade flows from price effects arising out of tariff reductions or eliminations. Earlier, we discussed the tariff structures of the USA and Australia. Clearly, the nearly 50 per cent of Australian tariff lines now applied at duty free and the more than 30 per cent of US duty-free tariff lines are irrelevant in terms of tariff preference effects on trade creation or diversion.

What about trade diversion? Take imports into the US market as our example. This will only occur in a situation where a non-Australian supplier to the American market is capable of producing and selling a perfectly competitive product at a competitive margin to the Australian producer less than 101 per cent of the MFN tariff into the US market. For sake of argument consider tennis racquets. Suppose the average American tariff on tennis racquets is 5.5 per cent. A Malaysian tennis racquet producer will be preferred over an Australian when the former sells at \$50 (duty-paid price \$52.75) and the latter at \$51 (duty-paid price \$53.81). AUSFTA would, however, result in classical trade diversion were duties eliminated on the Australian tennis racquet because it would now sell (duty-free) in the USA market at \$51 versus \$52.75 (duty-paid) for the Malaysian racquet. But if the Malaysian's initial price is normally more than 5.51 per cent cheaper than the Australian's price (\$48.19), then the elimination of the duty in favour of the Australian will not lead to trade diversion in tennis racquets because landed, duty-paid prices in the American market will be \$51 for the Australian and \$50.84 for the Malaysian.

Given the low average tariff rates, and the fact that many of both USA and Australian tariffs are duty-free, the question one really needs to ask is how many cases could there be where Australians are selling products to the USA (and vice versa) at prices that reflect these (very narrow) margins of competitiveness with third parties? The elimination of a five per cent tariff in the United States is not likely to see Australian producers suddenly taking over market share from (for example) Chinese competitors (if there are any products at all where Australian and Chinese companies operate at such competitive margins).

The economic modelling is not much help to us. Of the four studies, one found trade diversion and trade creation, with trade creation in AUSFTA calculated as greater than estimated diversion. Another found little trade creation and a great deal of damaging trade diversion. The third and fourth examinations didn't deal with trade diversion on an AUSFTA-specific basis. The analysis in all of the studies suffers from credibility in that the modelling is inherently incapable of addressing trade creating and diverting effects due to 'non-trade' 'third wave' provisions in AUSFTA. If we care about the economic effects of PTAs as much as we do about their political impact (and we should), we need to encourage further research into this problem.

Investment considerations

When the Productivity Commission released its study of past PTAs (most of which did not include the participation of Australia) it suggested that there was perhaps a more significant aspect to study: the impact of PTAs on investment flows (Productivity Commission, 2003:Chs 5 and 6.2). For the first time, the researchers began to look at how the changed nature of the modern PTAs affected their impact on trade and investment patterns. Trade impacts were seen as important, but so too were influences on investment.

While the Productivity Commission did not study the likely impact on the USA or Australia or third parties of the currently proposed AUSFTA, it did point out the changed nature of modern PTAs relative to past agreements. What was important, in their view, is that if one leaves the tariffs to the side and focuses on the impact on trade and investment of non-tariff trade liberalisation, one gets a much different picture.

The Productivity Commission's working paper sums up its consideration of the effects of non-trade provisions in 'third wave' PTAs (Productivity Commission 2003:101-102):

Chapter 5 does find evidence that foreign direct investment responds significantly to the non-trade provisions of PTAs. Interestingly, this is in contrast to a lack of response of FDI to bilateral investment treaties.

Further, for most of those agreements where non-trade provisions have affected FDI, the result has been net investment creation rather than diversion.

Although it is a weak test, this suggests that on balance, the non-trade provisions of these PTAs have created an efficient geographic distribution of FDI. This is consistent with the fact that at least some of the non-trade provisions (e.g. commitments to more strongly enforce intellectual property rights) are not strongly preferential in nature.

Further, the theoretical literature has stressed that if the non-trade barriers are of the sort to raise the real resource cost of doing business, rather than simply to create rents that raise prices above costs, then preferential liberalisation will be beneficial, even in the absence of net investment creation.

However, the trade that may be generated from the new FDI positions may still be diverted in the 'wrong' direction in response to the trade provisions of PTAs, and may therefore contribute to the net trade diversion found in chapter 4.

Thus the results of this research suggests that there may be real economic gains from the non-trade provisions of third-wave PTAs, but they also suggest that there are still economic costs associated with the preferential nature of the trade provisions. And these costs could be magnified in a world of increasing capital mobility.

Thus, the findings of this research on the effects of non-trade provisions of PTAs are more positive than those on the trade provisions. This suggests that there could be real benefits if countries could use regional negotiations to persuade trading partners to make progress in reforming such things as investment, services, competition policy and government procurement, especially if this is done on a non-preferential basis.

Overall economic impact of AUSFTA

As noted earlier, the ‘third wave’ character of AUSFTA seriously complicates the job of anyone attempting to predict its economic impact on the United States or Australia. The study by the Centre for International Economics did try to use information from the Productivity Commission and elsewhere to take account of some non-trade influences, mainly in services, but the other three studies relied almost entirely on studying the impact on trade of tariff elimination. Different inputs and assumptions produced different results. The CIE found big gains (a four per cent increase in Australian GDP by 2010). The ACIL Consulting study predicted ‘slightly detrimental’ effects to the Australian economy from completely free trade with the USA. John Gilbert (2003) also based his analysis only on tariff movements and found small welfare gains for both Australia (0.02 per cent of GDP) and the United States (0.01 per cent of GDP) — ascribed to an expected improvement of both countries’ terms of trade with non-members of AUSFTA. Finally, researchers at the United States International Trade Commission have published an analysis of possible free trade agreements between the United States and sixty-five other countries and found that a PTA between the United States and Australia would be beneficial to both — but not by very much (Andriamananjara and Tsigas, 2003).

From this discussion, it would seem that traditional approaches to estimating the effects of modern PTAs do not really work. Today, both the Australian and American economies are overwhelmingly services economies, yet the general equilibrium GTAP-type models basically ignore services. More importantly, they also ignore in their limited economic predictions, the potential impact on trading and investment relationships due to negotiated changes affecting technical barriers to trade, intellectual property rights protection, competition policy, mutual recognition agreements, removal of investment restrictions, changes in visa requirements, and business-to-business facilitation arrangements.

If we are going to try to judge the economic impacts of these ‘third wave’ agreements, we need to find a better way to assess the impact of non-trade elements on post-agreement trade and investment flows. There is some important work going on today by researchers such as those in the Productivity Commission. This is an area that should be given priority attention in order to give the assessment of PTAs some enhanced credibility. Otherwise, we will be condemned to arguing on the basis of one group’s speculation against another’s (like the four very different studies referred to above).

Concluding Observations

There is no doubt that a successful conclusion to the Doha Round of WTO multilateral trade negotiations has to remain the primary objective of governments and business seeking economic growth through trade liberalisation. Multilateral negotiations deliver much more significant results than bilateral or regional agreements and avoid the potential negative effects that preferential agreements

might cause through trade or investment diversion. The issue addressed in this paper is whether there may be some positive value added through bilateral preferential agreements — particularly at a time when the multilateral process has stalled.

We need to realise that our current tools to model expected economic effects of modern ‘third wave’ PTAs are insufficient because they cannot yet address the trade and investment effects of non-tariff and ‘WTO plus’ provisions in the PTAs. Tariffs are no longer the central issue in the negotiations. Some important work on estimating the effects of the other elements of the agreements has been done, but we seem to be a long way from being able to conduct reliable overall assessments through consistently agreed means. Economists should give this problem some priority in their research. So long as the issue remains unresolved, debate over the merits of PTAs is likely to rest more on political than economic arguments.

PTAs are also not ‘one size fits all’ agreements. They differ widely depending upon which countries are involved in the negotiations. There are ‘good’ PTAs and ‘bad’ PTAs from the standpoint of whether they contribute positively or negatively to global economic welfare and whether or not they could be seen as complementing the multilateral negotiating effort. This paper does not suggest that all PTAs are good, but it does posit that the Australia-USA FTA now under negotiation will be one of the ‘good’ agreements.

In terms of AUSFTA’s impact on the WTO negotiations, it could be worthwhile considering whether it fits the ‘policy ground rules’ suggested by the WTO in the 2003 World Trade Report (designed to ensure complementarity between the WTO and PTAs).

Do Australia and the United States refrain (in the AUSFTA) from engaging in regional commitments that governments would be unwilling, sooner or later, to extend to a multilateral setting? The answer must be yes.

Would Australia and the United States agree to a system that would map and monitor the timing and conditions attached to the non-discriminatory, multilateral application of commitments made in their bilateral PTA? Considering the standing commitments made in the APEC context and the position both countries have taken in Geneva in the Doha Round, the answer must once again be yes.

Australia and the United States have been clear that their first priority is a successful conclusion to the WTO round and that AUSFTA and other PTAs they have recently pursued are a way of keeping the process moving forward in the interim. ‘Competitive liberalisation’ only works as a policy if governments strive for trade liberalisation on a multilateral level as well as through PTAs.

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A New Zealand-US FTA? — A Reality Check

Rob Salmond

New Zealand governments, both Labour and National, have been aggressively pro-free trade for the past twenty years. New Zealand is one of the very few countries in the world *unilaterally* to tear down many of its tariff and other barriers to international trade — not demanding anything from anybody in return. Its domestic economy stands on the foundation of one of the most productive and efficient agriculture sectors in the world, and its value-added manufacturing and services industries, on the whole, continue to grow and prosper. Surely, given this background, New Zealand is an excellent Closer Economic Partnership (CEP — Kiwi politically correct-speak for Free Trade Agreement (FTA)) partner for anybody. Why would anybody *not* want to do a deal with them?

In recent months many have agonised about the FTA that New Zealand wants to sign with the US. Why are the Americans not responding to their increasingly desperate overtures? Is it their nuclear policy? Is it because New Zealand didn't support the war in Iraq? Simply, the public do not know. Until one of the principals admits to such a policy connection, the public can never be sure. Even if it could be shown that these factors are influential for some in the US system, it would be another thing entirely to show that they have been decisive.

If it is assumed for the purposes of argument that the US does make trade decisions based partially on non-trade issues, then a trading gain to the US ceases to become a sufficient condition for the negotiation of an FTA. But it remains a necessary condition. The US has not made a habit of handing out FTAs to countries just because they are foreign policy friends. There are, of course, a handful of exceptions to this rule. The US signed an FTA with Israel in 1985 without an overwhelming trade-policy interest being present. And in the 1960s, the US reduced duties on Japanese and South Korean goods without demanding that those countries reduce protection of their key domestic industries. In each of these cases, however, there was an important military-strategic element in play that the US felt was more important than the trade policy 'dis-interest'. Indeed once the military imperative for closer relations with North Asia became less salient, US enthusiasm for unilateral trade liberalisation evaporated very quickly. Given that no such military interest could conceivably exist in relation to New Zealand, these counter-examples are of no relevance to the New Zealand case. This paper argues that the necessary trading interest does not exist for the US, and therefore that a New Zealand-US deal is, in practical terms, almost overwhelmingly improbable.

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This paper will demonstrate that countries like the US have no bilateral incentive to deal with New Zealand and its already-liberalised trading arrangements. The essence of this argument is to ask the question: ‘why negotiate with somebody who’s already given you everything you want?’ The paper then goes on to show that the purported strategic benefits forming the bulk of New Zealand’s public case for an FTA do not flow towards the US in sufficient quantities to overcome the institutional hurdles standing in the way of an agreement.

It is possible that New Zealand’s geography is actually the key factor preventing it from gaining an FTA with the US. After all, why would the world’s only superpower make concessions to a small and essentially powerless country that is the gateway to nowhere? Despite this factor, New Zealand officials have made strong representations to successive US administrations about the possibility of a deal and have amassed a non-trivial stable of support from both the public and private sectors within the US. For the purposes of this paper, therefore, it will be the maintained assumption that New Zealand was not doomed from the *very* start, and that a country in its geographic position does have at least some potential as a free trade partner with the US.

The analysis proceeds as follows. First, two perspectives on trade that have been advanced in the academic community are outlined, showing also which theoretical camp New Zealand and American officials have sided with. Next the paper considers the reasons why the US wouldn’t sign an FTA with New Zealand given *only* bilateral considerations. Third, the strategic benefits that flowed from the Singapore-US FTA are compared and contrasted with those that might flow from a New Zealand-US FTA, showing how and why the New Zealand deal cannot pass based on strategic considerations. In this section the different situations facing Australian and New Zealand negotiators are also examined. Finally the paper presents some conclusions and related consequences.

If readers agree with the analysis here, they will leave with a pessimistic view of New Zealand’s chances of a bilateral FTA. Even if New Zealand retroactively supported the war in Iraq, allowed in nuclear armed and powered ships, rejected the International Criminal Court or the Kyoto Protocol, or engaged in any other foreign policy chumming-up to the US, there would likely still be no deal. This pessimism, however, is balanced by the consequent realisation that New Zealand can continue to pursue an independent foreign policy without worrying about the impact it may have on its trading prospects with the US.

Academic Perspectives on Trade

The two academic disciplines that have thought most about the issue of trade negotiations are economics and political science. They have not, however, seen eye-to-eye.

The dominant view among economists is that trade liberalisation is a good idea for any country, whether its trading partners liberalise or not. They argue that tariffs, subsidies, quotas and other technical barriers to trade cause deadweight

loss to the domestic economy. This is because they force everybody to pay higher taxes so that the government can enforce the rules, cause the misallocation of productive resources in the economy, and force up prices for consumers through the support of uncompetitive industries. Removing barriers to trade solves all of these problems, regardless of others' actions. Perhaps the best statement of the economists' position comes from noted Princeton economist Paul Krugman (1997:113):

If economists ruled the world, there would be no need for the World Trade Organisation. The economist's case for free trade is essentially a unilateral case: a country serves its own interests by pursuing free trade regardless of what other countries may do. Or, as Frederic Bastiat put it, it makes no more sense to be protectionist because other countries have tariffs than it would to block up our harbors because other countries have rocky coasts.

Other interesting commentaries on the economists' position on trade are found in Krugman (1987) and Baldwin (1992). For a summary of the economists' perspective, see Krugman (1993) or your favourite macroeconomics textbook.

The economists' prediction is that governments will race to liberalise their country's trade policy as fast as their domestic political institutions will allow. This will occur regardless of the actions of any other country — although clearly mutual free trade is preferred to unilateral liberalisation. Thus economists believe that a country's preferences should be (in terms of a bilateral model) mutual liberalisation first, followed by unilateral liberalisation by the self, unilateral liberalisation by another country, and mutual protectionism last.

Political scientists, on the other hand, have argued that the benefits to a country of FTAs come from liberalisation on the part of the other country. The act of opening up your own markets is just the price that has to be paid in exchange for your new market access. Political scientists often model bilateral trade negotiations as real world applications of the prisoners' dilemma game. Good examples of this kind of research are Keohane (1986) and Yarbrough and Yarbrough (1987). The structure of this game is that Country A's dominant strategy is to not liberalise regardless of Country B's position, but that joint liberalisation is preferable to mutual protectionism. Political scientists therefore believe that the preference ordering for the government of Country A is unilateral liberalisation by Country B first, followed by mutual liberalisation, mutual protectionism, and unilateral liberalisation by the Country A last. The prediction of this model is not that trade liberalisation will never occur, but rather that any freeing up of trade policy will occur only in the context of reciprocal and enforceable trade agreements. The competing perspectives of economists and political scientists are illustrated in Figure 1.

Figure 1: Two Perspectives on Trade Policy

ECONOMISTS			POLITICAL SCIENTISTS		
	They liberalise	They don't		They liberalise	They don't
We liberalise	Best	2nd best	We liberalise	2nd best	Worst
We don't	3rd best	Worst	We don't	Best	3rd best

In this paper, it is not important or necessary to evaluate the strengths and weaknesses of these two academic positions. It is, however, possible and useful to infer from a government's actions which perspective it agrees with. Governments that unilaterally tear down trade barriers have clearly sided with the economists. Governments that only liberalise their trading arrangements as part of a reciprocal agreement with other governments, on the other hand, are behaving exactly as the political scientists would predict.

Economists are the first to admit that very few governments have taken their trade advice:

International trade seems to be a subject where the advice of economists is routinely disregarded. Economists are nearly unanimous in their general opposition to protectionism, but the increase in US protection in recent years in such sectors as automobiles, steel, textiles and apparel, machine tools, footwear and semiconductors demonstrates that economists lack political influence on trade policy. (Baldwin, 1989:119)

Three of the few countries that have sided with the economists, however, are of critical importance to this paper. New Zealand, Australia and Singapore have at different times engaged in wide-ranging unilateral trade policy reform away from protectionism and towards very open markets. While several other countries such as Chile, Brazil and Thailand have also engaged in some unilateral trade liberalisation, their post-reform trade policies were not characterised by consistently low tariff rates and other barriers, and therefore those countries can only be said to have partially sided with the economists. Outside of the countries under direct study in this paper, only Hong Kong's trade policy seems fully to fit the economists' prescription.

Most readers will be familiar with the New Zealand and Australian policy of unilateral tariff reductions over the past ten or fifteen years, and therefore a review of the rationale behind the reforms is not provided here. Suffice to say that the New Zealand Ministry of Foreign Affairs and Trade (MFAT) talks glowingly

about the benefits in terms of manufacturing and consumer choice and prices that it claims have flowed from this one-sided free trade policy — 95 per cent of goods entering New Zealand now do so free of any tariffs or duties. New Zealand has demanded nothing of its trading partners in return for this liberalisation, which has brought increased sales and profits to importers and foreign suppliers at the expense of New Zealand's domestic car manufacturing and apparel industries among others. More extensive discussion of the differences between the Australian and New Zealand approaches follows is provided below.

Singapore's one-sided liberalisation occurred in the 1960s, when it rejected the import substitution policy of the other Asian tigers. Lacking natural resources and hinterland labour, Singapore opened its economy to international firms in the hope of attracting foreign capital to its shores. Over the next decade, this capital flowed into Singapore at a rapid pace, providing for much of the employment in the newly-rejuvenated port city. Although the investing firms had at least as much to gain from the trade liberalisation as Singapore did, the Singaporean government made no demands of the countries of registration of these firms.

Most countries in the world, however, behave as the political scientists predict, freeing up their trading arrangements only when their trading partners do too, liberalising a small amount at a time, and ensuring that any particular round of tariff cuts shares the benefits reasonably equitably among the parties. In the absence of these reciprocal FTA deals, existing protections for domestic producers remain.

The fourth country important to this article, the US, falls squarely into this second category. There simply are no significant unilateral tariff reductions in the US's recent history. Further, the US has been able to use its status to negotiate deals that in many cases keep significant protections for key US industries. To illustrate this, consider the position of the US agriculture sector — a part of the US economy that many argue is critical to the country's overall self-sufficiency. Despite multiple rounds of the GATT, the establishment of the WTO, NAFTA (an agreement with two countries with large agricultural sectors of their own), and other bilateral FTAs, on average American farmers still receive over half of their income from various organs of the US government, generally in the form of subsidies. These subsidies are allowed for in the agreements mentioned above despite the fact that subsidies are generally seen as antithetical to free trade. To take Mayhew (1974) out of context: if you were to design a country that best embodied the trade policy preferences outlined by the political scientists, you couldn't do much better than the US.

A Bilateral Model of Trade Negotiations

Two types of governments were outlined above, the few who believe unambiguously in the principle of free trade, and the many who are ready to believe in free trade but only if their friends do too. (There is also a third type of government, one which unambiguously rejects free trade, but that type of government is not of interest to the discussion in this paper.) This section briefly

shows what the result of any negotiation between any combinations of the two types of governments would be if *only* bilateral trading considerations were taken into account. The predictions are based on simple game theory, but the game theoretic tables are not presented here in order to keep the paper non-technical. Readers wanting an accessible introduction to simple game theory should see Dixit and Nalebuff (1991).

Any pair of countries involving a unilateralist free trader is rare — but the result of any negotiation between such a pair is easy to predict. If ever two unilateralist countries meet to negotiate an FTA, the negotiations should be quick, successful and largely non-controversial. Two countries with no trade barriers shouldn't need to talk for very long before agreeing that they won't charge each other any tariffs! Such was the case with the recently signed New Zealand-Singapore FTA.

If a unilateralist meets a contingent free trader, then the results are equally easy to determine. The unilateralist will want to liberalise no matter what. Knowing this, the contingent free trader is able to pick between their favourite outcome (protectionism on their side, liberalisation on the other) and their second favourite outcome (mutual liberalisation). This is not a difficult choice, and so the predicted result would be no FTA, but unilateral liberalisation on the part of the unilateralist. A possible US-New Zealand deal falls into this category.

The third potential meeting is of two contingent free traders. As alluded to earlier, this is an application of the prisoners' dilemma game, where each player has a dominant strategy of protectionism (producing a Nash equilibrium of mutual protectionism), but the players are both better off if an enforceable agreement calling for mutual liberalisation can be reached. Such an agreement cannot always be reached, but sometimes it is. Almost all FTAs in the world fall into this category, where the participant countries agree to liberalise conditional upon the agreement of other participants to do likewise, and conditional also upon the FTA agreement being enforceable.

Careful readers will have noticed an apparent contradiction. An FTA between unilateralist and a contingent free trader would be very unlikely according to the above analysis. Yet earlier sections talked about Singapore's unilateralist behaviour in the 1960s, and Singapore and the US have recently signed an FTA. How could this be?

The above predictions were based on the consideration of only bilateral benefits that might flow from any FTA, and in the ideal-type analysis in that section it was assumed that the unilateralist player had no remaining trade barriers. Despite Singapore's unilateral liberalisation activity in the 1960s significant trade barriers remained, especially in the financial services sector — a sector of strong interest to American firms. US businesses identified these barriers as impediments to their full engagement in the Singaporean economy. The removal of these remaining barriers would provide strategic trade benefits (see below) to US business interests, which induced them to encourage the US Administration to negotiate with Singapore, treating them as a contingent free-trader rather than a unilateral free-trader. The following sections demonstrate decisive differences

between the Singapore and New Zealand cases, and later between the Australian and New Zealand cases.

The Singapore-US FTA

In early 2003, the governments of Singapore and the US signed an FTA. It was not a model-FTA, as the US had negotiated transitional import tariffs on Singaporean apparel through 2013, but it was comprehensive in scope. In line with the theory advanced above, the deal did not raise a large amount of controversy in Singapore. In the US, however, there was strong support for the deal from larger corporations, but limited opposition from workers and their unions in the apparel industry.

There are three key elements that came together to ensure passage of the US-Singapore FTA. First, American corporate interests saw the FTA as an important first step towards a US-ASEAN FTA, which would open up huge new markets to American firms and end the protection of key Asian firms that grew from 'infant industry status' within some ASEAN nations. This formed an important part of the rationale presented by the US-Singapore FTA Business Coalition for supporting the agreement (USSFTA Business Coalition, 2003). Second, the prospect of an end to the significant remaining Singaporean barriers to entry into the banking and financial sectors were very attractive to US companies, especially in view of the first element above. Gaining a financial presence in Singapore would provide a great base from which to launch into the wider ASEAN market. Third, the apparel sector was not united in its opposition to the agreement. While the American Textile Manufacturers' Institute was adamantly opposed to the FTA, arguing that it would bring ruin to the domestic industry, the American Apparel and Footwear Association felt that Singapore would never become a significant player in the American apparel market, and therefore did not oppose the agreement.

In deciding whether to pass the Singapore FTA Bill, members of the US Congress faced strong support from local business interests and limited and divided opinion from the apparel sector. Importantly, these two constituencies tend to live in the same Congressional districts, located in large urban areas in industrial States. This meant that members of the House and the Senate weighed up support and opposition *on their own* before declaring a position, and before taking this position to Washington. The fact that Representatives and Senators did not need to negotiate *with each other* over this Bill significantly lowered the associated transaction costs and achieved smoother passage of the legislation.

The success of the US-Singapore deal was dependent on strategic trading benefits flowing to the US and Singapore's agreement of to eliminate immediately its remaining trade barriers. Its passage was further assisted by the geographic concentration of the affected groups in certain US Congressional districts.

A New Zealand-US FTA?

Some have attempted to mount a bilateral case for a New Zealand-US FTA, despite the gloomy predictions of the formal analysis above:

New Zealand is very small compared with the United States so the economic impact of an FTA would be quite modest for the United States and considerably larger for New Zealand. However, US merchandise exports to New Zealand would rise by about 25 percent and virtually every US sector would benefit. The inclusion of Australia would increase the magnitude of these results substantially; US exports would rise by about \$3 billion. The adjustment costs for the United States would be minimal: production in the most impacted sector, dairy products, would decline by only 0.5 percent and any adverse effect on jobs would be very small (Bergsten and Scollay, 2003:1).

These empirical claims are based on 'The Case for a Model Free Trade Agreement between the United States and New Zealand', prepared by Fred Bergsten and Robert Scollay at the Institute for International Economics for the US-New Zealand Council. The question to be asked is: 'how likely is it that this report will convince the right people in the US?' The answer is a reluctant 'not very'.

First, the dataset for the empirical estimates is flawed. The dataset is from 1997 (the latest available), and New Zealand has since reduced or eliminated important tariffs (for example in the forestry sector). Consequently, the current impact on US exports to New Zealand would be much less than that estimated with the 1997 dataset. For example, the dataset listed the New Zealand tariff on wood products as 6.3 per cent. In fact, the trade-weighted tariff on US wood products flowing into New Zealand was 3.4 per cent in 2003, and due to further New Zealand tariff reductions will reduce to 0.6 per cent on January 1, 2004. Thus the predicted 30 per cent increase in US wood products exports to New Zealand is overstated by a factor of almost two, and in 2004 that overstatement will increase to a factor of about ten.

In a similar vein, Bergsten and Scollay (2003:11) say that a 'noteworthy feature is the increase in US exports to New Zealand of milk products...' (Bergsten and Scollay,). The report estimates that US exports of milk products would increase by 63 per cent, which amounts to about US\$100,000 at 2002 commodity levels and exchange rates. The data are again flawed, however, overstating New Zealand tariff levels (as at 2002) by a factor of over three. Thus the 'noteworthy feature' actually amounts to about US\$35,000 per annum once the data errors are corrected.

Second, the Computable General Equilibrium (CGE) model on which the estimates were based contains some assumptions that are not innocuous in terms of driving the results. For good summaries of the CGE modelling process, see Scollay and Gilbert (2001), Bandara (1991) or Francois and Reinert (1997). It is

assumed in the CGE model that factors of production move costlessly between sectors of the economy in response to changes in relative tariffs. And it is also assumed that there is no inertia in any industry in a country's economic system. These assumptions help to drive the equilibrium results in the model. If the assumptions are false, then it is likely that the equilibrium state outlined in MFAT's summary will never be reached and therefore that the model mis-states the real world impact of an FTA. In this case, the assumption that giant US industries will be nimble enough to take up all the modest new opportunities offered in a small and far-away market is certainly open to question.

Also, the model only examines the impact of an FTA on exports and imports in equilibrium, without taking into account any of the side-payments to affected industries, costs occurred in realigning production factors, transfer payments made by governments to temporarily displaced workers and so forth. A model showing the net effect of an FTA on the US and New Zealand economies as a whole must take account of these costs. Further, the Report and MFAT's press treatment of it do not note that it is estimated to take some 10-12 years for the predicted changes in trade levels to take place. This result, which flows directly from the quite reasonable assumptions in the CGE model of mobile capital but non-mobile land resources, is a significant part of the result and it is surprising that the authors chose not to mention it.

For those, such as the US dairy industry, who believe they have a vested interest *against* the passage of an FTA, the above points are likely to have some resonance. A further question arises as to whether the US dairy industry, for example, actually needs to be won over for a New Zealand-US FTA to proceed. In answering that question, it is useful to adopt Putnam's (1988) persuasive logic that international relations decisions are two-level games, and therefore that one must consider both the international and domestic environments to predict a government's actions.

Given the structure of US decision-making institutions, the support (or non-opposition) of the dairy industry is in fact crucial. Consider the position of the US Senate in deciding whether to pass a New Zealand FTA. First, it needs to be remembered that in the US, 'all politics is local' and Members of Congress are extremely reticent about voting against their district's preferences (see Mayhew, 1974 or Fenno, 1978). Second, there aren't any Congressional districts in the US that place a particular priority of gaining an FTA with New Zealand — as most firms that deal with New Zealand already get tariff-free access, so it is difficult to *excite* them over an FTA. Third, note that: (i) large sections of the US agriculture industry are strongly opposed to a New Zealand FTA; (ii) the agriculture industry is the dominant source of employment in many of the small Midwest and Great Plains States in the US; and (iii) these States, by virtue of their small population, are over-represented in the US Senate. Once these facts are taken into consideration, it becomes clear that strongly antagonistic forces, in the absence of strong protagonists, are likely to result in no passage of an FTA through the Senate. Placating the Senate is costly, and it is questionable whether any US

presidential administration would be prepared to pay any such side-payments in order to secure a deal of very limited bilateral and strategic value.

One objection that may be raised to this argument is to point to the significant number of members of the US Congress (over 50) who have already declared their support of a New Zealand FTA. To take these declarations at face value is, however, naïve. One of the most widely agreed observations in the study of US Congressional politics is how willing Members of Congress are to make any costless statement put in front of them, no matter how sure they are that a proposal will come to nothing (Fenno, 1978:Ch 5). If, for example, a constituent wants a new highway built through a Senator's State, the Senator will always say: 'That's a great idea. I support that and will lobby for it in Washington'. Once it becomes clear in Washington that the project will not succeed, then the Senator can say: 'I tried, I tried very hard, but the others didn't see the brilliance of your proposal. They must be idiots'. Some have attributed the regular finding that Americans hate Congress but love their Member of Congress to this process (see for example Fenno, 1978:Ch 5; Smith, Roberts and Vander Wielen, 2003:Ch 1). The statements made thus far by Members of Congress fit this pattern very closely, and therefore should be taken with a large grain of salt.

Now it remains to be considered whether New Zealand can pitch an FTA based on strategic considerations. Some believe it can:

The largest gains, especially for the United States, would come from the strategic benefits of such an FTA with New Zealand. It would help restart and accelerate the momentum of trade liberalisation. It would help induce other trading partners to participate effectively in that renewed liberalisation process. It would contribute toward the accomplishment of APEC's goals of achieving 'free and open trade and investment in the (Asia Pacific) region by 2010', with their important political as well as economic implications. By doing so, it would reduce the risk of polarisation of the Asia-Pacific region between competing blocs in East Asia and the Americas, a development that would push the world toward a tripolar configuration that could be extremely dangerous in security as well as economic terms (Bergsten and Scollay, 2003:1).

Large portions of this argument, which has been repeated by New Zealand Ambassador to the US, John Wood (2003), rely on the concept of a 'demonstration effect', the same concept that underlay New Zealand's unilateral tariff reductions of the 1990s. Four points should be made in response to the claim of 'demonstration effect' strategic benefits:

First, the strategic benefits as framed in the Bergsten and Scollay report are grossly overstated. It is very difficult to argue, for example, that the role of a US-New Zealand FTA in avoiding 'a tripolar configuration [in the world] that could be extremely dangerous in security as well as economic terms' would be anything more than entirely trivial. New Zealand may box above its weight in international affairs, but its initial weight is low.

Second, the United States does not make a habit of engaging in demonstrative-but-not-beneficial behaviour. Even if New Zealand could convince the executive branch of the US government that this demonstration effect could be successful, it is another matter entirely to convince the legislative branch, where ‘all politics is local’. Localised politics leaves very little room for future-oriented trade posturing.

Third, the US does not *need* to engage in demonstrative behaviour in the same way that New Zealand does. New Zealand uses demonstrative behaviour to try and induce other more powerful countries to engage in similar behaviour. The US *is* one of these powerful countries, and it does not need to demonstrate the benefits of free trade to anyone. If the US wants to quicken the pace of global trade negotiations, then it does so. No demonstration needed.

Fourth, the audience for the ‘demonstration’ — which appears to be the governments and peoples in the ASEAN and NAFTA trade blocs (who may at some point consider combining their FTAs, which would be the single most important step towards APEC achieving its Bogor goal of region-wide free trade) — are far more likely to be watching developments in the US-Singapore case than in the US-New Zealand case. The US-Singapore deal gives the US direct entrée into an ASEAN nation, whereas a New Zealand deal does not. Along similar lines, if for some reason it *were* decided that a demonstration was needed of the workability of an FTA between the US and a non-NAFTA non-ASEAN nation, then the recently signed deal with Chile or any future agreement with Australia should suffice.

This section has only considered the strategic benefits put forward thus far by New Zealand officials, especially the purported benefit of providing a catalyst to wider liberalisation within both APEC and the WTO. The response argued here has been that the potential of this deal to fulfil the role of a catalyst is overstated, that the US has more effective means of providing such a catalyst than a New Zealand FTA and that the US does not traditionally engage in catalyst-like demonstrative behaviour. In contrast with the Singaporean deal, it also appears that a New Zealand FTA would not serve any strategic purpose for US firms trying to open up other markets using the FTA as leverage.

On the basis of the above observations, the prospect of strategic benefits from a New Zealand FTA appears not likely to convince US decision makers.

In September 2003, New Zealand further undermined its FTA negotiating position by announcing further unilateral cuts in its already low tariff schedule. The highest tariffs will fall from 19 per cent to 10 per cent over the next five years. In announcing the cuts, however, trade minister Jim Sutton said: ‘The government is not prepared ... to move to a zero tariff regime at this time. We will still retain some trade negotiating coin’. (Dalziel 2003) Although it is an open question whether New Zealand could ever have accumulated enough ‘negotiating coin’ to interest the US in a deal, this section has shown that New Zealand didn’t have enough currency to elicit a deal even before the latest round of unilateral cuts, and these new cuts simply serve to reinforce that position.

The New Zealand and Australian Cases Compared

Some in New Zealand have made the claim that '[Prime Minister] Helen Clark's criticism of the US during the Iraq war ... cost us a Free Trade Agreement' (English, 2003), pointing for evidence to Australia — a supporter of the war that now has FTA negotiations with the Bush administration. Implicit in such a claim is the notion that the two cases appear otherwise the same from an American standpoint. There is some appeal to this claim. Both countries are (compared to the US) small, are wealthy, are located deep in the South West Pacific, pursued a policy of unilateral trade liberalisation in the 1980s and 1990s, hold a broadly 'western' perspective on foreign affairs, and have economies with a significant agricultural base and relatively efficient production methods. The claim of similarity cannot, however, be sustained in the face of more thorough analysis.

First, and central to the argument made in this paper, the positioning of Australian tariff policy is different from New Zealand's. In 2000, the Australian Productivity Commission published a 'Review of Australia's General tariff Arrangements' in which it recommended that both the 5 per cent general tariff, which is applied to over 50 per cent of Australia's total imports, and the unpopular 3 per cent special tariff on business inputs be reduced to zero (Australian Productivity Commission, 2000:139). The Australian Treasurer (Hon Peter Costello), however, specifically rejected the recommendations of the Productivity Commission in December 2000. Costello (2000) said that the retention of both tariffs was beneficial to achieving 'trade objectives' and that the combination of Australia's past liberalisation record with current remaining tariffs would provide it with a 'powerful bargaining position in future trade negotiations'. While the tariffs may appear small, they have been big enough to cause a political struggle within Australia and to catch the eye of the private sector (and consequently the trade negotiators) in the US. This strategy of deliberately keeping a trade bargaining chip, even if a relatively modest one, differs significantly from New Zealand's strategy of promoting almost completely free trade through demonstration (Hon Jim Sutton's recent comments mentioned above notwithstanding).

Second, Australia is more important than New Zealand to US exporters. Australia is the thirteenth largest importer of American goods in the world, providing over seven times the foreign exchange revenue to the US than does New Zealand. Additionally, the US States that benefit most from Australian exports including Iowa, Illinois, Kansas, and Wisconsin (for whom Australia ranks among the top ten export destinations) are also those that would stand to lose from an increase in Australian agricultural products entering the US. Australia imported approximately A\$540million worth of farm machinery from the US in 2002, including over A\$200million worth of tractors (Department of Foreign Affairs and Trade, 2003:308-311), much of which was manufactured in the States mentioned above. New Zealand imported comparatively very little of these items. This fact may serve to dull the opposition of some farming-State legislators to a possible Australia FTA, because what some of their constituents lose through increased

commodity competition, others gain through increases in machinery sales. Thus the negotiating problem facing Australia in relation to the US Congress seems to have more similarities to Singapore's than it does to New Zealand's. In addition, the US has consistently exported to Australia about double the amount of goods as it imports from it, while the balance of trade with New Zealand has declined for the US in recent years, becoming essentially balanced at the end of 2001.

Third, the foreign policy differences between New Zealand and Australia are not limited to the 2003 Iraq war. New Zealand has taken a different position from the US on many international issues of note, including nuclear weapons and ships, the International Criminal Court and the Kyoto protocol on climate change. Indeed, some New Zealand officials stated privately that they are still confronted with the nuclear ships policy during discussions with some US legislators and officials, almost twenty years after its adoption. Australia, on the other hand, has carefully avoided offending the US on any of these issues. Prime Minister John Howard's infamous declaration of his desire that Australia be America's 'Deputy Sheriff in the Pacific' evidently extended to more than just military matters. Thus even if the trade policy postures of the two countries were the same (which they are not), and the two countries were of equal importance to the US (which they are not), New Zealand would need to change much more than its policy on Iraq before the cases would be indistinguishable in the eyes of the US.

Some New Zealand officials have suggested that an Australia-US FTA should come with an extension of the agreement, along the terms negotiated by Australia and the US, to New Zealand. The argument here is that the addition is natural (given the CER relationship) and costless to the US given that the terms would be unaltered from the bilateral agreement. The analysis above, however, suggests that such an extension would have gloomy prospects because it would be unlikely to be seen as beneficial or costless by the US agriculture lobby and therefore by a significant number of US Senators.

In addition, it is worth noting that the terms of an Australia-US FTA are likely to be far from the terms considered in Bergsten and Scollay case for a 'model FTA' between New Zealand and the US. The Australia-US negotiations are seeking to secure for US business lengthy adjustment periods in terms of tariffs, or in some politically sensitive cases zero change from the status quo, while requiring Australia to dismantle not only its remaining tariffs but also certain quarantine laws, producer boards, and even health bureaucracies. It seems that Australia and the US may be negotiating not an FTA in the full sense of the term, but rather an fTA, an (F)TA, or even just a TA. New Zealand officials have stated on many occasions that they are interested in trade agreements only if they are comprehensive (with the agriculture sector fully on the table), and the US has continually signalled that it isn't prepared to enter into model FTAs, especially when it comes to agriculture. This set of circumstances either calls into question the New Zealand government's willingness to sign such a watered-down agreement, or alternatively further calls into question the empirical findings of Bergsten and Scollay, given that they are based on a 'model' agreement when the prospects of such an agreement being negotiated are dim.

Conclusion

What is to be done about this situation? It has been shown that a US-New Zealand FTA is most unlikely given the trade policies of the two countries. Can this be changed somehow? Unfortunately not.

The first option open to New Zealand is to continue its policy of persuasion, hoping to convince the affected US legislators and their constituencies that a New Zealand FTA will not be as harmful as they might fear. For it to succeed, this policy would need to convince the powerful US agricultural lobby to take an enormous risk. History has shown that US farmers are very happy with their current privileged position, and that they have the political clout to ensure that their position remains intact. This paper has shown that current efforts to persuade them to relinquish this position to some extent are unlikely to succeed.

A second option that some might consider is for New Zealand to threaten to re-impose tariffs (up to the legally permissible WTO Bound Rates) if others do not negotiate with them for FTAs. Such a threat would, however, be entirely non-credible. The purpose of market distorting tariffs is to protect inefficient locally owned industry from foreign competition. Once a significant period goes by without tariff protection the size of such local industry falls significantly, often to zero. The demise of the New Zealand car manufacturing industry, and the decline in the locally owned apparel and computer operations are good examples of this phenomenon. In this situation, the re-imposition of tariffs serves to increase prices to consumers (thus lowering their quality of life) without the countervailing benefit of protecting local industries. Put simply, there aren't many uncompetitive local jobs to protect any more. Knowing this, other countries would view any threat to impose tariffs with contempt.

Some contend that a number of US trade liberalisation strategies are *consistent with* an FTA with New Zealand. This paper has shown, however, that no such strategy *relies on* a New Zealand FTA, that strong domestic political incentives provide formidable barriers to the passage of an FTA, and that there is very little bilateral trading interest in such a deal from the US-side.

The main conclusion of this paper, that New Zealand will probably not get tariff-free access to American markets until a WTO- or APEC-wide deal is struck, will come as a blow to many in New Zealand. Kiwi exporters would have much to gain from a New Zealand-US FTA, and they will be rightly disappointed at this finding.

None of this, however, is intended to make the argument that unilateral liberalisation was a mistake. In order to attempt such an argument, one would need to take into account not only the negotiating costs outlined here (with the caveat that it is always possible that the US wouldn't have dealt with New Zealand in any event), but also the costs in terms of lost jobs in previously protected industries. In addition, one must consider the enormous benefits in terms of the decreased price and increased quality and choice of goods and services available post-liberalisation to New Zealanders. This topic (framed in more general terms) is one of the most controversial and complicated facing the field of international

political economy, and is certainly beyond the scope of this narrowly focussed paper. Some of the leading technical contributions on this general question are Frankel and Romer (1999), Lindert and Williamson (2002), Dollar and Kraay (2001) and Rodrik and Rodriguez (2001). Leading non-technical contributions include Stiglitz (2002) and Easterly (1999).

There is, however, a silver lining to this paper's gloomy finding in relation to a New Zealand-US FTA. For many years, New Zealand has held an independent foreign policy. It does not take orders from large powers on questions of international peace and security, and it takes justifiable pride in that. In recent times, however, some senior National Party politicians have questioned whether New Zealand can afford such an independent stance, given the economic ramifications it may have. What this paper has shown is that trading relations with the US cannot advance on a bilateral basis much past where they are now, regardless of New Zealand's foreign policy position. This should, in fact, give policy makers some solace. New Zealand can continue to take a strong stance abroad, opposing aggression and injustice whatever its source, without worrying too much about its economic impact at home. Obviously, this does not give New Zealand policy makers absolute license to upset the US or any other powerful country — the current levels of trade access that New Zealand enjoys can ultimately be taken away if New Zealand foreign policy goes completely feral. But the realisation that foreign policy friendliness cannot lead to FTA gains significantly broadens the range of feasible foreign policy positions available to New Zealand governments.

One positive but unintended consequence of New Zealand's recent trade policy has been to insulate the other areas of its foreign policy from our trading relations with other western countries. While the lost economic opportunity stemming from New Zealand's recent trade policy should be mourned, the other foreign policy gains are worth celebrating.

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Evaluating Government Regulations

Bryce Wilkinson

Governments commonly acknowledge the need to improve the quality of government regulation, or to reduce undue regulatory burdens. This raises the question of what criteria should be used to evaluate the quality of a regulation.

Economists and lawyers — constitutional lawyers or legal draughtsmen — tend to use different, but arguably largely complementary, criteria to evaluate regulations. In New Zealand, at least, the two approaches have been evolving independently. The lead economic ministries have supported the Australian approach of a regulatory impact statement (RIS) requirement centred on cost-benefit analysis (CBA). This approach assumes, *inter alia*, that a recognisable legal system is already in place; otherwise a benefit could not be distinguished from a cost.

In contrast, a legal and constitutional approach to testing a regulation is directly concerned with its conformity with the requirements of a recognisable legal system and with legal and constitutional principles that relate to process and content. In New Zealand, Cabinet has made an *ad hoc* advisory committee of independent legal experts, the Legislation Advisory Committee (LAC), responsible for identifying such principles (see below). Legal arrangements in Australia differ markedly in some respects because of its federal structure and written constitution. This article focuses on the New Zealand situation.

In New Zealand, the Cabinet Manual requires regulatory proposals taken to Cabinet to be tested against both the RIS requirement and the tests identified by the LAC. The next two sections of this paper summarise these approaches. The first also argues that CBA cannot satisfy current expectations that it play a central role in improving the quality of regulations.

A third section motivates and outlines a synthesis of these two approaches to evaluating a regulation that is proposed and justified in much more detail in *Constraining Government Regulation: A Discussion Document*, (CGR, 2001). The writer was the principal author of this discussion document. He was assisted by his colleague Sue Begg, University of Chicago law professor Richard Epstein and George Mason University economics professor Tyler Cowen.

CBA does not play a central role in the proposed schema for evaluating the quality of a regulation. The proposed schema instead emphasises the importance of a principled approach to the issues of compensation and consent when the State uses its power of eminent domain to take some citizen's rights in private property for the benefit of others, or to reallocate uses of property held in common. The

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issues of compensation and consent are fundamental to a system of voluntary exchange and to constitutional government.

The final section makes some concluding observations on the principles and tests proposed for regulatory analysis.

Regulatory Reform Based on Comparing Predicted Outcomes

In recent years the Organisation for Economic Cooperation and Development (OECD) has advocated the use of regulatory impact analysis (RIA) in order to reduce regulatory excesses. RIA aims to improve transparency and public consultation by requiring assessments of important impacts, fiscal costs, compliance costs, or formal CBA.

In March 1995, RIA was a key component of the OECD Council's recommended ten-point checklist approach to regulatory reform. In 1997 ministers of member countries endorsed an OECD report on regulatory reform recommending that governments should integrate RIA into the development, review and reform of regulations.

While CBA is not necessarily at the centre of a RIA, it is at the centre of a widely adopted version of this approach — the requirement for new regulations to be accompanied by a Regulatory Impact Statement (RIS). Australia was ahead of most countries in adopting a RIS requirement in 1985 for all Commonwealth Cabinet proposals affecting business.

By 2000, according to Australia's Productivity Commission (2002:37), 20 of the 28 OECD countries used some form of a RIS requirement. It reported that 14 of those countries employed broadly similar requirements to those in Australia. These included Canada, New Zealand, the United Kingdom and the United States. A further six countries used RISs for some regulations or in some circumstances.

In New Zealand the RIS requirement is set out in sections 3.23-3.38 of the Cabinet Office's *Step by Step Guide*. The stated objective is to 'improve the quality of regulation making and to ensure that regulatory proposals are cost-effective and justified'. Sections 5.28 and 5.52 of the Cabinet Manual provide that all policy proposals submitted to Cabinet, which result in government bills or statutory regulations, must be accompanied by a RIS, unless an exemption applies.

Each RIS must contain statements of:

- the nature and magnitude of the problem and the need for government action;
- the public policy objective(s);
- feasible options (regulatory and non-regulatory) that may constitute a viable means for achieving desired objective(s);
- the net benefit of the proposal, including the total regulatory costs (administrative, compliance, and economic costs) and benefits (including non-quantifiable benefits) of the proposal, and other feasible options; and
- the consultative program undertaken.

How effective are such requirements? Competent analysis can be difficult, costly, and inconclusive. The OECD (1997:20) reports that:

... there is a broad consensus that, properly done, RIAs can be effective in helping to produce the most effective, least cost instruments, though they require additional resources. An evaluation of 15 RIAs in the United States found that they cost about \$10 million to conduct but resulted in revisions to regulations with estimated net benefits of about \$10 billion, or a benefit to cost ratio of about 1,000 to 1. The Canadian Business Impact Test has been judged effective particularly in assessing SME (small enterprises) impacts. But RIA is very hard to do properly. More work is needed to strengthen the methods, procedures and practice of RIA and to strengthen regulatory management to support its timely and effective use.

Reflecting the conceptual difficulties with CBA and the problems of costs and incentives, it should be no surprise that the OECD also reports 'massive non-compliance and quality problems' and that in most countries 'it is still a marginal influence on regulatory decision-making'.

Even in the United States, two decades of investment in RIA has not produced an encouraging result. Robert Hahn *et al* (2000) found that:

This study provides the most comprehensive evaluation of the quality of recent economic analyses that agencies conduct before finalizing major regulations. We construct a new dataset that includes analyses of forty-eight major health, safety, and environmental regulations from mid-1996 to mid-1999. This dataset provides detailed information on a variety of issues, including an agency's treatment of benefits, costs, net benefits, discounting, and uncertainty. We use this dataset to assess the quality of recent economic analyses and to determine the extent to which they are consistent with President Clinton's Executive Order 12866 and the benefit-cost guidelines issued by the Office of Management and Budget (OMB). We find that economic analyses prepared by regulatory agencies typically do not provide enough information to make decisions that will maximize the efficiency or effectiveness of a rule. Agencies quantified net benefits for only 29 per cent of the rules. Agencies failed to discuss alternatives in 27 per cent of the rules and quantified costs and benefits of alternatives in only 31 percent of the rules. Our findings strongly suggest that agencies generally failed to comply with the executive order and adhere to the OMB guidelines.

In Australia, achieving formal compliance seems to be a diminishing problem. The Productivity Commission (2002:8) reports an extremely high rate of compliance in recent years. For example, for the 2001-02 year it reported that 130

RISs out of a required total of 145 were prepared at the executive's decision-making stage, of which 128 were 'adequate'. Compliance was even greater at the tabling stage. It observed that compliance was noticeably lower (at 70 per cent) for proposals having a significant impact. At the state level, the rate of compliance with the separate RIS requirements of the Council of Australian Governments was also very high at 96 per cent.

While it is not clear how the Productivity Commission's standard for adequacy compares with that used by Hahn *et al*, its report enhances the expectation that materially improved outcomes should result from the Australian approach by asserting (2002:50) that the Commonwealth RIS requirements have 'in many respects led best practice internationally' and have a high degree of consistency with the OECD's best practice guidelines for RIAs. The report also makes a strong claim that materially improved outcomes have resulted. The first 'key point' it makes in its overview (2002:xii) is that the reform of regulations 'has generated significant gains for Australia'.

Unfortunately, the evidence the Productivity Commission's report presents in support of the claim of significant gains is disappointing. The overview focuses on improved compliance and does not establish that this has improved the quality of the regulations being passed. When the report compares regulations in Australia with other countries it focuses on business compliance costs. Even here it finds (2002:xviii and 44) only that the burden in Australia is around 2.9 per cent of gross domestic product. It puts this at around the OECD average, and higher than in New Zealand.

There are no grounds for surmising that New Zealand's lower burden results from its own RIS requirement. Tasman Economics (2001) reviewed the effectiveness of the RIS regime in New Zealand for the Ministry of Economic Development and the Treasury. The review found that 'many regulatory impact statements were far too brief, given the importance and complexity of the issues being addressed and were of poor quality'. It did not say whether any were satisfactory overall. It made a number of recommendations for improving the design of the regime and compliance with its requirements.

More recent examples of RISs in New Zealand indicate that this requirement lacks teeth (Wilkinson, 2002). Without a strong government commitment to ensuring high-quality RISs, government departments may rationally make little effort to undertake a competent analysis.

Nor may judicial review adequately guard against bad analysis. Economist William Niskanen (1997) has drawn attention to the reluctance of the courts to accept the role of evaluating scientific and economic studies. Epstein (1995:97 and 103) has independently argued in another context that it is desirable that judges focus on applying the law — determining if an action was legal — rather than allowing their decisions to be affected by explicit references to CBA.

In any case, techniques such as CBA cannot claim a mantle of pure scientific objectivity and efficiency. CBA is essentially a central planning tool, albeit one that is seriously limited in its ability to handle distributional issues. It presumes that costs, benefits and discount rates can be objectively determined and gathered

together in one place for the benefit of a government decision-maker with the precision necessary for taking a useful decision. However, opportunity costs are subjective and the costs of undertaking a competent CBA are so high as to ensure that in many cases decisions will be made on the basis of seriously inadequate information. Furthermore, CBA does not align the incentives of government decision-makers or analysts with the national interest. The problems of information and incentives create the potential for material bias. Viscusi *et al* report (1998:326) that a large amount of evidence rejects the public interest theory that regulation occurs where there is the potential for a net social welfare gain.

A competent CBA may usefully inform decision makers, but it cannot eliminate the need for significant and controversial value judgments in particular cases. Reflecting on the well-known weaknesses of CBA, Niskanen concluded that the net benefit standard does not provide a sufficient basis for the redistribution of income, the taking of private property for a public benefit, or for restricting the activities of individuals and firms that bear the full cost of their actions.

Boston University law professor Randy Barnett (1998:322-325) makes a more general argument. It is that the problems of information and incentives that make CBAs problematic affect public policy analysis generally. He concludes that law-making should be informed by considerations of justice rather than solely by public policy analysis.

Regulatory Reform Based on Legal Guidelines

Legal scholars and the professional lawyers that draft legislation examine the quality of its structure. Yale law professor Lon Fuller (1969) identified a number of tests for the very existence of a recognisable legal system — Will people be able to understand it? Does it actually give effect to the intended policy? Is it necessary, or does it replace existing common law by something less satisfactory? Is it constitutional? Is it internally consistent? Does it conflict with other laws? Does it require conduct beyond the powers of those affected, as in the case of retroactive legislation?

Legal experts, such as former academic and justice minister Sir Geoffrey Palmer and New Zealand's Law Commission (1995), have stated in very strong terms that legislation in New Zealand commonly fails to pass basic legal tests. In February 1986, the then Geoffrey Palmer, as Minister of Justice, established the LAC to help improve the quality of legislation in New Zealand. One of its two main functions is to produce guidelines that are fundamental for developing legislation, such as proper processes and basic legal principles. These are known as the *LAC Guidelines: Guidelines on Process and Content of Legislation (LAC Guidelines)*. Its second main function is to advise the relevant minister or the Cabinet Legislation Committee on these issues in relation to particular legislation, when requested to do so.

The Ministry of Justice services the LAC. The LAC reports to the Minister of Justice and the Legislative Committee of Cabinet on the public law aspects of

legislative proposals. Its first guidelines were prepared in 1987 and the latest edition was released in 2001. They are designed to set out central aspects of the law-making process and to specify elements of the *content* of legislation that should always be addressed.

The 2001 *LAC Guidelines* provide the following checklist for a regulation as it affects basic principles of New Zealand's legal and constitutional system:

1. Does the legislation comply with fundamental common law principles?
2. Have vested rights been altered? If so, is that essential? If so, have compensation mechanisms been included?
3. Have pre-existing legal situations been affected, particularly by retroactivity? If so, is that essential? What mechanisms have been adopted to deal with them?
4. Does the legislation enable the levying of money? If so, is the levy a tax imposed other than by Parliament?

Such tests potentially constrain the content of legislation, independently of the economist's calculations of likely future impacts, costs or benefits. A such they are different *in kind* from restrictions based on CBA.

The *LAC Guidelines* state that the common law is organised around a respect for individual dignity and individual possession of property, and the supremacy of Parliament as a source of law. However, where there is doubt as to exactly how a particular provision of a statute will mesh in with, or prevail over, the common law, the courts may reach a decision by giving weight to common law presumptions based on concern for the preservation of individual rights. Of particular interest here is the following statement in the *LAC Guidelines*:

The basic common law perspective of the courts is that a person's liberty and **property** will only be taken away or confined after due process of the law, which processes are designed to ensure that no one is deprived of individual liberty unless a case is proven against that person by fair procedures. [Emphasis in original.]

The same chapter of the *LAC Guidelines* cites approvingly Lord Hoffman's dictum in 1999 that while parliaments can legislate contrary to fundamental principles of human rights, fundamental rights cannot be overridden by general or ambiguous words. The courts may therefore presume that even general words do not remove the basic rights of the individual.

In contrast to the economic approach to evaluating regulations on the basis of predicted costs and benefits, the *LAC Guidelines* put common law principles on centre stage. However, this approach is not without difficulty. The *LAC Guidelines* enumerate an incomplete list of 18 'fundamental common law principles'. The list seems somewhat idiosyncratic. For example, it omits freedom of association, yet includes such novel rights as freedom from discrimination [by private persons] and conformity with the Treaty of Waitangi.

Of greatest interest to the topic of this paper is the unqualified statement that the principle that property will not be expropriated without full compensation is a fundamental common law right. The *LAC Guidelines* make no attempt to limit the definition of property to real estate. By way of elaboration, they state:

If property is involved and if what is proposed is a taking, consideration will need to be given as to whether or not compensation should be provided. In these circumstances, if compensation is not to be paid the legislation should make quite clear this presumption.

They state that '[t]he development of this presumption reflects the fact that "the protection of property is generally regarded as one of the fundamental values of a liberal society"'. (Cross, p 179)'.

The *Public Works Act 1981* fully conforms to the principle that compensation be paid in relation to land (see below). However, other legislation directly contradicts it. For example, section 85 of the *Resource Management Act 1991* commences: 'Compensation not payable in respect of controls on land' [*sic*].

Although the Cabinet Manual requires new legislation to be tested for its conformity with the *LAC Guidelines*, the author is not away of any evidence that they are having a material effect to date on the quality of new legislation. Evidence of the ongoing expropriation of property rights without due compensation is easy to find. For example, the legislation ratifying the Kyoto Protocol expropriates carbon sink credits. This has angered forestry plantation owners.

A 'Law and Economics' Synthesis

The formal 'Arrow-Debreu' neo-classical economics analysed production and exchange equilibria assuming that a 'given' system of individual property rights and freedom of contract was in place. CBA similarly assumes a given legal system of legitimate individual rights, otherwise it would not be possible to distinguish an avoided harm from a benefit. A regulation that takes only some of the legal rights of its victims could be said to benefit them because it does not take all of their rights.

Tom Bethell (1998) has documented the failure of economists for two centuries to analyse the legal institutions that underlay their analysis of production and exchange. He suggests that the classical economists failed to do so because the sanctity of private property rights was so entrenched that a defence would be superfluous. Nor did their successors adequately fill the breach when Marxist and other attacks succeeded in bringing the institution of private property into intellectual disrepute. Particularly in the environmental area, it seems common today for those supporting a restriction on land use to deny the legitimacy of the existing owner's 'development rights'.

Bethell has also documented the growing appreciation amongst some academic economists in recent decades, and in the last decade in international

organisations such as the World Bank, of the importance for prosperity of a legal system that facilitates production and exchange, and human welfare more generally. Economists such as Peru's Hernando De Soto have emphasised the relationship between chronic poverty and the absence of a legal framework that gives legitimacy to established (customary) rights.

The set of laws and regulations that is most conducive to economic efficiency or prosperity is not necessarily the same as the set that best secures individual liberty, natural rights, or diverse concepts of 'justice'. There is ample scope for disagreement, for example, as to whether the common law is, or should be, efficient. Nevertheless, there is also scope for much common ground between public policy lawyers and economists concerning the necessity for a sound legal system and the important characteristics of such a system.

Both a legal and an economic analysis may concur that a prime role of the state is to uphold the law so that individuals are secure in their rights to person and property. Many may also agree that in certain situations the state may validly take these rights in the public interest. (In the United States, the power of the state to take private property in the public interest is known as the power of eminent domain.)

There is an obvious tension between these two roles for the state. Frederic Bastiat (1850:14) pinpointed it vividly as follows:

As long as it is admitted that the law may be diverted from its true purpose — that it may violate property instead of protecting it — then everyone will want to participate in making the law, either to protect himself against plunder or to use it for plunder.

To guard against this danger, State takings must be limited and principled if the State is to achieve its prime purpose. The search for better laws and regulations is in good part a search for well-designed constraints on State takings.

One important constraint is to require the state to conform to due process. Ideally, independent courts determine whether due process has been followed and the individual's right of judicial review is protected. The due process clauses in the Fifth and Fourteenth Amendments to the United States constitution state that: '... nor shall any person ... be deprived of ... property without due process of the law'.

A second important constraint is the requirement that compensation be paid where the state does take private property in the national interest. The US Fifth Amendment states: '... nor shall private property be taken without due compensation'.

In the common law countries, the importance of limiting the use of the power of eminent domain is acknowledged in the legislation that providing for the taking of public land for public works. For example, key constraints in the initial *Public Works Act 1981* legislation in New Zealand included the provisions that:

- there was only to be recourse to compulsion if voluntary agreement was not obtained following due processes;
- required that the taking be ‘necessary’ for an ‘essential’ public interest;
- ensured that full compensation was paid to property owners; and
- incorporated the principle that those who benefit should fund the compensation (under the ‘betterment’ principle, a landowner might receive in cash less than full compensation for land taken for a public work if the same work increased the value of the landowner’s remaining land).

Economists might interpret the requirement to pay compensation as going some way to mimic the feature under a system of voluntary exchange where a supplier of a good or service relinquishes property rights in the same to the buyer in return for a consideration of at least equal value. Indeed, the features of mutual benefit and the absence of coercion that underlie a system of voluntary exchange are the hallmarks of civil society.

In a public good context, the requirement that the State should pay compensation for the taking of rights in private property can be interpreted as an imperfect safeguard against the system of forced and predatory exchanges of the type feared by Bastiat. The safeguard is particularly imperfect to the degree that any compensation is funded by taxpayers who are not representative of the group that actually stands to benefit from the expropriation of property. Taxpayer funding without the consent of taxpayers or their representatives puts taxpayers at risk.

By the same token, a decision to take private property without ensuring full compensation is in general a decision to tax the owners of that property. Again such taxes should conform to sound tax principles, both as a matter of justice and economic efficiency. Any taxes used to fund public goods should, in principle, raise the welfare of all citizens. If so, they should be able to command the general consent of those who pay the taxes.

Indeed, the events leading to the American declaration of independence in 1776 demonstrated the power of the fundamental constitutional principle that taxes should not be levied except with the consent of those being taxed, or their representatives. This principle raises the issue of who can validly claim to be the representatives of those being taxed. The constitutional presumption that parliament should not delegate the power to tax indicates acceptance of the view that parliament is more representative of taxpayers’ interests than is executive government. Even so, parliamentarians face an obvious conflict of representation when it comes to taxing one group of voters for the benefit of others. (Clearly, an uncompensated taking may be a highly predatory tax.) This difficulty motivates consideration of other constraints such as a bicameral system and greater recourse to referenda. Space does not permit their discussion here.

These principles — the desirability of limiting government takings under the power of eminent domain to important matters of public interest and the need to conform to sound principles for taxation and compensation — provide a different approach to testing the quality of a law or regulation from that adopted under the

above RIA or RIS approaches. In particular, they do not treat subjective future costs and benefits as technocratic variables that can be objectively estimated by central planners or economists who are not personally incurring the costs or the benefits.

CGA used the above principles of consent and compensation, and the presumption in favour of fundamental common law principles, to propose the following five principles for testing a law or regulation:

- (a) Laws and regulations should enhance security from legal harms in person, liberty, contract and property;
- (b) Laws and regulations should preserve common law causes for action that have prevailed for centuries against harms caused by strangers. They should not introduce novel or expanded concepts of legal harms and expansive definitions of an interested party, or remove legal harms whose utility has survived the test of centuries;
- (c) Laws and regulations should preserve or enlarge the scope for individual action, and thereby for voluntary cooperative action. They should enhance freedom of contract and exchange;
- (d) Laws and regulations that reallocate legal rights by force must be justified on the basis that they are necessary for the achievement of an essential public interest. In addition, such laws and regulations must:
 - (i) not delegate from parliament the power to levy taxes;
 - (ii) preserve the principle that taxes should be levied in the public interest only with the general consent of those who are liable to pay those taxes;
 - (iii) preserve the principle of full compensation for those whose legal rights under common law are taken or impaired in the public interest;
 - (iv) preserve the principle that such compensation should be funded by the new legal owners or, if the government assumes the taken rights, by those in whose interests the taking was justified;
 - (v) preserve the principle that surpluses arising from the exercise of the power of eminent domain are divided amongst those who are parties to the exchange in proportions that reflect the size of their original contributions;
 - (vi) require evidence of consent under principle d(ii) from those who are effectively being taxed in cases that are an exception to principles d(iii) or d(v);
- (e) Laws and regulations should otherwise preserve or enhance the rule of law. In particular, they should:
 - (i) not take retrospective effect;
 - (ii) avoid imprecise terms and complexities that materially undermine the ability of citizens to understand the law and therefore to comply with it;
 - (iii) increase certainty as to what actions are legal;

- (iv) ensure that the constraint of judicial review applies to the exercise of delegated administrative and executive powers in relation to the discretion to set user charges, attach conditions to permits or consents, or change the use of assets within the public sector;
- (v) uphold the principle that all are subject to the law – including the government and its agencies; and
- (vi) uphold the principle of equality under the law. Laws should be general and abstract, not mentioning specific categories of persons, gender, race, creed or religion, time or place.

Principle (a) provides for the use of police power. It allows laws and regulations that assist the state to enforce existing legal rights better. Law-abiding people should be secure in their persons, liberty and possessions.

Principle (b) is designed to test for stability in laws whose enduring value has been proven through the course of time. This is best interpreted as a consequentialist position, although such laws are likely to get the status of ‘natural’ laws or rights over the centuries.

Principle (c) aims to protect the domain for voluntary action from government encroachment by imposing a burden of proof on the latter. This guards against excessive regulations that stem from factional pressures, excessive paternalism, and grandiose presumptions about the ability of those in government to command the information needed to determine what outcomes best serve the interests of diverse individuals.

Principle (d) allows for the principled use of the power of eminent domain, including the power to tax in cases of necessity for an essential public interest (see below).

Principle (e) incorporates other elements of the rule of law. Subsection (e)(v) provides for judicial review.

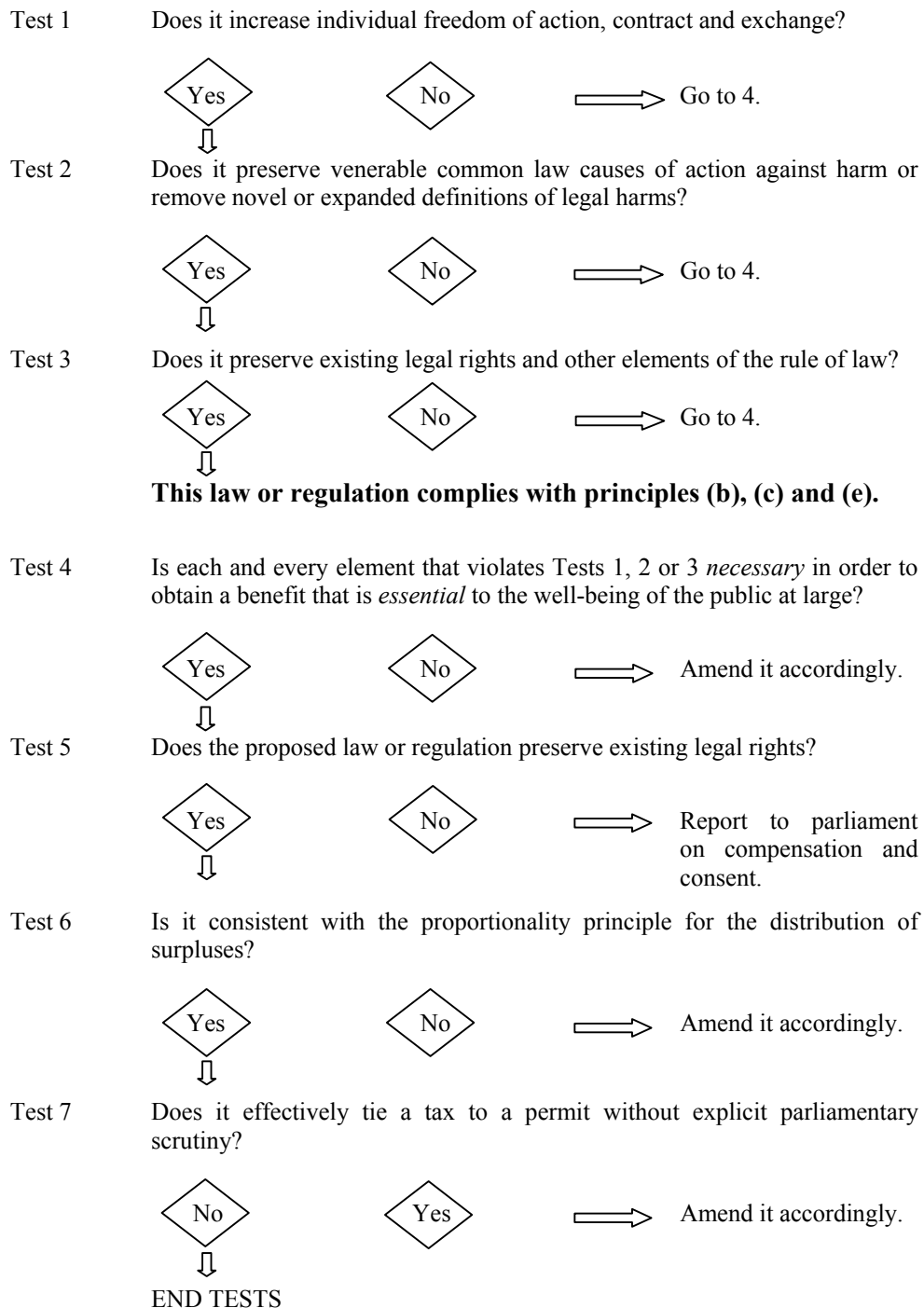
The thrust of these principles is to allow laws and regulations that are consistent with them to escape the detailed scrutiny that would then be applied to other laws and regulations.

The 2001 *LAC Guidelines* and the above principles have much in common. Both acknowledge the importance of preserving fundamental common law principles, although the language differs. Both emphasise the importance of individual security in person and property and the concomitant importance of paying compensation when private property is taken in the public interest.

However, there are also some noteworthy differences. The *LAC Guidelines* list freedom from discrimination and compliance with the Treaty of Waitangi as fundamental common law principles. They do not include freedom of association and the principle of consent to taxation.

CGR converts the above five principles into the following sequence of tests that could be used to screen laws and regulations.

Exhibit: Schema for Using the Proposed Principles to Test a Law or Regulation



Tests 1, 2 and 3 incorporate principles (c), (b) and (e) respectively. A regulation that passes these three tests passes all the tests. It will be a regulation that does not use the power of eminent domain to reallocate ‘venerable’ common law rights. These are no doubt analogous to the concept of fundamental common law principles in the *LAC Guidelines*, except that the test of what is venerable is more clearly a consequentialist test.

Deregulation — the removal of command and control regulations aimed at imposing outcomes rather than clarifying rights that can later be voluntarily reassigned — should pass these three tests. Taxes to fund state-provided public goods are likely to fail test 1.

Laws and regulations based on the use of the power of eminent domain may fail those tests, particularly test 3, for practical reasons. The scheme then screens these and other regulations for their compliance with tests 4 to 7.

Test 4 incorporates principle (d). It screens regulations that fail one or other of the first three tests for their necessity in terms of an essential public interest. It allows tax-funded public goods where the tests of necessity and essentiality are satisfied.

Tests 3 and 4 would allow for a taxpayer-funded welfare safety net where tests of the consent of taxpayers or their representatives and of necessity and essentiality were satisfied.

Test 5 aims to ensure that the issue of compensation is addressed by parliament. It also invokes the issue of consent.

Test 6 asks whether the regulation distributes any surpluses that arise from the exercise of the power of eminent domain in a non-proportional, exploitative, manner. It aims to ensure that the distribution of any surpluses is scrutinised.

Test 7 screens for the abuse of the power to attach conditions to the issuance of permits.

These tests could inform any thorough review of existing regulations. They could also be incorporated into any guidelines or processes put in place to guard against regulatory excesses in new laws or regulations.

How effective might these tests be? They are less likely to be effective the greater the degree to which the problem of too many bad laws or regulations stems from voter failure rather than from political failure. In the absence of any clear agreement in the community about the need for constitutional constraint and principled government takings, the problem of voter failure is particularly intractable. Obvious weaknesses in the above proposals arise in practice from the need to secure meaningfully constraining definitions for terms such as ‘venerable’, ‘essential’, ‘necessary’ and ‘public interest’. Formally, for example, necessary as a mathematical term means ‘otherwise impossible’ as in ‘A is a necessary condition for B’. However, there is an obvious risk that popular governments and compliant courts could soon define ‘necessary’ to mean ‘convenient’ (to the ruling elite).

Similarly, the term ‘essential’ public interest is intended to impose a high threshold in the form of requiring that the power of eminent domain only be used

sparingly where it is necessary to do so in order to achieve a major gain in community welfare. Economists might measure this by the sum of producer and consumer surplus. However, again, governments or the courts could easily emasculate such a constraint if public or elite opinion was sufficiently quiescent. For example, in New Zealand the test of essentiality in the *Public Works Act 1981* was repealed in 1987, ostensibly on the grounds that it created too many definitional problems. However, it is not obvious that the new criteria of ‘fair, sound and reasonably necessary’ are any better in this respect. Section 7.5 in *CGR* discusses many of these complexities in greater detail.

Concluding Comments

Civil society depends on securing principled, constitutional government — as distinct from arbitrary, unprincipled, or despotic government. In conjunction with high levels of economic freedom this should also facilitate wealth creation.

The principles and tests proposed here and in *CGR* are designed to complement the RIS tests based on CBA by adding a law and economics perspective. The proposed synthesis aims to reduce reliance on CBA assessments by putting greater reliance on evidence of the participants’ assessments of the costs and benefits.

The proposed principles and tests accept that regulations that take private property rights by force may be sometimes desirable in order to overcome barriers to mutually beneficial exchanges. However, they aim to preserve the principle that such exchanges, if welfare enhancing, should have the potential to make all parties to the forced transactions better off (*ex ante*) than if the regulation were not passed. Even where practicalities prevent such a pure result, compliance with due process based on the principles of constitutional restraint, consent to taxes, mutual benefit, and respect for the legitimate rights of others should both promote civil society and preserve incentives to create wealth by guarding against unprincipled and predatory takings.

The proposals in *CGR* are intended to promote public debate about the need for a deeper and more far-reaching approach to a widely acknowledged problem. The tests are proposed as a basis for discussion and refinement. They are not a panacea for the problem of an excess of bad regulation. Nor is there a program for putting them in place. To put them in place would require real political will to improve the quality of regulations by constraining future governments to take a more principled approach. Such a will is likely to emerge in time if current remedies prove to be ineffectual and the problems persist.

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Randomised Policy Trials

Andrew Leigh

In the eighteenth century, the notion that new medical treatments should be evaluated through randomised trials began to gain acceptance. Despite criticism from doctors, who believed that their scientific expertise should be taken on faith, evidence-based medicine gradually gained adherents. Today, randomised trials are a necessary step in the licensing of drugs in Australia and throughout the developed world.

By contrast, in the Australian policy sphere, robust evaluation of the effectiveness of particular programs remains rare. While policy evaluations have become more common over recent years, the efficacy of most of these evaluations remains questionable. Because randomised trials are so rare in Australia, the political rhetoric is usually substituted for hard evidence. Yet in the United States (US), where randomised trials are most common, researchers in education, health and welfare have convincingly demonstrated that they are the most effective way of testing whether policies achieve their stated goals.

The discussion in this paper outlines why randomised trials tend to be superior to other forms of policy evaluation, and address six common objections to their use. The early evolution of randomised evaluation, first in medicine, and then in the social sciences is then discussed. This is followed by an analysis of several recent examples in which policy knowledge has been advanced through the use of randomised trials. The paper then concludes with some suggested areas in which evidence-based policy could be implemented in Australia.

Why Randomised Trials?

Randomised trials represent the most robust method of evaluation known to social science. Just as in medicine, when we want to know the impact of a policy intervention, randomised trials provide the most accurate answer — allowing policymakers to conduct a true ‘policy experiment’.

In a randomised framework, the treatment and control groups are alike in all respects except the treatment itself. The alternative — commonly employed in non-randomised ‘pilot programs’ — is to make some heroic (and generally incorrect) assumptions about what would have happened in the absence of the intervention. Non-randomised evaluations generally take one of two forms. The first approach is to look at participants before and after the program, while the second is to compare participants with some other group of people who did not participate in the program. Both these alternatives are flawed. In the first case, it is impossible to know how the participants would have fared in the absence of the

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program. In the second, there is a good chance that the decision to enrol is related to other factors that affect outcomes. For example, an evaluation of a quit smoking program might compare those who enrol with those who do not enrol. Yet we would probably think that those who sign up for a quit smoking course are more likely to quit, and hence that do not are a poor control group. This type of evaluation is inherently flawed, yet it is frequently used in government policy evaluations.

In effect, random assignment of participants to treatment and control groups provides us with the perfect counterfactual. It enables us to answer the question: what would have happened to these same participants if they did not enrol in the program? With random assignment, the outcomes for the control group (the non-participants) represent what would have happened to those in the treatment group in the absence of the program. With a sample size in the hundreds, we can expect that the two groups will be very close on any possible measures — not only in observable characteristics such as age, income, sex and race — but also in unobservable characteristics such as intelligence, motivation, family background, and prior knowledge of the program.

Objections to Randomised Trials

Since randomised trials are often criticised on a number of grounds, it is worth dealing with some of these criticisms. (For a more thorough rejoinder to the critics, see Cook and Payne, 2002.)

Objection 1: Randomised trials don't work because it is too difficult to define the goals of most policies

To successfully conduct a randomised trial, it is necessary to precisely define the outcomes that the policy aims to achieve. But can policy goals be measured? It is true that in some cases, policies have immeasurable elements. For example, the effect of school class sizes on students' test scores can be assessed, but the effect of class sizes on self-esteem is more difficult to gauge. Randomised trials would be likely to be more effective at gauging the impact of class size on test scores than on self-esteem. It is also the case that some policies do not need to be assessed because their impact is self-evident. For example, the provision of public pensions is a simple fiscal transfer, and is generally regarded as a success if the money reaches the intended recipient. So long as the payment process is in place, it is difficult to see why we would need to carry out a randomised trial of pension provision.

Yet between these two examples lie a vast array of policies whose outcomes are measurable, but whose effectiveness is questionable. In many cases, policy goals can be measured, yet in the absence of a randomised trial, it is not self-evident that the policy achieves its intended purpose. Industry assistance is generally aimed at creating extra jobs, and fostering research and development, yet governments frequently do not know what would have happened if they had not

provided assistance. Job search and job training programs are aimed at increasing employability and earnings, but are rarely subjected to proper assessment (for two exceptions, see Barrett and Cobb-Clark, 2001; Breunig *et al.*, 2003). The Baby Bonus, introduced by the Howard Government in 2001-02 as a means of boosting fertility rates, was not subject to any rigorous trial to see whether it indeed achieved its goal. And at a state level, changes in policing policies often occur in a blitz of rhetoric, with minimal attention paid to results.

A subtler version of this objection is that randomised trials sometimes take place in an environment that creates unusual incentives (one such example is discussed below). In medicine, drug trials can be ‘double blind’, meaning that neither the subject nor the doctor know whether the patient is receiving the drug or a placebo. Because subjects and administrators cannot be ‘blinded’ in randomised policy trials, they may adjust their behaviour in ways that undermine the experiment. But this is not an argument against randomised policy trials *per se* — merely a warning that policy experiments should be conducted in a manner that does not create peculiar incentives for the participants.

Objection 2: Randomised trials involve denying treatment to worthy individuals

Because randomised trials involve withholding potentially beneficial treatments from some individuals, some critics have charged that they are unethical. Yet this ignores the fact that governments never provide assistance to all those who would benefit from it. With any rules-based system of administering welfare benefits results, bureaucrats will end up denying assistance to those who do not fully satisfy the set eligibility criteria but would otherwise benefit from the program.

Additionally, in the case of a pilot program, the objection that those in need will miss out is ameliorated by the fact that researchers genuinely do not know whether it is preferable to be assigned to the treatment or control group — otherwise they would not conduct the trial. Cook and Payne (2002) point out that a review of randomised medical trials shows that the treatment outperformed the control only about half the time. They quote Chalmers (1968), ‘One has only to review the graveyard of discarded therapies to discover how many patients might have benefited from being randomly assigned to a control group.’

In the case of a program that is already in place, many would consider it unfair to deny it to some recipients. But an ethical way of testing the efficacy of existing programs is to provide financial compensation to ensure that no-one suffers as a result of participating in the trial. For example, in the RAND Health Insurance Experiment, researchers were able to persuade participants to volunteer by promising that those who were assigned to the ‘minimal insurance’ group would be given financial compensation to ensure they were still better off as a result of participating (though this proved a costly option).

Objection 3: There are already good alternatives to randomised trials

What about alternatives to randomised trials? According to some critics, there is no need to implement randomised trials, because the alternatives are just as good.

The proliferation of non-randomised ‘pilot programs’ is often cited as an effective way of discovering whether or not policies work. But unfortunately, too many pilot programs are methodologically suspect, and therefore probably a waste of public funds. Without randomisation, researchers lack an appropriate control group with which to determine what would have happened in the absence of the policy intervention. As has been discussed above, the two main alternatives to randomisation — looking at the participants before and after, or following a group of non-participants — produce results that are of questionable veracity. Policymakers should be suspicious of any pilot program relying on a control group that is not truly comparable to the treatment group.

Other critics of randomised trials claim that they are unnecessary because econometric advances now allow researchers to conduct ‘quasi-experiments’ (also known as natural experiments). It is true that advances over the past two decades have substantially improved researchers’ ability to analyse policies in the absence of randomisation. Techniques such as differences-in-differences, regression discontinuity, instrumental variables, and propensity score matching, all help to simulate the conditions of an actual experiment (Angrist and Krueger, 1999). In certain instances, randomised trials will not be feasible for ethical reasons, because the expected effect is very small (necessitating an overly large study), because we are interested in general equilibrium effects, or because the policy is only thought to take effect with a long lag.

In the past decade, a number of seminal quasi-experimental studies have been produced.¹ Differences-in-differences techniques have allowed researchers to analyse the effect on employment of changes in state minimum wage rates, regression discontinuity has been used to study the effect of compulsory school attendance laws on lifetime earnings, and state policy changes have been used to analyse the effect of abortion legislation on crime rates. Quasi-experimental techniques can also be useful in dealing with problems that may occur in randomised trials — such as attrition bias or non-compliance with experimental protocols (Heckman *et al*, 2000). Yet many questions are simply not amenable to quasi-experimental studies, particularly where unobserved ability and selection into the program play a significant role. Where randomisation is feasible, it remains the gold standard in social research (Burtless, 1995).

Objection 4: Qualitative research is more important than quantitative research

In most cases, randomised evaluations focus on measurable outcomes, such as employment, earnings, crime rates, or test scores. While these measures are powerful ways of measuring what policymakers and citizens care about, they are generally incomplete. Qualitative outcomes, such as how policies affect

¹ A significant impediment to quasi-experimental studies in Australia is the difficulty in obtaining microdata. Although the Australian Bureau of Statistics makes some data available to Australian university researchers as Confidentialised Unit Record Files, significantly less information is available than in many other developed nations (Leigh and Wolfers, 2003).

participants' self-esteem, and what participants feel is the most important impact of a policy intervention, are also critical parts of any assessment.

As Weiss (1998:14) points out, a key result of the 'paradigm wars' of the late-1970s and 1980s, which pitted qualitative and quantitative researchers against one another, was the discovery that both methods could effectively complement one another. At their best, randomised trials can also include a qualitative component — for example, analysing the social context in which the policy is implemented. In the Moving to Opportunity trial (discussed in more detail below), researchers measured statistics on health, education and employment outcomes. They then carried out in-depth surveys with members of the treatment and control groups, asking them how they felt about their environment. Through this, they discovered that participants found the biggest impact of moving to a low-poverty neighbourhood was a substantial reduction in crime, and a lessening in participants' fear of crime (Kling, Liebman and Katz, 2001). Quantitative analysis allowed researchers to compare outcomes for the treatment and control groups, while qualitative research was necessary to find out what subjects saw as the most important aspect.

Objection 5: Politicians are interested in re-election, not results

Inevitably, the need for governments to win an election every three or four years shapes policies. All governments face the accusation from their opponents that they are 'poll-driven', and during election-time, the same charge is often levelled at oppositions. The growth of 'middle class welfare', in which taxation revenue is raised (with its associated deadweight loss) and then returned to the same taxpayers as non-means tested benefits, is frequently cited as an example of this form of politics.

Yet while the growth of telephone surveys in recent decades has facilitated poll-driven politics, it would be premature to conclude that Australian governments do not care about the results of their policies. Using data from Australian federal elections, Cameron and Crosby (2000) and Wolfers and Leigh (2002) show that governments' success in lowering unemployment is a significant predictor of whether or not they will be re-elected. Even governments that are only concerned with being re-elected should devote more energy to testing their policies. At the same time, political actors who are more concerned with good policy than election outcomes (the public service, think-tanks, academics, and perhaps the media) have an important role to play in holding governments to account. Calling for political claims to be tested via randomised evaluations is one way in which this can be done.

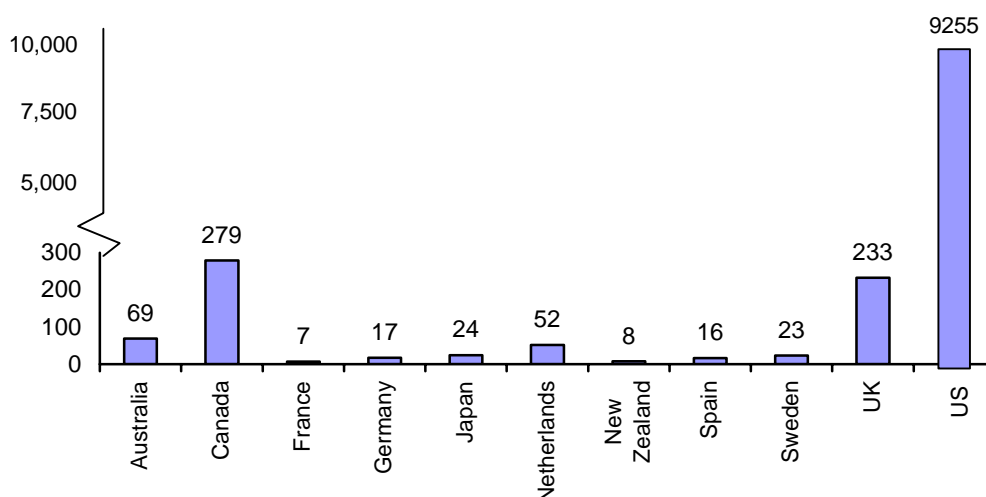
Objection 6: Only in America

While many of the examples in this paper are drawn from the US, it is not true to say that randomised trials are primarily confined to America. An international database of randomised trials in the social sciences (Campbell Collaboration, 2003), attempts to exhaustively catalogue all such trials. The database contains

more than 10,000 randomised policy experiments in the fields of social policy, psychology, education and criminology. Figure 1 shows the breakdown of these trials for selected countries. While the US clearly dominates, Canada and the UK have each carried out over 200 randomised policy trials. Sixty-nine Australian policy experiments appear in the Campbell Collaboration randomised trial database.

Further evidence of the international interest in policy trials is the international nature of the Campbell Collaboration itself. In February 2003, its conference in Stockholm, Sweden drew researchers from throughout Europe and the Americas. As will be discussed below, randomised trials of social programs may have had their genesis in the US, but today, policymakers and researchers in a variety of countries are looking at how they can be used to produce better policies.

Figure 1: Randomised Policy Trials by Country



Source: Campbell Collaboration (2003).

Note: Figures were obtained by searching all indexed and non-indexed fields of the C2-SPECTR database. To allow for variants on country names, the UK was searched as England or Great Britain or Scotland or Wales or United Kingdom or UK or U.K., while the US was searched as America or United States or U.S. or US.

The Evolution of Randomised Trials

In medicine, the theory underlying randomised trials has existed for at least three and a half centuries. Debus (1970:34) quotes John Baptista van Helmont, a physician writing in the mid-seventeenth century:

Oh ye Schooles ... Let us take out of the hospitals, out of the Camps, or from elsewhere, 200 or 500 poor People, that have Fevers, Pleurisies, etc. Let us divide them into halves, let us cast lots, that one halfe of them may fall to my share, and the other to yours; ... we shall see how many Funerals both of us shall have ... Here your business is decided.

Yet it was not until the late-nineteenth century that these ideas began to gain wider acceptance. Clinical psychologists began using randomised trials around 1850-1880, while Denmark tested a diphtheria serum in randomised trials in the late-nineteenth century. Following a formal demonstration of the statistical theory underlying randomisation (Fisher, 1935), the 1940s and 1950s saw a rapid growth in randomised trials for treatment of tuberculosis and poliomyelitis.

In social science, Lyndon Johnson's War on Poverty saw the evolution of randomised trials. During the late-1960s, the Head Start program, and the Ypsilanti pre-school program were among the first to be evaluated through randomised trials (Cicirelli and Associates, 1969). And commencing in 1968, the Mathematica Foundation conducted the 'New Jersey-Pennsylvania Income Maintenance Experiment' (Kershaw and Fair, 1976), a large-scale social experiment designed to test whether the payment of supplementary income to poor families acted as a work disincentive.

During the 1970s, randomised experiments began to flourish. A California jail used random assignment to test whether group counselling reduced recidivism (Ward and Kassebaum, 1972), while the Baltimore LIFE experiment (Rossi, Berk, and Lenihan, 1980) tested whether financial assistance to prisoners upon their release improved outcomes for former inmates. The Housing Allowance Design Experiment analysed the effect of various different types of rental subsidies on recipients' housing quality (Struyk and Bendick, 1981). The RAND Health Insurance Experiment analysed behavioural responses to a variety of different health care plans (Newhouse *et al*, 1981). And a randomised trial in Mexico tested whether watching Sesame Street on a daily basis improved educational outcomes (Diaz-Guerrero *et al*, 1976).

Boruch, De Moya and Snyder (2002), who analyse randomised trials across a number of spheres of social policy, including criminology, education, and welfare, concluded that the rapid growth in randomised experiments during the 1960s and 1970s may have been followed by a slight decline during the 1980s. Weiss (1998:13) speculates that this may have been due to a decline in federal funding after 1981, when Ronald Reagan took office, and notes that evaluation made a comeback under Bill Clinton's administration. In recent years, evaluation has also become substantially more popular at the state and local level (Weiss, 1998:14).² Yet randomised policy evaluations remain comparatively rare — for every

² There is one notable exception to this. During the 1980s and early-1990s, a number of states obtained waivers from the federal government to experiment with various alterations of their welfare programs. As a result of the 1996 welfare reform legislation, most of these waiver experiments were discontinued (Moffitt and Ver Ploeg, 2001:30).

randomised policy trial, 24 randomised medical trials take place (*The Economist*, 2002:74).

Policy Lessons From Randomised Trials

In the past two decades, randomised trials have become familiar to researchers in the US and elsewhere. But how have they contributed to our understanding of policy problems? Some of the most important randomised trials that have been conducted in recent years, and their implications for policy are now discussed.

Training for unemployed workers

The randomised evaluation of the Job Training Partnership Act (JTPA) by the US Department of Labor is one of the most important randomised trials to have been conducted in the job training sphere. One of the major challenges in evaluating job training programs is that such programs have a high attrition rate. This is equally true in Australia — a recent review of the Job Network found that its training programs had a 60 percent dropout rate (Productivity Commission, 2002:5.14, 5.17-5.18.). The dropout rate causes an ‘attrition bias’, since those who participate in job training are not a representative sample of the jobless. Participants are likely to be the most motivated of the unemployed, who would have been most likely to find a job even in the absence of the program. Comparing the outcomes for participants and non-participants is therefore likely to produce a biased estimate of the effect of job training.

By randomly assigning some participants to training and others to a control group, the JTPA evaluation found that job training for 16-22 year olds generally failed to boost participants’ earnings (Orr *et al*, 1996). In one sense, this was a dispiriting finding, but in another, it focused energies into more effective ways of improving the employment prospects of young adults.

By contrast, Australian politicians of all persuasions have shied away from serious trials of job training programs. No randomised trial was conducted on Labor’s Working Nation program, which cost over \$1 billion per year. Under the Coalition, the Department of Family and Community Services has recently conducted two randomised trials on the Job Network (Barrett and Cobb-Clark, 2001; Breunig *et al*, 2003), but both have focused on the effectiveness of intensive caseworker interviews. Job training programs in Australia are yet to be subjected to a randomised trial.

A likely explanation for the failure to properly analyse labour market policies in Australia is that the available evidence (from non-randomised evaluations) suggests the returns to job training programs are limited (Productivity Commission, 2002; Chapman, 1999). Politicians may be fearful that the results from a randomised trial will indicate that their policies are having limited results.

Education

By comparison with labour market and welfare, randomised trials in education have been relatively rare. Burtless (2002) speculates that this may be due to the fact that social scientists have never exercised significant influence over education policy evaluation, coupled with the fact that educators and parents wield substantial political influence, and are reluctant to surrender control over any aspect of teaching or curriculum.

Nonetheless, it is clear that more educational randomised trials have been carried out in the US than in any other country. The most prominent of these is Tennessee's Project Star, an experiment in which students were randomly assigned to classes of varying sizes (Krueger, 1999). Here, randomisation helped avoid the problem that students assigned to smaller classes are often different from those who are assigned to regular classes. Because schools frequently place talented or struggling students in smaller classes, a non-randomised comparison can give a false picture of the effect of class sizes on student performance.

Unfortunately, Tennessee's Project Star suffered from the fact that teachers had been told prior to the experiment that if students in the smaller classes outperformed those in the larger classes, class sizes would be reduced in all schools. This created a false incentive for small-class teachers to work harder than large-class teachers — what is known as a 'Hawthorne Effect' (Hanushek, 1998).³ While a randomised trial was a promising way of discovering the effect of smaller classes, the political context of Project Star undermined the reliability of its results.

Nonetheless, randomised trials have great potential to expand what we know about educational reforms. DARE, a school-based anti-drugs program, was revised in 2001 following randomised trials showing that the program did not deliver promised results (Boruch, De Moya and Snyder, 2002). Research on young driver education programs showed that rather than reducing road deaths, they actually increased the road toll — by encouraging high school students to drive at a younger age (Hatcher and Scarpa, 2001:55-56). In the debate over school vouchers, randomised trials have recently been implemented in Washington, DC, Dayton, OH and New York, NY. Their analysis and re-analysis has contributed substantially to policymakers' understanding of the effects of school choice on student performance (Peterson, Myers and Howell, 1998; Krueger and Zhu, 2003).

³ The Hawthorne effect was named after a 1927-32 study conducted at the Hawthorne Works of the Western Electric Company, aimed at determining the effect of lighting conditions on worker performance. After finding that both increased and decreased lighting caused an increase in productivity, the researchers concluded that it was the act of being observed which caused the change (Roethlisberger and Dickson, 1939). For more discussion of the Hawthorne effect, see Rossi and Freeman (1993:236-238).

Neighbourhood Effects

Another field in which a randomised experiment has contributed substantially to the understanding of a social policy issue is the debate over neighbourhood effects and locational disadvantage. In the 1990s, a US program, known as Moving to Opportunity (MTO), analysed the effect of providing housing vouchers to enable poor families to move from high-poverty to low-poverty neighbourhoods. While social scientists had long speculated that the physical and social environment had a significant impact on individual outcomes, little supportive evidence existed. In the words of MTO researcher Professor Jeffrey Liebman, the problem arose because 'it was difficult to find truly comparable individuals living in different neighbourhoods' (quoted in Leigh and Wolfers, 2001:32).

Moving to Opportunity was conducted in five cities — Baltimore, Boston, Chicago, Los Angeles and New York. A four-year follow-up found that those who won the MTO lottery and moved to a low-poverty area reported substantially lower levels of exposure to violence — while those families who stayed in poor neighbourhoods reported continuing high levels of fear. Moving had benefits in a range of other dimensions, too. Mothers who moved reported being healthier, feeling calmer and less prone to episodes of depression. For younger children, moving boosted test scores for both reading and mathematics. Among older children, moving reduced absenteeism, lowered school dropout rates, and — at least among boys — lessened behaviour problems. Child health also improved, with asthma attacks declining markedly. While researchers were unable to discern any statistically significant difference in employment or earnings between the two groups, movers were healthier, safer and had better outcomes for their children than non-movers (Katz, Kling and Liebman, 2003). And as mentioned above, qualitative research found that families who moved nominated crime as the biggest difference MTO made to their lives (Kling, Liebman and Katz, 2001).

Treatment of Drug Offenders

While the previous three topics have drawn almost exclusively upon US randomised experiments, the treatment of drug offenders is an area in which a randomised evaluation was recently carried out in Australia — evaluation of the NSW Drug Court.

The background to the NSW Drug Court evaluation was conducted in 1999-2000. During the previous decade, several US states and European countries had experimented with drug courts, but evidence from randomised trials on the effectiveness of these courts was severely limited. In addition, no randomised evidence existed on the cost-effectiveness of drug courts (Lind *et al*, 2002).

The NSW Drug Court trial consisted of non-violent offenders who met a series of criteria, including dependence on illicit drugs, and willingness to plead guilty. Participants were then randomly assigned either to the Drug Court, or to a regular court. Over the two years in which the trial was in operation, 514 people participated in the trial. Because the Drug Court was in a pilot phase, its

detoxification program had only limited capacity — making the exclusion of some applicants politically palatable and acceptable by policymakers and administrators.

The evaluation found that individuals processed through the Drug Court had significantly lower rates of recidivism for drug offences than those processed through the normal criminal justice system. While the cost of the Drug Court exceeded the cost of regular courts, the cost *per offence averted* was substantially lower under the Drug Court (Lind *et al*, 2002). Using best practice social science techniques, the Drug Court evaluation demonstrated that innovative criminal justice methods could actually turn out to be cost-effective.

Conclusion — Try it and See

What is the future for randomised trials in Australia? As demonstrated by the Drug Court example and the two trials conducted by the Department of Family and Community Services, the door to randomised evaluation is not entirely closed. But in comparison to the US, where rigorous policy evaluation has become a part of the political landscape, evaluation in Australia has a long way to go. Some small part of this might be due to our three-year election terms, but a more likely factor is that Australia has few evidence-based think-tanks and lacks America's culture of policy contestation. In its absence, there is a risk that cost-benefit calculus will be carried out with electoral maps, rather than by policy analysts.

For an ambitious government, there is little limit to the policy questions that might be answered in Australia through well-designed randomised trials. Criminologists know little about the effects of different forms of incarceration, and different in-jail programs, on rates of recidivism and subsequent employment patterns. In education, more evidence is needed on how teacher merit pay affects student performance and whether after-school programs improve educational attainment. In welfare, job training, tax credits, and early childhood intervention programs could all usefully be tested. And in industry assistance, new industry assistance or trade promotion programs could be tested via a small-scale randomised experiment to assess their impact on wages, employment and productivity. In each case, the cost of undertaking randomised pilot programs would be cheap — particularly when compared with the cost of policy mistakes.

In some of these cases, Australian policy researchers can simply free ride off research conducted in the US and elsewhere. But in other instances, Australia's unique institutions should make us question whether policies that are successful in America are likely to be effective on the other side of the Pacific. In education, Australia has an unusually high rate of enrolment in non-government schools by comparison with most other developed countries. In the labour market, we have higher rates of long-term unemployment and part-time work than many other nations. In welfare, our unemployment benefits differ from those of most other countries in not being time-limited. And for Australian firms, our economy is substantially more dependent upon international trade and investment than the US economy. Because of these factors and many more, Australian policymakers

should consider carrying out research themselves, rather than merely relying on overseas evidence.

At the turn of the twentieth century, Australia was known as ‘the social laboratory of the world’. The nation was known for its policy innovation — among the first to use the secret ballot, allow women to vote, provide workers with a minimum wage and unemployment benefits, and introduce an aged pension. Australian policymakers should summon up the vigour of their predecessors, and conduct randomised trials on a variety of current and proposed policies — providing evidence on what works, and what does not.

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REVIEWS

Achieving a More Egalitarian Australia

*Fred Argy, **Where to From Here? Australian Egalitarianism Under Threat**, Allen and Unwin, Sydney, 2003*

*Reviewed by **John Freebairn***

Fred Argy is concerned with what he sees as a threatening decline in egalitarianism in Australia over the last 25 years. In a highly readable and concise 200 pages he provides a survey of the facts on the current distribution of, and recent trends in the distribution of, opportunities and outcomes in Australia; an assessment of some of the economic, political and attitudinal changes driving the (mostly) Federal government redistributive policies; and a concluding chapter with his views on a minimalist policy strategy and a far-reaching social reform policy strategy, respectively, to retain and to improve egalitarianism in future Australia. Argy provides an excellent and a balanced synthesis of available material describing many different dimensions of distributional equity, and he offers a good tour of the main forces driving policy attitudes, objectives and the choice of policy instruments to affect redistribution. By contrast, his articulation and analysis of proposals to achieve greater egalitarianism is rudimentary and it raises more questions than answers to what is a highly challenging and complex set of issues.

Chapter 1 summarises the many academic studies and government reports, and for more recent information newspaper reports, on the distribution of economic opportunities and outcomes in Australia over the last 25 years. Not surprisingly, Argy reports some measures indicating greater equality and others indicating greater inequality. Overall, he concludes that the relative pattern of distributional equity has become more unequal.

On the positive or more egalitarian side of the ledger, he points to reduced discrimination against migrants and of discrimination by gender, age and sexual preference, the universality of Medicare, higher secondary school and tertiary education enrolments, employer contributed superannuation, the end of discrimination against Aborigines but still poor outcomes on all economic and social measures, more and better targeted family support, the Job Network, and better assistance in moving from welfare to work.

Examples of measures showing greater disparities in equity include less job opportunities, both high unemployment and the growing share of part-time and casual jobs with limited career prospects, greater dispersion of wages and work conditions, access to welfare now is more conditional and moralistic, the tax system has become less progressive in both design and in the greater availability of opportunities for tax avoidance to the better-off, greater regional disparities in

opportunities and outcomes, greater power imbalances in the workplace, and a fall of government expenditure on education as a share of GDP. While disposable incomes of the poor and those on middle incomes have increased and they have shared in the remarkable growth of Australian real incomes over the 1990s, those in the upper deciles of the distribution have increased their share of the economic pie. Also, Argy points out that Australia is a less egalitarian society when compared with countries in Continental Europe.

The various pictures of distributional equity provided by Argy are of the static, snapshot form. That is, cross-section data for a particular point in time is used. To a large extent limited data availability dictated this approach. It would be highly desirable to complement the static, snapshot pictures with panel data showing distributional outcomes over a life cycle, or at least over several years. A few studies in Australia and overseas find that many individuals and households with very low or very high outcomes in one particular period have a more average experience in other periods so that the extent of variation over a lifetime or several years is much less than is indicated by a static, snapshot picture. People experience temporary good and bad times, they have careers and they move through different family and household arrangements which affect measures of equity. Also of interest is whether economic and social mobility, so much a point of superior distributional equity in Australia relative to Europe in the first part of the twentieth century, has changed over recent decades.

I am in full agreement with Argy that high unemployment has been a major failure of the Australian economy of the 1990s and 2000s. This failure is particularly acute when one adds the hidden unemployed and the under employed, a group which in aggregate at least equal the six per cent plus of the workforce who are registered as unemployed. By contrast with recent times, in the 1950s and 1960s unemployment seldom exceeded two per cent of the workforce. Unemployment is a major cause of income inequality, low personal self-esteem and other measures of inequality. Society and political complacency with continued high unemployment, and a dearth of discussion of policy initiatives to increase employment, rightly is a major concern for all, as well as one highlighted in this book.

Arguably the rapid growth of part-time and casual employment from less than 10 per cent of the workforce in 1970 to nearly 30 per cent now is less a threat to egalitarianism than is the case painted by Argy. Many, but certainly not all, of those in part-time and casual employment self report that they are happy with and prefer these employment arrangements. To a large extent the rapid expansion of non-standard working arrangements has been a consequence of our demand, supported by higher incomes, for all types of services to be available 24 hours a day, seven days a week, versus the olden days with a less consumer friendly 9 to 5, 5 days a week service.

Chapter 2 is about the trade-off between equity and efficiency. Argy clearly and repeatedly, in Chapter 6 for example, argues in favour of economic growth to increase the aggregate size of the economic pie available for redistribution. Further, he recognises the necessity of dismantling of the Australian Settlement

policies and the benefits of microeconomic reform of the last 25 years in raising productivity and promoting growth. He is explicit about the need for further productivity growth and structural change for the future. Argy points to some instances of complementarities between equity and efficiency, for example, the importance of a safety net for effective operation of the labour market and for risk taking, investments in education, and social stability providing a more conducive environment for productive investment and work effort.

But in other dimensions there is a trade-off between equity and efficiency, and here Argy considers disincentives and distortions caused by taxation to fund greater government outlays on programs to achieve equity, and the crowding-out effects of budget deficits to fund public investment. Focussing primarily on taxation distortions to labour supply decisions, Argy asserts that the equity/efficiency trade-off with Australia's relatively low (statutory but not effective) tax rates is low, and much lower than those in Continental Europe where the sky has not fallen in because of higher tax rates.

In my view Argy has drawn an optimistic scenario on the low efficiency losses of further government outlays to achieve greater distributional equity. As noted in some detail in chapter 3, there are high effective marginal tax rates arising from interaction of the taxation system, and here not only income tax but also the expenditure taxes, including GST, excise taxes and the State taxes which reduce real spending-power, and withdrawal of means tested social security pensions and benefits. Effective marginal tax rates often are of more concern than the top statutory income tax rate of 48.5 per cent. Some 15 per cent of couples with children and 23 per cent of sole parents face effective marginal tax rates of over 60 per cent, and these households generally have higher labour supply elasticities than do high income earners.

Here there are policy challenges to rationalise the complex social security system with its stacking of withdrawal rates of different support measures, and then to better integrate the income tax system for individuals with the social security system which means tests on family income and assets. Argy ignores also the distortions and efficiency costs associated with Australia's hybrid or mongrel tax system which places very different tax rates on different investment and savings choice options and on different forms of business organisation and financing.

A part of Argy's agenda for greater equity involves more public expenditure on education, health and housing. Since most of these products have private-good properties and are provided by governments for free or well below cost, it is almost certain that consumption efficiency losses will be involved. These examples are not to say that Argy is incorrect in claiming that the efficiency costs of larger governments are acceptable, but that he underestimates these costs, and, importantly, there are more areas of the reform agenda to follow.

Using the results of attitudinal surveys, in Chapters 4 and 6 Argy argues that while there is a high level of cynicism in the broader community, and in the policy making precincts, about the motives and effectiveness of government intervention

in the economy, there remains a strong body of support for intervention to achieve distributional equity, especially of equality of opportunity.

In chapter 5 it is asserted, rather than rigorously argued, that globalisation does not unduly restrict the use of government policies to redistribute for equity goals.

Argy then chances his arm in Chapter 7 with proposals to achieve a more egalitarian Australia in the future. His preferred far-reaching social reform agenda would include; further poverty relief for the most disadvantaged, including indigenous people; special taxation assistance for the working poor, for example a variant of the US earned income tax credit; labour market programs for the long term unemployed; more equal access to school education and to health care; direct assistance to low income families to build their wealth; and regional policies.

The required extra funding he suggests in part could come from broadening tax bases and removing concessions favouring the better-off, from reviewing the efficacy of existing programs and by allowing governments to run short and medium run deficits for public investment expenditure so long as they pass a formal benefit cost assessment. Unfortunately it has to be said that some of these policy proposals have been tried before with very limited success, including labour market programs and selective regional assistance policies. The overall effectiveness of other parts of the package, such as the earned income tax credit, is controversial, and other parts of the package, and in particular the low income wealth scheme, are largely untried. In my view, this chapter is too short on supporting analysis and detailed evidence to convince other than the already converted.

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Australia's Involvement with Asia

David Goldsworthy and Peter Edwards (eds), Facing North: A Century of Australian Engagement with Asia, Volume 2: 1970s to 2000, Department of Foreign Affairs and Trade, Melbourne University Press, 2003

Reviewed by Rawdon Dalrymple

This very useful book is a remarkable achievement. The Preface describes the complex bureaucratic and scholarly machinery involved in its creation. That this all succeeded in creating a finished product of such a standard is a compliment to those principally involved, and especially, one assumes, the two editors Peter Edwards and David Goldsworthy. The main text of the book—the Introduction, eight chapters and Conclusion — is 330 pages, which is not a lot to cover Australia's involvement with Asia from the 1970s to 2000. It would have been essential to choose chapter themes that dealt with as much of the main ground as possible in the available space and to have those themes relate to one another in a coherent way without duplication or puzzling gaps. On the whole the chapters work well in this sense. For one who was involved through the period in the issues discussed there seems a good balance, even if in some places (Chapter 4 'Regional Relations') it has obviously been very hard to cover the necessary ground even at a gallop, while in others (Chapter 7 'Social and Cultural Engagement') the scenery is surveyed in a relatively detailed way.

Goldsworthy's Introduction sets the scene for the book by sketching in some of the relevant history. He notes that already in the 1930s 'the case for more substantial engagement with the region was being pressed by... people such as Latham, Eggleston and Ian Clunies-Ross who were few in number but politically influential'. (Yet that period and the Pacific War were in fact rather inglorious chapters in the history of Australia's regional involvement.) Goldsworthy looks at the factors which induced the later post-war intensification of Australian engagement with the region, and concludes (on solid grounds) that the principal driver was economic opportunity. Indeed, in the 1970s, after the British entry into the European Community, it was economic necessity.

The first chapter takes up that theme under the heading 'Regional Economic Co-Operation'. In it Roderic Pitty has done an excellent job of telling clearly and concisely the complex story of the development of Australia's regional economic co-operation policy from the Crawford – Okita relationship and related Australian National University initiatives, the first Pacific Economic Co-operation Council meeting in Canberra in 1981, and the continuation of that attempt to lay the basis for structured and institutionalized economic cooperation with the region. But not just with the East Asian region. The United States was also involved, which was immediately a cause for some ASEAN uneasiness, and was in due course a sleeper issue for Australia that is still unresolved. Pitty deals well with the APEC story.

At the end of the chapter he refers, as most commentators have, to Australia having been alone with Japan 'in sponsoring all three of the IMF packages, for Thailand, Indonesia and South Korea'. This has become an Australian mantra that, while literally correct, is rather misleading. There was a standby commitment of \$1 billion in each case, but none of this has been drawn on, to my knowledge; that is to say, Australia did not in the end provide any funds at all. The Japanese commitment was, I think, \$40 billion, and Japan actually delivered substantial assistance outside the IMF rescue packages.

The second chapter, 'Strategic Engagement', was also produced by Pitty. He takes the reader through the new thinking set out in the Dibb Report and the point-counterpoint of Defence (Kim Beazley) and Foreign Affairs (Gareth Evans) reviews and statements on strategic policy. The latter was especially concerned with consultation and the promotion in the region of schemes for cooperation and institutionalization. It records that my old friend, the late Raul Manglapus, then the Philippines Foreign Secretary, 'commended the Australian sensitivity to ASEAN's concerns' at the ASEAN Post Ministerial Conference in Jakarta in 1990, when Gareth Evans was promoting the idea of a Conference on Security and Co-operation in Asia (CSCA). This was a testing initiative because of reservations by other ASEAN nations. At the same time Evans 'sought to allay American concern that his discussion of new ideas on security issues would involve anything inimical to US interests'. In this he was not successful, as Pitty's account of the subsequent correspondence with Secretary of State Baker shows. There were also reservations on the part of the main academic experts in Canberra, Paul Dibb and Des Ball. In the end the Prime Minister found a formula that 'closed the gap that had appeared between American and Australian policies, thus enabling Evans to advance regional security dialogue with ASEAN'. The chapter goes on to deal with bilateral military cooperation leading to what at the time seemed (including to this observer) a striking achievement of Australian defence diplomacy: the Agreement on Maintaining Security with Indonesia. It concludes with success of a very different kind: the INTERFET intervention in East Timor.

A reading of these two first chapters, especially the second, reinforces one's recollection of this period, especially the years between the late 1980s and 1996, as a period of quite extraordinary activity by Australia in its relations with East Asia, from China to Indonesia. The Garnaut Report in 1989 was a landmark, and much flowed from it and other reports initiated by the Hawke Government. The pace quickened after Gareth Evans became Foreign Minister, and indeed became at times almost frenetic, especially during the Keating years. In retrospect it was not surprising that there was a reaction after the Coalition took office in 1996. It was not much in evidence at first, but the East Asian financial crisis in 1997/8 and the collapse of the Soeharto regime, followed by the East Timor crisis, took the shine off the region for much of Australian opinion, and the government shifted ground accordingly.

The 'Regional Relations' chapter covers some of what I see as the durable underpinning of Australian policy in the region into the future, and it is done well. But the format of just a few pages on each country means that it does not provide

the satisfying exploration of decisions and negotiations, based on original documents, that is provided by the two chapters just discussed. The chapter on Indochina allows its authors a bit more space per country than the 'Regional Relations' chapter, although barely sufficient. There is enough here, however, to convey a sense, or a reminder, of what a large role Indochina played in Australia's relations with Asia over the period under review. It included Australia's most intensive ever diplomatic campaign (on Cambodia), in a role that probably only two or three countries could have played. It was worth the effort, although its longer term success was less than had been hoped. Goldsworthy's East Timor chapter is a judicious and expert treatment of a watershed in Australia's foreign policy, and I wish I had space to discuss it here. But he ends with what seems an odd observation:

One last point is worth emphasizing. For all the difficulties, reversals and costs incurred, Australia's participation in the East Timorese transition laid a foundation for a defence and development relationship with East Timor which is bound to continue for a long time to come.

There is no arguing with that, but what is the implication? Some would say it means ongoing large costs, and few benefits, for Australia.

The book has two chapters on the domestic Australian end of the relationship: 'Social and Cultural Engagement' and 'Immigration and Multiculturalism'. The former covers a large canvas and will be a useful chronicle of developments in business, education and tourism contacts, and on relevant exhibitions, tours and so on in various areas of the arts. It mentions with approval *Celebrate Australia*, a large scale pioneering festival mounted in Tokyo at the end of 1993, and that was the forerunner of similar events in other countries in the region. The prime planner and executor of this was Gregson Edwards in the Australian Embassy in Tokyo (who is not mentioned). Reading these two chapters in 2003 one is left with two thoughts: Yes, no doubt there was some excess of enthusiasm of engagement at times. But surely we have retreated much too far from that enthusiasm for our own long term good.

In his thorough and interesting chapter on 'Human Rights Diplomacy, David Dutton deals with the complex and difficult issue of consistency, without concluding (as most practitioners would) that it is just not possible for a country situated as is Australia to apply human rights tests consistently to all other countries, whether they are large or small, remote or very near. He concludes that 'at the end of the century issues of human rights remained vital to Australia's engagement with Asia'. Certainly some community opinion would regard them as 'vital', but that does not appear to be the view of the government or of most of the electorate. Dutton notes that

Whereas previous governments had emphasized the ways in which Australia needed to change in order to engage successfully with Asia ... the Howard government exhibited a determination to engage Asia on

Australia's own terms without sacrificing Australia's values, traditions or heritage.

That brings us to Peter Edwards' concluding 'thoughts about the future' in which he argues that Australians will prefer to think of their region in terms of 'the Asia-Pacific' rather than 'Asia' because the former would include the United States and the South Pacific. He thinks that tensions between Australia's links with Asia and its many links with other parts of the world could be resolved if we 'posit Australia as a sub-region of its own, within the greater Asia-Pacific region'. That may well be an accurate estimation of current mainstream Australian opinion, but there are few signs that 'the Asia-Pacific' has much resonance anywhere but in Australia. Is it plausible to think of Australia as a 'sub-region' of its own, going on through the twenty-first century with a population of a bit over twenty million in this part of the world? There is no need for Australia to seek engagement with its near region that would exclude its links with others further afield. The present members of ASEAN + 3 (China, Japan and Korea) are not so constrained. But for all their differences they do have a nascent sense of community. Australia could hardly do less than it now does to seek to share in that. Perhaps it will never want to do so. But it might be pretty lonely protesting that there should be a community of the Asia-Pacific, whatever that is.

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Evaluating Megaprojects

*Bent Flyvbjerg, Nils Bruzelius and Werner Rothengatter, **Megaprojects and Risk: An Anatomy of Ambition**, Cambridge University Press, Cambridge, 2003*

*Reviewed by **John Quiggin***

It is a commonplace of Australian political debate that a project like the Snowy Mountains Scheme could not be undertaken today. This is largely because of the prevalence of the kinds of criticisms raised in books like *Megaprojects and Risk*.

As the authors observe, megaprojects, despite their actual and symbolic importance, 'have strikingly poor performance records in terms of economy, environment and public support' (p. 3). This observation is backed up by empirical evidence showing that the studies used to justify transport megaprojects typically underestimate costs and overestimate benefits, sometimes by orders of magnitude.

The central task the authors set themselves is to investigate the processes behind the approval and implementation of megaprojects. The primary focus is on transport projects such as international transport links and urban passenger rail networks. Three case studies are offered: the Channel Tunnel; the Great Belt link between East Denmark and Continental Europe and the Øresund link between Sweden and Denmark.

The central thesis of the book may be summarised as follows: The typical ex ante evaluation of a large transport project is based on what the World Bank calls EGAP (Everything Going According to Plan). In practice, of course, things do not go according to plan. Occasionally, things go better than expected, as in the case of the Øresund road bridge, which experienced substantially more traffic than was expected. But, more often than not, things go worse than expected. Hence, the EGAP evaluation yields estimated benefit-cost ratios that are biased upwards.

The extent of this bias is startling. The authors find that real cost overruns of between 50 and 100 per cent are common, and overruns above 100 per cent are not uncommon, while demand is typically overestimated, with typical overestimates between 20 and 70 per cent.

The tendency to overestimation is particularly severe in the case of urban rail projects. The average cost overrun for urban rail projects studied by the authors was 45 per cent, with 25 per cent experiencing overruns of more than 60 per cent. Meanwhile, the average ridership was half that estimated in ex ante evaluations, and 25 per cent of projects realised less than 30 per cent of the estimated ridership. Thus, the typical benefit-cost ratio actually realised was about one-quarter of the estimated value, with many projects performing even worse than this.

The core of the book is devoted to illustrating the central problem of over-optimism in *ex ante* evaluations, and discussing the characteristics of the policy process that generate systematic bias on the part of project proponents. The authors make a range of useful suggestions

In addition to the core point regarding overestimation of benefits, the book offers useful discussion of environmental aspects of the megaproject process, and of the costs and benefits of private provision of infrastructure.

As regards environmental issues, little has changed since the introduction of environmental impact assessments in the 1970s. Typically, these occur in the middle of the process, after the design phase, and before construction begins. The authors argue for more consistent attention to environmental issues beginning in the design phase and ending with *ex post* assessments of actual, as compared to predicted, environmental impacts.

Privatisation is an issue that will be of particular interest to Australian readers. In the 1980s, the poor performance of infrastructure projects was commonly attributed to public ownership and the associated potential for political concerns to override economics. Privatisation was commonly presented as a panacea. As the authors observe, however, private provision of infrastructure solves some problems and creates others. Moreover, the complexity of the issues raised by transport megaprojects, including environmental concerns, planning implications and international negotiations is such that the idea of getting politics out of the process is chimerical.

Their conclusion (p. 104) is so carefully balanced as to give no comfort to either side of the debate. 'Whilst far from offering a panacea to the risk and accountability problems for megaprojects, given an appropriate and properly implemented institutional framework, private involvement may be helpful'.

This conclusion is reinforced by the equivocal example of the Channel Tunnel, one of the three main case studies. This was a BOOT (Build, Own, Operate and Transfer) project, with a lease initially set at 35 years. Cost overruns and demand shortfalls substantially reduced the viability of the project. While much of the risk was borne by private investors, the project was salvaged only because the British and French governments agreed to a longer and more favourable lease. Unless governments are prepared to allow projects to fail outright, privatisation leaves them in the position of guarantors, bearing substantial risk for no returns. More generally, the willingness of governments to let a project fail, an enterprise close down, or a service be withdrawn is a good test for the viability of privatisation.

The book suffers from one important analytical weakness. As is common in discussion of benefit-cost analysis, the term 'risk' is used in an ambiguous fashion. Most of the time, 'risk' is used in its ordinary-language meaning, to refer to the possibility of an adverse outcome (this is sometimes called 'downside risk'). On other occasions, however, the authors implicitly refer to the concept of 'pure risk', that is, uncertainty that may produce either favourable or unfavourable outcomes relative to some given mean or other measure of central tendency. In economic analysis, the term 'risk' is normally used to refer to 'pure' risk.

The failure to distinguish between 'downside' and 'pure' risk leads the authors into serious analytical errors. They assert that governments should employ market discount rates, on the assumption that the risk premium for equity reflects the expected loss associated with downside risk. In fact, the risk premium implies a market price for 'pure' systematic risk far higher than that implied by standard consumption-based versions of the capital asset pricing model. If as seems likely, this excess risk premium arises from capital market failure, there is no reason to include it in the discount rate for public projects (Grant and Quiggin, 2003). Although a case can be made for the use of the private market risk premium, the authors do not make it.

A couple of more minor criticisms may be made: The book opens with the claim that the 'megaproject' phenomenon it addresses is a new one. On the contrary, the history of public and private megaprojects stretches back to the pyramids of Egypt, and there is no good reason to believe that megaprojects are more important today than in the past.

To take a more homely example, the authors mention among a list of worldwide megaprojects, the Sydney Harbour Tunnel, which was completed in 1992 at a cost of a little under \$800 million or 0.2 per cent of GDP. Sixty years earlier, the Sydney Harbour Bridge cost 6.25 million pounds or about 1 per cent of GDP (based on the estimates of Clark and Crawford, 1938).

Also, although the authors (p. 2) correctly observe that the Internet is 'the ultimate megaproject' their attention is confined to transport infrastructure. This is understandable, given the authors' background and the difficulties raised by an assessment of the recent economic bubble. However, consideration of the Internet and telecommunications bubble would have reinforced the authors' doubts about the likelihood that private provision of infrastructure would reduce the likelihood of megaproject disaster.

The total amount invested in Internet and telecommunications megaprojects, mainly undertaken by private enterprises, during the bubble of the late 1990s was of the order of \$1 trillion. Except for the portion paid to European governments for telecommunications spectrum this money was almost entirely wasted. Over 90 per cent of the optical fibre cable laid during the bubble has never been used. Most investments in 'dotcom' businesses were lost; in many cases there was barely enough left to pay the liquidators. Even for enterprises such as Yahoo and Amazon that have survived and reported intermittent profits, the rate of return on invested capital has been low.

Despite these limitations, this book is a valuable contribution to the debate on infrastructure investment and on public policy formulation in general. The suggestions for a more transparent and forward-looking policy process are well thought-out and well-argued. If adopted such proposals would greatly improve the process of project selection and evaluation.

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Can't buy me love — Public Policy Implications of Cattanach v. Melchior

Natasha Cica

The question of whether compensation could be awarded for raising a healthy child born as the result of a doctor's negligence was recently examined by the High Court of Australia in *Cattanach v. Melchior* (2003) (hereafter 'Melchior'). the case involved litigation brought by Kerry and Craig Melchior, a married Brisbane couple, against an obstetrician and gynaecologist, Dr Stephen Cattanach. In 1992 he had performed a tubal ligation on Kerry Melchior. She sought the procedure because, having given birth to two healthy daughters, she and her husband had decided they did not want more children. Four years after the sterilisation procedure, at age 44, Kerry Melchior became pregnant. This happened because both she and her doctor mistakenly believed she only had one fallopian tube, and he had only clipped that tube in the operation. Kerry Melchior carried the pregnancy to term and in 1997 gave birth to a healthy son, Jordan.

Kerry and Craig Melchior initiated legal proceedings in both tort and contract in respect of the failed sterilisation, against Stephen Cattanach and the State of Queensland, as the authority responsible for the public hospital where the procedure was performed. The action in contract was not pursued, but the trial judge agreed the doctor had been negligent in respect of his provision of advice about the risks of further conception. She awarded around \$103 000 damages to Kerry Melchior in relation to the pregnancy and birth, \$3 000 to her husband for 'loss of consortium' associated with the pregnancy and birth, and around \$105 000 damages to both plaintiffs for the cost of raising Jordan to age 18. The defendants appealed unsuccessfully against the last component only of this damages award — compensation for the cost of bringing up the child — to the Queensland Court of Appeal, and then to the High Court. By a majority of four (Justices McHugh, Gummow, Kirby and Callinan) to three (Chief Justice Gleeson and Justices Hayne and Heydon), in July 2003 the High Court upheld the original award of damages.

Before the High Court's decision Australian legal authority on whether damages could be awarded in these circumstances was limited and inconclusive. Two Queensland cases had allowed recovery for the cost of raising a healthy child born as a result of medical negligence — *Dahl v. Purnell* (1992) and *Veivers v. Connolly* (1995). The NSW Court of Appeal subsequently addressed the question in *CES v. Superclinics* (1995), denying recovery by a 2:1 majority. The High Court of Australia granted special leave to appeal against this last decision, in *Nafte v. CES* (1996), but did not ever hear the case as the parties settled out of

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court. The confused state of Australian law before Melchior reflected divergent legal and philosophical analyses of this question delivered by judges in both common law and civil law settings overseas (see Kirby J, 2003:paras 119-132; Weir, 2002).

Objections to the result in Melchior relied on three main claims. First, the claim that the case would open (or widen) the floodgates on successful litigation against doctors, placing them under increased and unacceptable economic strain, and affecting their ability to deliver professional services to the community. Second, the claim that the result in Melchior was the product of inappropriate judicial activism. Third, the claim that awarding damages for the cost of raising Jordan Melchior was a step onto the slippery slope of commodifying and devaluing children. This paper challenges these claims, and suggests some different questions that should be posed to facilitate more constructive public policy debate.

The Escalating ‘Medical Indemnity Crisis’

The Australian Medical Association (AMA), the most politically influential doctors’ organisation in Australia, was a leading and vocal critic of the result in Melchior (Molloy, 2003; Haikerwal, 2003a and 2003b). Its objections were expressed against the backdrop of considerable public concern about Australia’s so-called ‘medical indemnity crisis’ (Dudley, 2002; Jamieson, 1999; Cashman, 2002), specifically about medical negligence litigation inhibiting doctors’ ability to provide, and consumers’ ability to access, the full range of medical services. All this occurred in the context of widespread community anxiety about the socio-economic impact of soaring public liability insurance premiums in Australia in recent years, widely (but not universally) perceived as caused by a rising incidence of large damages payouts for personal injuries in successful negligence claims (see generally Kehl, 2002; Senate Economics Reference Committee, 2002; Davis, 2002; Graycar, 2002; Coonan, 2002b; Luntz, 2002; Vines, 2002; Callinan, 2002).

Questions related to public and professional liability began receiving especially intense attention in Australia at the beginning of last year, in the economic wake of the collapse of HIH Insurance and the 9/11 terrorist attacks in 2001, and pursuant to the provisional liquidation of leading Australian medical defence organisation United Medical Protection in early 2002 (see Dudley, 2002). Media reporting of these matters was frequently sensationalist, and arguably skewed public understanding of relevant legal principles and their public policy implications. Criticising this phenomenon, Justice Atkinson of the Supreme Court of Queensland stated ‘we cannot conclude that litigiousness is on the rise ... by reference to isolated cases, or worse still, by reference to imaginary cases as they are portrayed in *Ally McBeal*, or the ABC’s latest legal drama *MDA*’ (Atkinson, 2003:3; see also Callinan, 2002:860-2; Cashman, 2002:893-4). By contrast, other Australian judges have accepted that our society has become aggressively and unacceptably litigious (see views cited in Spigelman, 2002:436-7).

The Federal Government instituted a process of inquiry and reform in response to this public concern. In May 2002 the Commonwealth appointed an expert panel, chaired by Justice David Ipp, to examine the law of negligence (Coonan, 2002a). The Ipp Inquiry was directed to devise 'a method for the reform of the common law with the objective of limiting liability and quantum of damages arising from personal injury and death' (Ipp, 2002:ix). The Ipp panel reported in August and September 2002. It recommended far-reaching national reforms to the law of negligence in Australia, including as it specifically applies to the liability of medical practitioners. The Ipp recommendations aimed to reduce both the quantum of damages payouts and the frequency of successful negligence claims, regardless of whether the claim is brought under tort, contract or on a statutory basis (Ipp, 2002:1-4). This package of recommendations differed in important respects from those suggested by the Australian Health Ministers Advisory Council (AHMAC) Legal Process Reform Group, in its own report released in September 2002 (AHMAC, 2002; AMA, 2002; LCA, 2002a). All Australian governments chose the Ipp model as their template for reforming negligence law. By mid-2003, each State and Territory government had either introduced or foreshadowed legislation giving broad effect to the Ipp reforms, with complementary legislative moves at Federal level.

In opposing the Melchior result, the AMA asserted it would serve to undermine the mooted benefits of the Ipp reforms. AMA spokesmen variously stated that 'medical practitioners [are left] even more exposed in the current medical indemnity crisis ... the court's decision means there are now even more opportunities to grant compensation ... [which] will drive up medical indemnity costs and the cost of patient care' (AMA, 2003), '[t]he potential explosion in costs is awesome' (Molloy, 2003) and '[t]his will have a major impact on awards even beyond sterilisation failure' (Molloy, 2003). In relation to this last concern, the AMA raised the spectre of general practitioners being pressured by rising insurance premiums and fear of litigation to limit their delivery of contraceptive advice and other family planning services (Molloy, 2003; Haikerwal, 2003a). While doctors' subjective anxiety in connection with Melchior clearly is very real, it is not clear that this anxiety is objectively justified.

First, the fact situation in Melchior was highly unusual — certainly the failure rate of both sterilisation and contraception procedures is not insignificant, but the percentage of such cases where a doctor has been negligent in legal terms is very small, and even smaller is the number of cases where successful litigation ensues. Dr Paul Nisselle (Nisselle, 2003), the CEO of the Medical Indemnity Protection Society, observed that in most legal claims where medical negligence leads to an unwanted pregnancy,

... the same motivation which led the patient to seek sterilisation or contraception leads to a decision to terminate the pregnancy ... [hence] compensation is limited to the costs of the termination, some loss of wages and a relatively small general damages claim. Further, many people in the position of the Melchiors do not seek compensation.

Having decided against terminating the pregnancy, having decided against putting the child up for adoption, many people get over the shock of the unwanted pregnancy and decide to enjoy the unexpected joy of the child without seeking compensation.

Kerry and Craig Melchior, of course, did seek compensation. The facts of the case suggest their claim was driven by genuine financial need rather than greed, as indeed does the relatively — some would say remarkably — modest amount of their claim for the costs of raising their unplanned son. Indeed, the modesty of this claim was remarked on by a number of judges in Melchior. The Melchiors claimed just over \$105 000 to cover the financial costs associated with rearing Jordan, from birth to age 18. This amount excluded compensation for a range of costs that might be claimed by more socially and economically aspirational parents. The Melchior ruling thereby raises the theoretical prospect of ‘middle class welfare’ par excellence — namely, the possibility of much larger compensation claims by parents who, for example, envisage their dependant child attending costly private schools, being taken on frequent overseas holidays, receiving ‘expensive clothes, toys, pastimes, presents and parties’ (Heydon J, 2003:para 306), necessitating extending the family home and upgrading the family car, and receiving tertiary education within Australia or abroad (even, perhaps, at blue-chip universities like Princeton or Cambridge). It is far from evident, however, that ambit claims of this kind will arise in practice with any real frequency, and even less clear that courts — responsibly alert to ‘exaggeration’ and ‘excess’ (Kirby J, 2003:para 180) — would award the full amounts sought.

Second, even if Melchior had been decided differently, there remains doubt that the Ipp reforms will achieve the result desired by the medical profession: namely, to stop medical indemnity costs rising. Arguably these important reforms were explored and implemented too hastily. The Ipp Inquiry’s terms of reference were announced in July 2002 and its final report was delivered less than three months later. The national peak representative body of the Australian legal profession, the Law Council of Australia (LCA), expressed strong reservations about the short time-frame of the Ipp Inquiry, having earlier advocated referring these questions to a Law Reform Commission (LCA, 2002b; LCA, 2002c:iv; see similarly Spigelman, 2002:451). Arguably, the post-Ipp legal regimes may actually invite litigation, as parties seek court interpretation of loosely drafted statutory tests and definitions (Atkinson, 2003:10-11; Crossland, 2002a; Luntz, 2002:841). Arguably, too, it is not certain that tort reform alone will reduce premium levels. The Law Council of Australia has consistently disputed the direct relationship between tort reform and premium rates, attributing the cause of rising premiums to insurance market factors including ‘loss of capacity by international re-insurers and insurers following September 11, the collapse of HIH Insurance, the substantial fall in the value of worldwide equities markets, and new prudential standards imposed by the Australian Prudential Regulation Authority’ (LCA, 2002d). Writing in the aftermath of Melchior, Nisselle (2003) stated:

I think the judgment will not substantially increase medical indemnity costs. Further, it may blunt, a little, the effect of the various reforms we've seen around the country, but it will not undo it. That's because I think the latter, whilst clearly desirable, were never going to produce substantial falls in medical indemnity costs ...

The various tort law changes and compensation reforms implemented over the last year or so will be likely to flatten the gradient of growth in the number of claims and the average cost of claims. However, we know that only a very small percentage of people who could sue successfully actually choose to. In an increasingly consumerist environment, it is likely that percentage, and hence total claims numbers, will rise faster than tort law reforms will reduce the average cost of a medical claim. In the US, insurers very carefully say that the tort law reform they suggest will lead to premiums 15 per cent lower than they would be without the reforms — that is, they don't say the premiums will fall.

Third, the AMA has seemed mainly worried by the reminder in Melchior that doctors, through their insurers, will be liable for the foreseeable consequences of providing substandard medical care. Instead, presumably, it would prefer the resulting costs to be directly met by patients themselves, or by the broader community through some operation of the welfare state. The welfare state might supply assistance through social security payments or a 'no-fault' accident compensation scheme. A scheme of this kind has operated in New Zealand since 1972 (see Todd, 2002). The Whitlam Labor Government attempted to introduce a similar scheme in Australia, but the *National Rehabilitation and Compensation Bill 1975 (Cth)* fell victim to the Dismissal. During the 2002 public liability debate, proposals of this kind were advocated by a number of Federal politicians (see Koutsoukis, 2002, citing Hockey; Kerr, 2002). No-fault compensation was strongly advocated by commentators who considered that the tort reform debate had become pincerred between the intransigent vested interests of two opposing lobby groups — lawyers on the one hand, and insurers on the other (see Crossland, 2002b; Luntz, 2002). No-fault compensation is not without its critics, however, who have argued that by comparison with the operation of the common law of negligence, schemes of this kind deliver insufficient compensation to people injured by negligent behaviour, remove the incentive for responsible risk-management, and are not necessarily less costly to the wider public (LCA, 2002c:13-14 and generally Chapter 3). This recites the three key public policy functions of tort law: namely, providing fair and just compensation to victims of negligence; creating incentives for safe behaviour and risk management by potential tortfeasors, which reduces the overall cost to society from negligently inflicted harm; and justly placing responsibility for repairing any such harm upon the actual and potential wrongdoers, rather than placing the burden on individual victims or the wider society. The first and third of these functions are often

described as ‘corrective justice’ while the second is often characterised as the ‘deterrent’ or ‘normative’ function of tort law (see LCA, 2002e:7 and 9; Finnis, 1980:166 and 178; Cane, 2001).

In advocating measured (legislative) reform of tort law, the Chief Justice of New South Wales has argued that the law of negligence is in many respects — now it seems improperly, and certainly unfashionably — the ‘last outpost’ of the welfare state (Spigelman, 2002:434):

The traditional function of the law of negligence ... appears to have reached definite limits as to what society is prepared to bear ... For those of us who came to maturity during the years of the welfare state, the relevant ‘progressive’ project for the law was to expand the circumstances in which persons had a right to sue. We were brought up on ‘Australia Unlimited’ supplements in the quality newspapers. We are now more conscious of limits — social, economic, ecological and those of human nature. Hobbes has triumphed over Rousseau. For several decades now, the economic limits on the scope of government intervention have received primacy in more and more areas of social discourse. The law cannot be insulated from such broad trends in social philosophy.

This comment arguably obscures the important fact that the choice between a ‘welfare’ model and a ‘corrective justice/individual responsibility’ model for compensating injured people is not as stark as it is often portrayed. Arguably, the Australian system to date, despite its perceived flaws, overall has steered a middle course between these two extremes. It has done this by denying doctors immunity from the legal consequences of substandard service provision, but at the same time allowing them to relieve themselves from personally paying the full cost of their tortious conduct by partly sharing that cost with the wider community (for example, by allowing doctors’ insurance premiums to be claimed as a tax deduction, or through doctors passing part of the cost of the premiums they pay to their patients through fees). Chief Justice Spigelman’s comments nonetheless reveal the essentially political nature of disagreements surrounding the best policy approach to meeting the economic costs arising from negligent behaviour. In the *Melchior* case, the result and reasoning of the majority judges came down firmly on the side of maintaining the status quo, in respect of their accepting the core function of the law of negligence as the delivery of ‘corrective justice’ (see, for example, Callinan J, 2003:301). All this points to a largely overlooked public policy question underscoring the *Melchior* case: what role should the judiciary play in resolving this kind of political and policy disagreement?

Judicial Activism

Judicial rulings are frequently criticised, characterised and caricatured as examples of so-called ‘judicial activism’. This label generally is attached where the

commentator is of the view that the (appointed) judge has inappropriately 'stretched' legal principle to give effect to a policy result that properly should be determined by the (elected) legislature. The charge is often accompanied by an assertion that the judge's so-called activism has produced a legal result that reflects the judge's own personal or political views. These accusations frequently arise where the personal or political perspective of the commentator as to the desirable policy result differs from the perspective imputed to the judge.

The rulings of the majority judges in *Melchior* attracted such criticism from at least one commentator (Albrechtsen, 2003) who objected to the awarding of damages in this case, notwithstanding these judges' explicit statements that they considered they were applying well-established legal principles to resolve the factually novel problem before them. Others who objected to the result, however, accused the same judges of engaging in inappropriate 'legalism' (Shanahan, 2003) or 'literalism' (Nisselle, 2003). Shanahan called instead for an approach that can only be described as judicial activism:

It is a pity, and an appalling reflection on Australian values, that the judges of the High Court have apparently put the law of damages ... above [the principle that a child should never be seen as a 'damage']. The law is built on ethical and moral values, and the judges must acknowledge that.

This fundamental division of critical response to the result in *Melchior* reveals a Kafkaesque dimension of the long-running debate in Australia about the virtues and vices of judicial activism (see further Sackville, 2001). The judicial activism/legalism divide is substantially a constructed, although not entirely false, dichotomy. As Ackland (2003) has argued:

... large quantities of judicial reasoning frequently involve coating personal values in what law is to hand to lend support. To suggest that is not activism or adventurism is really too much of a con to swallow. The principle to bear in mind when weighing the value of the commentary is that whenever a court's reasoning does not conform to a conservative perception of values, then it is denounced as 'judicial activism.' Conversely, for a liberal minded person, a decision that favours conservative values invariably is said to be infected with 'excessive legalism'. They are entirely unhelpful labels deployed to enhance or rebuke judges according to the acceptability or otherwise of the values they bring to their task.

Illustrating this point, Ackland refers to the minority opinion of Justice Heydon in *Melchior*, a judgement replete with speculative commentary about the psychology and duties of good parenting and about what is conducive to 'the health of family life' (Heydon J, 2003:paras 323-4, 269), as well as value-laden assertions that human dignity is affronted by attempts to estimate the impact of an unplanned child on its family in economic terms (Heydon J, 2003:paras 353, 347

and generally 352-362). Not dissimilar, but more balanced and restrained, statements about social and family values were made by the other minority judges in *Melchior*, especially with regard to their claim that allowing damages in this case would represent ‘commodification’ of children or of the parent-child relationship (Gleeson CJ, 2003:paras 35, 38 and cf 8; Hayne J, 2003:paras 194 and 258-261). Justice Heydon’s approach in this case deserves special attention, however, in the light of his outspoken extracurricular attacks on judicial activism, defined by him as attempts to further ‘some political, moral or social program’ (Heydon J, 2003b:10). With respect, it is difficult to see how Justice Heydon’s own approach in *Melchior* differed, in process if not flavour of result, from judges he has criticised as:

... soigné, fastidious civilised, cultured and cultivated patricians of the progressive judiciary — our new philosopher-kings and enlightened despots — [who] are in truth applying the values which they hold, and which they think the poor simpletons of the vile multitude — the great beast, as Alexander Hamilton called it — ought to hold even though they do not. (Heydon J, 2003b:21)

This is not to say that the legal pronouncements of judges are, can, or should ever be detached from the values of the society in which the law operates. As Justice Kirby reminded us in *Melchior*, the common law ‘does not exist in a vacuum. It is expressed by judges to respond to their perceptions of the requirement of justice, fairness and reasonableness in their society’ (Kirby J, 2003:para 106). Justice Kirby discussed an interpretive approach that would allow judges explicitly to rely on public policy considerations when resolving novel claims for damages in negligence (Kirby J, 2003:paras 120-122; see further Mason, 2001). A policy-oriented approach of this kind was set out by the House of Lords in *Caparo* (1990). Justice Kirby himself has advocated the *Caparo* approach but now (and with apparent reluctance) considers himself bound by its rejection by the majority of the High Court in *Graham Barclay Oysters* (2002).

Justice Kirby went on in *Melchior* to assert (Kirby J, 2003:para 137; see also paras 151, 159) that judges

... have the responsibility of expressing, refining and applying the common law in new circumstances in ways that are logically reasoned and shown to be a consistent development of past decisional law ... [but] they have no authority to adopt arbitrary departures from basic doctrine ... [least of all] in our secular society, on the footing of their personal religious beliefs or ‘moral’ assessments concealed in an inarticulate premise dressed up, and described, as legal principle or policy.

On the one hand, according to Justice Kirby, judges must not be unduly susceptible to Scripture, their personal morality or the dangers of ‘overwhelming legal analysis with emotion’ (Kirby J, 2003:para 159). On the other hand, they must somehow be alive to ‘reality in contemporary Australia’, which includes:

... non-married, serial and older sexual relationships, widespread use of contraception, same-sex relationships with and without children, procedures for ‘artificial’ conception and widespread parental election to postpone or avoid children ...

and to the values of a society that has changed substantially since ‘the far-off days of judicial youth’ (Kirby J, 2003:para 164). This suggested approach may be described as one of ‘cautious but creative legalism.’

The other majority judges in *Melchior* adopted a similar approach to Justice Kirby, albeit one where legalism arguably inclined more towards the cautious than the creative. All three judges apparently shared Justice Kirby’s stated enthusiasm for application of existing and established legal principle to novel tortious claims, regardless of the personal views of the judge on underlying questions of policy or morality. As Justice Callinan (2003:para 296 and para 292 — see also McHugh and Gummow JJ, 2003:para 77) stated:

It may well be seen by some to be distasteful for others to claim, and indeed for judges to assess, damages in a situation of this kind. The fact that I might as a judge find it personally distasteful to be required to assess damages of the kind claimed, can however provide no reason to refuse to award them if the application of legal principle requires me to do so.

These judges injected a larger dose of caution than Justice Kirby, however, into their recognition of the importance of judicial awareness of contemporary social realities in adjudication of negligence claims. In the course of their legal reasoning, Justices McHugh and Gummow (like Justice Kirby) did explicitly advert to the social reality of widespread use of contraception in our society by people like the *Melchior*s, in the course of rejecting the assertion that damages should be barred because the birth of a child is always a ‘blessing’ (McHugh and Gummow JJ, 2003:para 79). They went on, however, to emphasise both the difficulty of divining what should be accepted as the ‘paradigm of social behaviour’ in contemporary Australian society, and the importance of judges showing restraint in developing the common law according to changing social mores (McHugh and Gummow JJ, 2003:para 83). Justice Callinan referred in passing to ‘changed views in society about reproductivity’ in discussing the legal questions arising and foreshadowed by this case (Callinan J, 2003:para 294), but otherwise seemed prepared to have recourse to relatively strict legalism in upholding the *Melchior*s’ claim.

Where does the approach of the majority in *Melchior* really leave judges who are called upon to resolve novel damages claims in negligence? Arguably, in an uncomfortable position. Their discomfort is likely to be highest where judges deliver results that attract the ‘distaste’ of their individual conscience or of vocal segments of wider Australian society. In the current political climate — where the community is sensitised to the costs of rising insurance premiums in respect of professional and public liability, but generally ill-informed about the philosophical

and legal framework within which judges remain obliged to deliver ‘corrective justice’, unless and until the legislature imposes a different framework — this could occur against almost any factual setting. Arguably, however, judicial discomfort is most likely in negligence cases which, like *Melchior*, demand some delineation of rights and responsibilities in relation to the conception, bearing and raising of children, and produce symbolic as well as practical statements about the interrelationship of law, morality and human sexuality. These are ‘hot button’ issues in any society, no matter how notionally secular, liberal and pluralist. They generate controversy because they engage fundamentally competing understandings of what furthers or derogates from human dignity and personhood, based on differing conceptions of ‘existence, of meaning, of the universe, and of the mystery of human life’ (see *Planned Parenthood v. Casey*, 1992:2807). Even the most cautious and creative judge cannot hope to please all of the people, all of the time — and perhaps not even most of the people, most of the time — in adjudicating these questions.

Commodifying Children

Albrechtsen (2003) described *Melchior* as Australia’s *Roe v. Wade* (1973), referring to the groundbreaking decision of the United States Supreme Court establishing the constitutional protection of a woman’s right to abortion. Her analogy is partly accurate but substantially misleading.

The critical difference between *Roe v. Wade* and *Melchior* is that the result in the Australian case was not delivered in reliance on constitutionally protected or otherwise fundamental ‘rights’. The members of the High Court did not craft their judgements in *Melchior* in terms of rights — such as rights protecting reproductive choice, grounded perhaps in a right to privacy (as in *Roe v. Wade*), liberty and security of the person (as in the Canadian case *Morgentaler*, 1988), or even equality — because it was not legally or politically feasible for them to do so. Unlike many Western democracies in the common law tradition, such as Canada, South Africa and the United States of America, Australia has no Bill of Rights conferring fundamental, judicially enforceable rights and freedoms upon individuals. Unlike New Zealand and the United Kingdom, Australia has failed to enact even ordinary, non-entrenched legislation conferring or importing a menu of individual rights and freedoms which, although lacking full constitutional protection, nonetheless have some legal effect. Additionally, the existing Australian Constitution apparently contains little scope for judicial development of implied rights and freedoms. Further, Australian judges historically have displayed a marked reluctance to discern and develop common law rights, including in relation to questions associated with reproductive choice.

Yet a number of judgements in *Melchior* did contain explicit reference to the notion of reproductive choice. For example, Chief Justice Gleeson affirmed the ‘freedom’ the law grants couples like the *Melchior*s to ‘choose’ the size of their family, noting without elaboration that the legal harm resulting from denying such choice is ‘a loose concept’ (Gleeson CJ, 2003:para 23). Further, in their joint

judgement Justices McHugh and Gummow (2003:para 66) acknowledged the Melchior's legal interest in determining their own 'reproductive future[s]', expressly referring to the language adopted on these questions by courts in the United States of America. Notwithstanding the doubts cast by Justice Hayne on the 'utility' of describing the interest at stake as 'reproductive autonomy' — 'if only because it may reflect echoes of the wholly different debate in the United States about issues discussed [in] *Roe v. Wade*' (Hayne J, 2003:para 191) — to a limited extent the Melchior case suggested a potential new flavour of Australian jurisprudence on questions about the rights and responsibilities of reproduction. Given the concerns about judicial activism outlined above, however, that potential is likely to remain substantially unrealised without domestic enactment of a Bill of Rights.

Notwithstanding Justice Hayne's assertion that the issues raised in Melchior were 'wholly different' from those in *Roe v. Wade*, there are important similarities as well as differences between the two cases. Both involved judges answering a novel legal question relating to the kind of 'hot button' subject matter referred to above. Both explored legal questions related to unwanted pregnancy, unplanned children, and the reproductive choices legitimately available to women and men. Both rulings divided community opinion. Both rulings were broadly embraced by 'pro-choice' commentators, as examples of formal recognition of the philosophy of freedom of individual choice that underlies the modern family planning project (regarding Melchior, see Graycar, 2003; Cannold and Cica, 2003). Both rulings were attacked by conservative critics, as examples of secular liberalism run rampant, and as results that would devalue children and the experience of raising them (regarding Melchior, see Anderson, 2003; Shanahan, 2003; Albrechtsen, 2003).

Central to this last claim was the assertion that the majority position in each case represented a retreat from adherence to the so-called 'sanctity of life' doctrine, which demands that respect be given to the intrinsic value and dignity of every human life, and that every child be seen as a blessing or 'gift from above' (Anderson, 2003). The baldest form of this assertion is difficult to refute. The majority judges' recognition in *Roe v. Wade* of a woman's right to choose abortion was clearly inconsistent with an absolutist approach to 'sanctity of life', especially one that assumes human life begins at conception. Three of the four majority judges in Melchior explicitly disagreed with the view (previously relied on by courts in Australia and overseas to deny compensation to parents like the Melchior's) that legal result should proceed on the basis that all healthy children, in all circumstances, must be considered a 'blessing' or a 'gift from God' (Kirby J, 2003:paras140-2, 151, 191; McHugh and Gummow JJ, 2003:para 79; also see Callinan J, 2003:para 297, arguably displaying implicit, if not deliberate, support for this view). All majority judges in Melchior emphasised their conclusion was driven by the question of who should pay for the cost of raising an unplanned child born as the result of medical negligence, rather than the question of whether the unplanned child, once born, was in fact unwanted by his parents or indeed by wider society: 'In the real world, cases of this kind are about who must bear the

economic costs of the upkeep of the child. Money, not love or the preservation of the family unit, is what is in issue' (Kirby J, 2003:para 145 and see further paras 95, 148-9 and 153; Callinan J, 2003:para 298; McHugh and Gummow JJ, 2003:paras 68, 88 and 90). The majority also dismissed as merely speculative the minority judges' concerns that a child in the position of Jordan Melchior would grow up feeling unwanted or unloved, or otherwise psychologically damaged, simply because his parents had sought compensation for the financial costs of raising him (Kirby J, 2003:para 145; McHugh and Gummow JJ, 2003:para 79; Callinan J, 2003:para 298).

With respect, the reasoning on this question offered by the majority judges in Melchior does not entirely demolish the arguments of those concerned that awarding damages in this kind of case both offends the notion that all children are a blessing, and contributes to the 'commodification' of children by assigning to them a 'market value' (Hayne J, 2003:para 248; Gleeson CJ, 2003:para 35; Heydon J, 2003:para 353; see also Anderson, 2003). The Melchior result most certainly does both these things — not by saying, in the words of the Deputy Prime Minister of Australia (Anderson, 2003), that a child like Jordan Melchior is 'a consumer durable there for our pleasure, rather like an expensive fridge or a new DVD player', but certainly by reminding us that in important respects even the most loved and wanted children do represent 'an economic burden that can be enumerated and tabulated'. The Melchior result exposes the disingenuous fiction that childrearing in our society is everything to do with sacrificial love and nothing to do with money.

In Australia today, where public policy and politics is increasingly driven by 'user pays' ideology, that particular fiction is practically a fairytale. It is commendable to protest that children should never be seen as commodities, but at the end of the day someone must meet the financial cost of bringing up each child. Single mothers are well acquainted with this reality, as are fathers who are legally obliged to pay child support pursuant to the *Child Support (Assessment) Act 1989 (Cth)*. Significantly, '[n]o court would be moved by the argument coming from a putative father that he should not be required to provide financial support for the child he has fathered on the grounds that he has bestowed on the mother a priceless blessing' (see Graycar, 2003). From the direct cost of providing a child with basic food, clothing, shelter, education and entertainment — Percival and Harding (2003) estimate it costs \$448 000 for the average Australian couple to raise two children from birth to age 20 — to the opportunity cost of forgoing career advancement to maintain a feasible balance between work and family commitments (Gray and Chapman, 2001), Australian parents pay a high economic price for raising the citizens and taxpayers of tomorrow.

By itemising exactly what it costs parents to raise a child today, by scrutinising who should pay these costs where the child is born as the result of negligence on the part of a third party, and even by opening the door to more damages awards along these lines, arguably the High Court in Melchior was simply bringing one part of the common law in line with some contemporary realities associated with raising children in today's society and economy. In other

words, the High Court was not so much stepping onto a dangerous slippery slope of commodifying human life and dignity as revealing how far down that slope Australian society has already slid. A not insubstantial part of the popular disquiet at the Melchior result may originate substantially in shocked surprise at being confronted directly with one of the unsavoury consequences of the current ascendance of radical neo-liberal economic theory. Hamilton (2003) has identified a far wider range of socially, economically and morally objectionable consequences of neo-liberalism-in-action. If citizens are now pre-eminently consumers or shareholders, and if every cost and benefit must be scrutinised and itemised, why should the question of allocating responsibility for meeting the tangible economic costs of raising children be treated more tenderly than similar questions in relation to paying for health care, education, utilities and other social services formerly caught more substantially by the net of 'social welfare'?

The Melchior judgements advert to another worrying consequence of elevating the economic and rational over finer, more generous feelings. Namely, the possibility that the High Court might one day decide that plaintiffs are legally obliged to mitigate their financial loss by either aborting an unplanned pregnancy resulting from medical negligence (where the abortion would be lawful under the applicable State or Territory law), or adopting out the child born as a result. The question was not raised in argument in Melchior, hence the High Court did not answer it. This question was raised in relation to adoption, however, in *CES v. Superclinics* (1995). The majority (Priestley and Meagher JJA, Kirby A-CJ dissenting) of the New South Wales Court of Appeal held that a woman who had lost the opportunity to choose to abort an unwanted pregnancy by virtue of medical negligence, could not claim damages for the economic cost of raising her healthy child, because she had chosen not to surrender the child at birth for adoption. Recall this case settled out of court before the High Court could hear an appeal. The judges in Melchior referred, with markedly different emphases and concerns, to the unanswered legal questions about abortion and adoption flowing from both *Superclinics* and Melchior itself (Gleeson CJ, 2003:para 35; Kirby J, 2003:paras 112-4; Hayne J, 2003:paras 220-2; Callinan J, 2003:paras 292 and 294). It remains to be seen if, when and how the High Court will resolve these questions. It is certainly open to defendants to advance a literalist 'failure to mitigate loss' defence (Nisselle, 2003). Should the High Court ever conclude that women and men situated similarly to the Melchiors are under some obligation to abort or adopt, the controversy generated by Melchior would pale into comparative insignificance.

Conclusion

The questions to which Melchior alludes may be more interesting than those it directly answers. These questions go far beyond the three key objections raised in response to the damages award in this case: namely, that this result will exacerbate Australia's so-called 'medical indemnity crisis'; it involved unjustified judicial activism; and it devalues and commodifies human life. None of these

three claims is clearly substantiated. Yet there are elements of some truth in all three claims, which should be used to interrogate the broader neo-liberal socio-economic project. Responsibility for correcting the excesses and shortfalls of that project is properly a matter for the legislature, not the courts. In meeting this wider responsibility, our elected representatives might usefully be guided by the sentiment underlying these words of Justice Hayne in *Melchior* (Hayne J, 2003:para 222):

... 'choice' is an expression apt to mislead ... For some, confronted with an unplanned pregnancy, there is no choice which they would regard as open to them except to continue with the pregnancy and support the child that is born. For others there may be a choice to be made. But in no case is the 'choice' one that can be assumed to be made on solely economic grounds. Human behaviour is more complex than a balance sheet of assets and liabilities. To invoke notions of 'choice' as bespeaking economic decisions ignores that complexity.

Postscript

Around one month after the High Court's ruling in *Melchior*, the Queensland Attorney-General introduced the *Justice and Other Legislation Amendment Bill 2003 (Qld)*, clause 41 of which aims to deny recovery for the costs of raising a healthy child in future cases of this kind arising in Queensland. At the time of writing, the Queensland Parliament had not yet debated the proposed legislative change and its stated rationales. Namely, that *Melchior* 'has exposed medical practitioners to an indeterminate liability in relation to any claim for costs associated with raising [a child born pursuant to negligence in relation to sterilisation]', that the High Court's ruling 'has cast doubt on the future of medical sterilisations in Queensland', and that it 'threatens to undo the benefit of the historic reforms ... passed last year', that is, the Ipp reforms (Welford, 2003). The content, quality and outcome of that debate remains to be seen.

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