ANECDOTAL EVIDENCE

Our sales this year are going to be an absolute record, this is going to be the biggest Christmas we have ever had, we are going to break all the records.

Gerry Harvey, Chairman of Harvey Norman
Canberra Times, 23 November 2009

A Toorak mansion in the city's inner-east has set a Melbourne record, selling for more than $20 million. Melbourne's previous record for a free-standing house was Steve Vizard's Toorak abode, which sold for $17.5 million in 2007 after a buyer knocked on the door. But while the sale may be a high for Melbourne, it is well below the Australian record of $45 million paid for Alco founder David Coe's Sydney harbour-front mansion last year.

Australian Financial Review, 19 November 2009

The South Australian government has spent $56 million on consultants and staff on four public–private partnership projects, the state opposition says.

Australian Financial Review, 10 November 2009

The Pharmacy Guild of Australia has released a new report which strengthens its argument that the PBS should not be a target for further cuts. The latest analysis of the sustainability of the scheme, commissioned by the Guild and conducted by Access Economics, has found that the cost of the system to taxpayers will continue to come in much lower than the estimates put forward in the Federal Government's 2002 and 2007 Intergenerational Reports. In 2002, Intergenerational Report 1 projected PBS spending as a percentage of Gross Domestic Product would increase to 3.4 per cent by 2041–42. However, an analysis by Access Economics in March put it at 1.6 per cent.

Pharmacy News, 6 October 2009

Taxpayer-funded subsidies to the aluminium industry will remain secret after the Victorian Government rejected a call for transparency from the state-appointed environmental watchdog. The Age last month revealed Alcoa smelters at Portland and near Geelong were likely to cost Victorians $4.5 billion by the time contracts expire in 2014 and 2016. The Government said energy contracts were commercial-in-confidence and established more than 20 years ago.

The Age, 27 November 2009
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The ‘Excellence in Research for Australia’ Scheme: A Test Drive of Draft Journal Weights with New Zealand Data

DAVID L. ANDERSON AND JOHN TRESSLER

Abstract

The paper assesses the draft weighting system used by the Excellence in Research for Australia (ERA) scheme for measuring the output of refereed economics journal articles. It does so by using data from New Zealand’s economics departments to demonstrate how the rankings of departmental and individual researchers are affected by the use of ERA weights rather than alternative weights employed in the economics literature. It concludes that the draft version of the ERA scheme, as released in August 2008, rewards research quantity over research quality, as traditionally defined.

Introduction

In February 2008, the Australian government announced its intention to develop a new quality and evaluation system for research conducted at the nation’s universities. The scheme — ‘Excellence in Research for Australia’ (ERA) — will be based on a combination of bibliometric techniques and peer judgement; unlike most government-wide research-evaluation schemes employed internationally, it will not be used to allocate research funding. However, it defies reason to think that the scheme, given its complexity and aims, will not be used at some point to allocate, directly or indirectly, research funding. Although the ERA
scheme will utilise several measures to evaluate institutional performance, we have chosen to focus on one element only: the assessment of refereed journal-article output based on ERA’s own journal-weighting scheme.

The results of the ERA exercise will only be reported at the discipline and institutional level; however, if universities are to implement plans to improve their performance, they will track the activity measures back to individual responsibility centres such as the academic department. Furthermore, if individual departments are to take steps to design strategies to improve performance over time, they will focus on the publication and citation records of the individual researcher. We must stress the last point since the official ERA line is that the research-evaluation scheme is not based on individual assessment. This is technically correct, but in practice the individual researcher is the basic building block of the scheme and hence will be under pressure to perform.

Therefore, for both the academic department and academic staff members, the nature of the journal-specific weighting scheme is of some importance. The ERA weighting scheme will undoubtedly shape the reward structure facing university administrators and individual academics. Our objective is to explore the nature of the ERA weighting scheme for economics, and to demonstrate how it impacts on departmental and individual researcher rankings relative to rankings generated by alternative schemes employed in the economics literature. In order to do so, we utilise data from New Zealand’s economics departments and the draft set of journal weights (ERA) released in August 2008 by ERA officials. Given the similarities between Australia and New Zealand, our findings should have relevance to the Australian scene. As a result, we hope to provide the reader with a better understanding of the type of research activity that influences ERA rankings at both the departmental and individual level.

This paper assesses the draft weighting system used by the Excellence in Research for Australia (ERA) scheme for measuring the output of refereed economic-journal articles. We do so by using data from New Zealand’s economics departments to demonstrate how the rankings of departmental and individual researchers are affected by the use of ERA weights rather than alternative weights employed in the economics literature. We show that the proposed journal weights are ‘low-powered’ by international standards. Partly, this results from the generous weights allocated by ERA to Australian-based journals. In summary, we demonstrate that the draft version of the ERA scheme rewards research quantity over research quality as traditionally defined.
The Literature on Ranking Research Output

The economics literature on the ranking of economics departments is extensive. Although much of the early work was US-based, in more recent times research measurement and ranking studies have been conducted for many countries. The first rigorous study of Australian economics departments was conducted by Harris (1988). Harris arbitrarily developed a complex weighting system for virtually all forms of academic research output. This was followed by several studies based, in part, on citation counts. Towe and Wright (1995) placed 78 journals in three categories and then developed rankings of all Australian economics departments for each category. They also developed an overall ranking but implicitly assumed that all categories were of equal value. Subsequent work by Promfret and Wang (2003), Neri and Rogers (2006 and 2007), Macri and Sinha (2002, 2004, 2006, and 2008), and Sinha, Macri and McAleer (2009), employed various journal-based weighting schemes to rank Australia’s economics departments and, in some cases, individuals.

Of particular relevance to our study are three papers authored by Macri and Sinha: in these papers they incorporated New Zealand institutions into their analysis. Although Macri and Sinha (and, in one case, with McAleer) generally found Australian institutions to occupy the top positions in their per-capita rankings, the average performance of New Zealand’s economics departments generally matched those of their Australian counterparts. For example, Macri and Sinha (2006) derived per-capita rankings for 31 university economics departments: seven in New Zealand and 24 in Australia. Their overall ranking placed New Zealand institutions solidly in the middle of the pack: Canterbury (9), Otago (11), Auckland (12), Waikato (16), Victoria (19), Massey (22) and Lincoln (28). Although Australian departments occupied the top eight positions, New Zealand departments performed slightly better overall (a mean rank score of 16.36 versus 17.20 for Australian departments). This suggests that using New Zealand data to test the ERA journal-weighting system should yield relevant results for Australian policymakers and university administrators.

There is another reason for using New Zealand, rather than Australian, data for testing the impact of ERA journal weights on departmental and individual rankings: independence. The discipline-specific weights are derived from a

---

4 For a good overview of the economics department-related ranking literature, see Liner and Amin (2004) and Macri and Sinha (2006).
5 For alternative approaches to ranking Australian economics departments, see Abbott and Doucouliagos (2003); Rodgers and Valadkhani (2006); and Rodgers and Neri (2007).
6 The relevant papers are: Macri and Sinha (2006); Sinha and Macri (2009) and Sinha, Macri and McAleer (2009).
7 The Auckland University of Technology (AUT) is not in the Macri and Sinha study due to the fact that the institution did not obtain university status until after the start of the sample period.
committee process that is based, in part, on advice provided by other academic
groups. Given that many, if not most, of the members of these groups were
Australian academics, it is plausible to suggest that some degree of game playing
may have taken place in the journal selection and allocation process.

Journal Data

Our dataset covers all of New Zealand’s academic economists on staff at its
eight universities as of 15 April 2007, and we have collected information on
each researcher’s publication record over the six-year period beginning on 1
January 2001 and ending 31 December 2006.\(^9\) It should be noted that relevant
publications have been defined to be refereed articles in journals listed in
*EconLit* as at 15 April 2007 (1217 in number). In total, we found that 102 of New
Zealand’s 139 academic economists published 589 refereed papers in *EconLit-
listed journals (in whole or in part) over the relevant time period.

We have followed prevailing practice by allocating author shares on multiple-
authored papers by utilizing the 1/n rule, where n is the number of authors.
Although the ERA scheme gives preferential weighting to papers with multiple
authors, if one or more of the authors are from different institutions, we can
find no justification in the literature for doing so. Our decision to use the 1/n
allocation rule is based on the premise that journal editors (and reviewers) do
not take into account the number of authors on a paper when making their
decision to accept or reject it.

The second allocation decision to be faced relates to the process of allocating
papers to specific institutions. Under the Stock method, one allocates all of a
given researcher’s output to her/his employer at the census date (in this case, 15
April 2007) regardless of where the work was performed. The Flow method, on
the other hand, assigns journal articles to a researcher’s employer either at the
time of publication or when the paper was completed. We have adopted the Stock
method since it gives a better indication of a department’s current and short- to
medium-term research capability. Under the Flow method, a department may
have been strong in the past, but may now employ few of its past stars. Indeed,
it should be noted that virtually all studies in Australia and New Zealand are
based on the Stock method of output allocation;\(^10\) furthermore, the ERA scheme
is also based on this method of allocation.

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9 A six-year time period has been chosen since it is the assessment period adopted by the ERA scheme
for measuring research activity. It is also the relevant time span adopted by the UK’s Research Assessment
Exercise (RAE) and NZ’s Performance Based Research Funding (PBRF) scheme.
10 The exception is the work of Neri and Rodgers (2006 and 2007).
Once again, we follow convention, and adopt the ‘share-adjusted, weighted page’ as our unit of output. Our share-adjustment process was described above, but the ‘weighted page’ requires an explanation. We adjust for page-size differentials between journals, with the average-size AER page being the reference point and assigned a value of 1. The page-size differences for 171 journals have been addressed by applying correction factors derived by Towe and Wright (1995) and Gibson (2000). For papers in all other EconLit-referenced journals (69 in total), we have used the average value derived by Gibson for his residual category journals; more explicitly, pages in such journals are assumed to contain 0.72 as many words as an average AER page.

**Weighting Schemes**

The draft ERA journal-weighting scheme (ERA) was developed by a committee of the Australian Research Council (ARC); this group chose a large number of relevant academic journals, and allocated them to one of four categories. The top journals were classified as ‘A+’, the next best an ‘A’, followed by ‘B’ and ‘C’ groupings. According to the ERA website, recognised journals were to be designated as follows: the top 5 per cent as ‘A+’, the next 15 per cent as ‘A’, the next 30 per cent as ‘B’, and the remaining 50 per cent as ‘C’. In the case of Economics, 611 journals were recognised as research-relevant, and the actual percentage of journals assigned ‘A+’ through ‘C’ were 6.9, 16.0, 32.3 and 44.8, respectively. In order to arrive at the stated purpose of ranking academic units, numerical grades must be given to the ‘A+’ to ‘C’ classification system.

For the purposes of this paper, we assign a grade of ‘4’ to an ‘A+’, and so on to a ‘1’ for a ‘C’. In addition, economics journals not officially recognised by the ERA scheme, but listed in EconLit, are given a grade of ‘0’. Therefore, in reality, the ERA ranking scheme is based on a five-point scale. We must stress that these are our weights, not those of the ERA scheme. Probably in order to avoid being responsible for a ‘government’-sanctioned rating scheme, the developers of the ERA scheme stress that the information provided to the final decision-making group (Research Assessment Committee (RAC)) will not be aggregated. This means that the committee members will, by necessity, assign their own weights to each evaluation category. However, if the system is to be transparent, and if it is to be used eventually to allocate research funding, it is difficult to imagine that official weights will not be developed. We have chosen our weighting scheme

11 We must stress that we are testing the draft version of the ERA journal weights for economics. As noted earlier, according to the ERA’s website, as at 21 April 2009, the final version is expected to be released in late 2009.
based on academic convention – a version of the traditional weighting scheme employed by many universities, especially in North America, for converting from letter to numerical grades.

In order to provide the reader with a frame of reference, we have selected four journal-based weighting schemes that have been used by economists to rank economics departments. The set of possibilities is large, so in order to keep the discussion manageable we have arbitrarily selected two schemes from each of the so-called ‘high-power’ and ‘low-power’ camps. By ‘high-powered’ we have in mind schemes that discriminate significantly between the very best and lesser-quality journals. In such schemes, the top journals sometimes receive weights that are 1000 times or more the weight allocated to the lowest-ranked journals. It is quite common to find, say, the thirtieth-ranked journal receiving only 10–20 per cent of the weight accorded to the top journal. Such systems are based on the pioneering work of Liebowitz and Palmer (1984), and are generally known as ‘impact-adjusted citation’ measures. Liebowitz and Palmer’s work was updated and refined by Laband and Piette (1994); Kalaitzidakis, Mamuneas and Stengos (2003); and Kodrzycki and Yu (2006).

We have chosen to use Kalaitzidakis, Mamuneas and Stengos (KMS) weights because they are well known in the rankings community and are based on more recent citation counts than Liebowitz and Palmer (1984) and Laband and Piette (1994). On the other hand, although the Kodrzycki and Yu (2006) weights (henceforth denoted as KY weights) are based on more recent citation counts than KMS, we have chosen to employ the KMS scheme for the following reasons. First, to date, the KY weighting scheme has not been widely used in ranking studies;¹² and second, in a thorough evaluation of the characteristics of the KMS and KY schemes, Henrekson and Waldenstrom (2007) found the former to discriminate more sharply between high- and low-ranked performers. Given that our purpose is to demonstrate the differences in outcomes between using a generally accepted, aggressive weighting scheme and those generated by ERA weights, the KMS scheme is deemed to be appropriate.¹³

Given the recent expansion of the citation-counting industry, several up-to-date weighting schemes, based on a variant of the ‘impact-adjusted citation’ method, are available for selection. We have chosen to use the ‘recursive discounted impact factors’ derived by RePEc (Research Papers in Economics), as displayed on their website on 23 January 2009.¹⁴ Not only is this scheme based on recent

¹² The only paper we found that did so was that by Henrekson and Waldenstrom (2007).
¹³ In some respects, KMS stands out as first amongst equals in the rankings literature. For example, Macri and Sinha (2006) refer to it as the ‘industry standard’, and, although in disagreement, Henrekson and Waldenstrom (2007) state that the scheme is held in high regard by many influential economists.
¹⁴ For details, see the organisation’s website [http://repec.org] and Zimmermann (2007).
citation activity, it also covers a broader range of journals than KMS (540 versus 143). However, it must be stressed that this weighting scheme is still officially at the experimental stage of development.

At the other extreme, we have arbitrarily selected two schemes that we have labelled as ‘low-powered’. The most radical scheme is denoted as EQUAL; this implies that all journals listed in EconLit, as at 15 April 2007 are of equal value. That is, a page in, say, the AER is considered to be of equal value to a page in a newly established regional journal. In practice, the EQUAL weighting scheme yields a quantity rather than a quality indicator of research activity. However, it is included here in order to give the reader some idea of how closely the rankings generated by ERA correspond to those generated by an undifferentiated weighting system, and to shed some light on the underlying quantity-versus-quality debate.

Our second ‘low-powered’ scheme was derived by Bauwens (1998). Bauwens collected citation counts and derived simple impact factors for approximately 600 journals. He then multiplied the two results to generate a journal-specific score. Using an arbitrary allocation process, Bauwens assigned journals to one of five categories, with the highest ranking journals being given a ‘5’, the next group a ‘4’ and so on. Under the Bauwens scheme, 1.33 per cent of journals were placed in Group 5 and 7.64 per cent in Group 4. The corresponding figures for Group 3, Group 2 and Group 1 journals are 7.64, 7.64 and 75.75 per cent, respectively. All journals in EconLit for which impact factors could not be calculated were placed in Group 1. For this weighting scheme, the spread between the best journals and the worst (5 to 1) is roughly comparable to the ERA scheme wherein the spread is formally 4:1, but some EconLit-listed journals are unranked and thus receive a weight of ‘0’.

Before proceeding to discuss our findings, we should address a possible reason for ERA being based on peer-review or perceptions rather than on more traditional bibliometric techniques. If the Australian government desires to encourage research on local and regional issues to improve the economic and social well-being of Australians, citations counts are not likely to yield journal weights that encourage such behaviour. Instead, they tend to be biased in favour of issues and subjects with a global appeal or to research with a large-countries or large-region focus. For example, a study of labour issues in Tasmania is not likely to be as widely cited as an article of similar quality and methodology that focuses on the US or the EU.

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15 Bauwens notes that the equal number of journals in categories 4 to 2 is not intentional.
16 We wish to thank an anonymous reviewer for pointing out another reason for over-weighting domestic journals: to help foster dialogue between academics and the broader community by rewarding producers of readable, policy-oriented articles.
17 For a short discussion of this matter, in the Australian context, see Rodgers and Valadkhani (2006: 32).
To address this problem, a number of researchers have arbitrarily added leading regional publications to their top journal lists. For example, see Harris (1988), KMS (1999), King (2001), Jin and Hong (2007), and Anderson and Tressler (2008). A somewhat different approach to addressing the issue was taken by Pomfret and Wang (2003): they acknowledged the importance of six Australian journals by considering them to be a separate category for output-determination purposes. The ARC committee has apparently followed the former approach rather extensively and perhaps aggressively.

<table>
<thead>
<tr>
<th>Table 1: Rankings of Australian Economics Journals Under Various Weighting Schemes</th>
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<tbody>
<tr>
<td><strong>Journal Name</strong></td>
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<tr>
<td>Agenda</td>
</tr>
<tr>
<td>Australian Ec. History Review</td>
</tr>
<tr>
<td>Australian Ec. Papers</td>
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<tr>
<td>Australian Ec. Review</td>
</tr>
<tr>
<td>Australian J of Agr and Resource Ec.</td>
</tr>
<tr>
<td>Australian Journal of Labour Ec.</td>
</tr>
<tr>
<td>Bulletin of Indonesian Ec. Studies</td>
</tr>
<tr>
<td>Economic Analysis &amp; Policy</td>
</tr>
<tr>
<td>Economic Record</td>
</tr>
<tr>
<td>History of Economics Review</td>
</tr>
<tr>
<td>Pacific Economic Bulletin</td>
</tr>
<tr>
<td><strong>Number of Journals Ranked</strong></td>
</tr>
</tbody>
</table>

Notes: NR (non-ranked); KMS (Kalaitzidakis, Mamuneas and Stengos (2003)); MSF (Mason, Steagall and Fabritius (1997)); CoupeIF (Coupe (2003), Impact Factors); KYEI (Kodrzycki and Yu (2006), Economic Impact Version); RePEc (Research Papers in Economics (2009)); LP84 (Liebowitz and Palmer (1984)); LP94 (Laband and Piette (1994)); and ERA (Excellence in Research for Australia (2008))

As shown in Table 1, the ERA scheme has placed most of Australia’s EconLit-listed economics journals in a much higher category than that found in several widely used international classification systems. Note that only the Economic Record and the Australian Journal of Agriculture and Resource Economics are consistently ranked by the leading schemes, and even then they are found in the middle to lower-middle echelons. However, under the ERA, they are designated as ‘A’ journals. The other listed domestic journals are, in most cases, unranked internationally, but under the ERA they are frequently found in the ‘A’ and ‘B’ categories, and in the case of the Bulletin of Indonesian Economic Studies, in the ‘A+’ classification. The above discussion is not to belittle these journals, but
to point out to the reader that the ERA journal-weighting scheme aggressively attempts to offset the small-country bias of the pure citation-based ranking systems.\textsuperscript{18}

**Departmental Results**

Before proceeding to discuss our findings, it should be noted that our results are presented in per-capita terms (output per eligible researcher) since it is our objective to determine productivity differences between departments. Our findings are presented in Tables 2 and 3. In the former, we present the standardised scores for each New Zealand economics department for each of our five weighting schemes. That is, the highest-scoring department has been given a score of ‘100’, and all other raw scores are scaled accordingly. Therefore, a reported score in Table 2 of, say, 60.0 means that the average academic in that department produced 60 per cent as many ‘share- and size-adjusted, weighted pages’ as the average academic in the leading department.

<table>
<thead>
<tr>
<th></th>
<th>ERA</th>
<th>KMS</th>
<th>RePEc</th>
<th>Bauwens</th>
<th>EQUAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auckland</td>
<td>61.86</td>
<td>100.00</td>
<td>100.00</td>
<td>64.09</td>
<td>46.42</td>
</tr>
<tr>
<td>AUT</td>
<td>20.18</td>
<td>4.40</td>
<td>3.2</td>
<td>19.94</td>
<td>24.83</td>
</tr>
<tr>
<td>Canterbury</td>
<td>62.64</td>
<td>53.94</td>
<td>89.09</td>
<td>73.02</td>
<td>68.50</td>
</tr>
<tr>
<td>Lincoln</td>
<td>46.06</td>
<td>14.27</td>
<td>13.28</td>
<td>48.67</td>
<td>53.97</td>
</tr>
<tr>
<td>Massey</td>
<td>43.04</td>
<td>10.82</td>
<td>12.88</td>
<td>44.58</td>
<td>50.13</td>
</tr>
<tr>
<td>Otago</td>
<td>100.00</td>
<td>53.96</td>
<td>74.28</td>
<td>100.00</td>
<td>85.97</td>
</tr>
<tr>
<td>Victoria</td>
<td>65.97</td>
<td>45.68</td>
<td>99.73</td>
<td>68.85</td>
<td>48.75</td>
</tr>
<tr>
<td>Waikato</td>
<td>90.08</td>
<td>19.62</td>
<td>46.97</td>
<td>97.28</td>
<td>100.00</td>
</tr>
</tbody>
</table>

In Table 3 we provide the associated departmental rankings; for discussion purposes we shall focus on the latter table. Note that under our ‘high-powered’ schemes (KMS and RePEc) Auckland is the leader, with Canterbury, Otago and Victoria (especially under the RePEc scheme) all performing relatively well.\textsuperscript{19} On the other hand, Waikato finishes in fifth place under each of these schemes.

\textsuperscript{18} Given that we are using New Zealand data, we face a similar problem in how to treat the New Zealand Economic Papers, the leading economics journal in New Zealand. Following Anderson and Tressler (2008), we have given the New Zealand Economic Papers the same weight as the Economic Record throughout the study. The rationale is the same as that used by the ERA designers — the need to overcome the small-nation bias in citation-based schemes. Indeed, one might argue that the problem facing New Zealand journals is even more severe than that facing their Australian counterparts given the respective sizes of the two nations.

\textsuperscript{19} It must be noted that Peter Phillips, an internationally renowned economist, is not included in the Auckland data. We have restricted our dataset to academics holding ‘regular’ appointments at New Zealand universities. By ‘regular’ we mean an appointment akin to what in a North American setting would be called a ‘tenure’ or ‘tenure track’ position. A regular appointment need not be a full-time appointment.
If we now move to look at our ‘low-powered’ schemes (Bauwens and EQUAL), we find that Waikato and Otago occupy either first or second place for each set of weights. Auckland now drops dramatically in the rankings, finishing in fifth and seventh place respectively under Bauwens and EQUAL. Under the ERA scheme, Otago leads the group, closely followed by Waikato, while Auckland holds fifth position. At this point it should be noted that for all of our weighting schemes, Lincoln, Massey and AUT always finish in fifth, seventh or eighth place, save for EQUAL.

### Table 3: Rankings; Per Capita Output; Share-Adjusted Weighted Pages
**New Zealand Economics Departments, 2001–2006**

<table>
<thead>
<tr>
<th></th>
<th>ERA</th>
<th>KMS</th>
<th>RePEc</th>
<th>Bauwens</th>
<th>EQUAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auckland</td>
<td>5</td>
<td>1</td>
<td>1</td>
<td>5</td>
<td>7</td>
</tr>
<tr>
<td>AUT</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Canterbury</td>
<td>4</td>
<td>2</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Lincoln</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Massey</td>
<td>7</td>
<td>7</td>
<td>6</td>
<td>7</td>
<td>5</td>
</tr>
<tr>
<td>Otago</td>
<td>1</td>
<td>2</td>
<td>4</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Victoria</td>
<td>3</td>
<td>4</td>
<td>2</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Waikato</td>
<td>2</td>
<td>5</td>
<td>5</td>
<td>2</td>
<td>1</td>
</tr>
</tbody>
</table>

It is apparent from the above discussion that ERA results are rather similar to those generated by Bauwens and EQUAL, and somewhat different from the KMS and RePEc rankings. This interpretation is reinforced by the information presented in Table 4. In this table we display the pair-wise correlation coefficients of the standardised scores between ERA and the other journal-based weighting regimes employed in this study. Note that ERA/Bauwens and ERA/EQUAL are highly correlated at 0.99 and 0.89, respectively. On the other hand, the resulting pair-wise correlation coefficients for ERA/KMS (0.42) and ERA/KMS (0.59) are much weaker.

We have focused our discussion on Otago, Waikato and Auckland in order to illustrate the underlying nature of the ERA scheme. Otago’s results are rather insensitive to the weighting scheme used; they are first or second for every measure, save for a fourth-place finish under RePEc. Waikato also holds first or second place for all but our ‘high-powered’ schemes, but for these measures its

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20 Some of the journals listed in *EconLit* as at 15 April 2007, and containing articles published by New Zealand economists over the period 2001–06, are considered to be finance journals by the ERA scheme. For these journals, we have used the relevant weights listed under the ‘Banking, Finance & Investment’ heading.

21 The correlation coefficients reported in Table 4 are over the output scores shown in Table 3. Spearman correlation coefficients over ranks show a similar pattern: ERA/Bauwens (0.98), ERA/EQUAL (0.71), ERA/KMS (0.63) and ERA/RePEc (0.56).
performance drops to fifth. The reverse applies to Auckland: first-place finishes under KMS and RePEc, but fifth place under ERA and Bauwens, and seventh under the EQUAL scheme.

Table 4: Correlation Coefficients over Standardised Output Scores, Various Weighting Schemes, NZ Economics Departments, 2001–2006

<table>
<thead>
<tr>
<th></th>
<th>ERA</th>
<th>KMS</th>
<th>RePEc</th>
<th>Bauwens</th>
<th>EQUAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>ERA</td>
<td>1.00</td>
<td>0.42</td>
<td>0.59</td>
<td>0.99</td>
<td>0.89</td>
</tr>
<tr>
<td>KMS</td>
<td>0.42</td>
<td>1.00</td>
<td>0.87</td>
<td>0.42</td>
<td>0.09</td>
</tr>
<tr>
<td>RePEc</td>
<td>0.59</td>
<td>0.87</td>
<td>1.00</td>
<td>0.61</td>
<td>0.27</td>
</tr>
<tr>
<td>Bauwens</td>
<td>0.99</td>
<td>0.42</td>
<td>0.61</td>
<td>1.00</td>
<td>0.91</td>
</tr>
<tr>
<td>EQUAL</td>
<td>0.89</td>
<td>0.09</td>
<td>0.27</td>
<td>0.91</td>
<td>1.00</td>
</tr>
</tbody>
</table>

What accounts for these variable results, at least for Auckland and Waikato? First, it should be noted that Otago's strength is that its average output level is high (as evidenced by a second-place finish under EQUAL), and its researchers tend to publish in a broad mix of journals — a good proportion of which are highly valued by every weighting scheme in the study. In contrast, researchers at Auckland tend to publish relatively little (only AUT has a lower 'share-adjusted, unweighted page' output), but they tend to publish in mainstream international journals that are often highly ranked by 'impact-adjusted citation' schemes. The reverse holds for Waikato: active publishers, but often in lesser-ranked journals. In addition, Waikato-based researchers publish more widely in field- and policy-oriented journals than their Auckland counterparts.

As shown by our ERA results, the new Australian scheme can be said to favour Waikato-style activity rather than that displayed by Auckland-based researchers. One can also see why the ERA results favour high-volume over low-volume producers by referring to Table 5. Note that over 50 per cent of the papers published by New Zealand-based economists are in 'A+'- or 'A'-ranked journals and 75 per cent of all such publications are in journals ranked 'B' or above. The results for individual departments are rather striking: at Victoria 78 per cent of all publications are rated 'A' or above; the corresponding figure for Auckland is 64 per cent. Equally interesting is the fact that 92 per cent of the papers at Victoria and 86 per cent at Auckland are rated 'B' or higher. However, we must remind the reader that the overall ERA leaders, Otago and Waikato, have production profiles that are more widely distributed across the ranking system, 22

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22 As noted earlier, we have given the New Zealand Economic Papers (NZEP) the same weight as the Economic Record for all schemes employed in this analysis. However, the ERA official weighting is a 'C', not an 'A' as follows from our treatment of NZEP. Although it is difficult for us to imagine that if New Zealand officials were designing an ERA-like weighting scheme, that they would place NZEP in the 'C' category, it is a possible outcome. If this were the case, the departmental rankings given above would not change, but the transfer of 38 publications from the 'A' to the 'C' category would obviously change the results presented in Table 3. The overall percentage of papers in category 'A' would decline from 39.0 to 32.0; and the percentage of papers in category 'C' would increase from 12.2 to 19.1.
but they generate substantially more publications per capita than Victoria and Auckland. More specifically, although Otago and Waikato have only 53 and 44 per cent of their papers classified as ‘A’ or above (still impressive numbers), they produce approximately twice as many refereed-journal pages per-capita.

### Table 5, Percentage Allocation of Economics Publications By ERA Category

<table>
<thead>
<tr>
<th></th>
<th>A+</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>X*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auckland</td>
<td>23.7</td>
<td>40.8</td>
<td>19.7</td>
<td>7.9</td>
<td>7.9</td>
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<tr>
<td>AUT</td>
<td>10.0</td>
<td>10.0</td>
<td>40.0</td>
<td>20.0</td>
<td>20.0</td>
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<tr>
<td>Canterbury</td>
<td>14.1</td>
<td>36.6</td>
<td>21.1</td>
<td>4.2</td>
<td>23.9</td>
</tr>
<tr>
<td>Lincoln</td>
<td>3.6</td>
<td>39.3</td>
<td>5.4</td>
<td>41.1</td>
<td>10.7</td>
</tr>
<tr>
<td>Massey</td>
<td>2.5</td>
<td>29.1</td>
<td>30.4</td>
<td>17.7</td>
<td>20.3</td>
</tr>
<tr>
<td>Otago</td>
<td>12.8</td>
<td>40.4</td>
<td>33.0</td>
<td>6.4</td>
<td>7.4</td>
</tr>
<tr>
<td>Victoria</td>
<td>23.8</td>
<td>54.0</td>
<td>14.3</td>
<td>0.0</td>
<td>7.9</td>
</tr>
<tr>
<td>Waikato</td>
<td>5.0</td>
<td>39.0</td>
<td>25.0</td>
<td>13.0</td>
<td>18.0</td>
</tr>
<tr>
<td>Weighted Average</td>
<td>11.8</td>
<td>39.0</td>
<td>23.0</td>
<td>12.2</td>
<td>14.0</td>
</tr>
<tr>
<td>ERA Scheme**</td>
<td>6.9</td>
<td>16.0</td>
<td>32.3</td>
<td>44.8</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Notes: * X represents articles in journals not ranked by the ERA scheme.

** Percentage distribution of ‘Economics’ journals in each ERA category.

The above suggests that the ERA scheme is not, in practice, a very discriminating weighting system. This view is reinforced by the fact that 6.9 per cent of the journals ranked by ERA have been designated as ‘A+’ journals whereas 11.8 per cent of all publications by New Zealand economists in our study are to be found in this category. Our position that the ERA scheme is a ‘low-powered’ weighting scheme is further augmented by the following Gini coefficients: KMS (0.738), RePEc (0.663), Bauwens (0.306) and ERA (0.220).

### Individual Results

As noted previously, the formal ERA evaluation process does not rank individual researchers. However, given that individual research records are the basic building block of the scheme, it defies logic to think that such results will not be informally calculated and disseminated. That is, individual rankings are likely to be of interest to most members of Australia’s academic departments since high rankings may generate pecuniary rewards.24 Highly ranked

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23 These results are for ranked journals only. Under the KMS, RePEc and ERA schemes, some journals are not formally ranked, and we have assigned a weight of zero to such journals. If all zero-ranked journals are included in the analysis, the resulting Gini coefficients are as follows: KMS (0.898), RePEc (0.794), Bauwens (0.306) and ERA (0.412).

24 It should be noted that it will be relatively easy for individuals to calculate their own outputs, and that of their colleagues, since the two critical components of the calculation will be in the public domain: refereed
performers will undoubtedly use such information in promotion applications and, where possible, in merit-pay requests. Even more importantly, highly ranked individuals will find themselves in demand in the recruiting market as some departments attempt to game the system and improve their relative performance. Such behaviour is quite likely in subsequent rounds of the ERA process. Rephrased, high rankings have economic value in addition to traditional psychic benefits such as bragging rights.

In Table 6 we display the results for the top 25 ERA performers, and provide the corresponding rank for these researchers under each of our four competing schemes. The overall message is clear: how one measures research output does matter at the individual level. It is apparent that, at least at the upper levels, ERA rankings are closely associated with our ‘low-power’ schemes (Bauwens and EQUAL) and are far less so with our ‘high-power’ regimes (KMS and RePEc). For example, consider the top five performers under the ERA. These very same individuals hold the top five spots under the Bauwens and EQUAL regimes. On the other hand, only one researcher in the ERA top five is in the same group under KMS. For RePEc the results are less extreme, with three of ERA’s top five holding such scores, but the two other individuals in the RePEc top five hold the seventeenth and twenty-fifth positions in ERA, and the sixth-ranked ERA performer is thirty-fifth under the RePEc scheme. It should also be noted that only eight of the top 25 ranked economists by ERA are also in the top 25 for all other weighting schemes used in this study.

Although the above analysis is based on casual empiricism, it is supported by the relevant pair-wise correlation coefficients of the output scores for the ERA top twenty-five researchers. The results are as follows: ERA/KMS (0.049); ERA/RePEc (0.471); ERA/EQUAL (0.858) and ERA/Bauwens (0.948). The corresponding estimates for the full set of active researchers (N=102) are somewhat higher but still consistent with the above pattern: ERA/KMS (0.361); ERA/RePEc (0.598); ERA/EQUAL (0.897) and ERA/Bauwens (0.966). All of this suggests that many academics that have performed well under more traditional, internationally recognised weighting schemes may be surprised by their standing under the ERA scheme, and may find their economic value to Australian-based departments reduced.

publications in EconLit and the requisite weights from the ERA website.

25 However, such behaviour will be constrained by the desire of many academics for international mobility and acclaim, and knowledge that research-evaluation schemes may change radically over time.

26 Spearman correlation coefficients over the implied ranks for the top 25 economists as ranked by ERA are: ERA/KMS (0.27), ERA/RePEc (0.46), ERA/Bauwens (0.81) and ERA/EQUAL (0.87). The corresponding Spearman correlation coefficients for the full set of active researchers (N=102) are somewhat higher but still consistent with the preceding pattern: ERA/KMS (0.67), ERA/RePEc (0.69), ERA/Bauwens (0.94) and ERA/EQUAL (0.90).

<table>
<thead>
<tr>
<th>Last Name</th>
<th>First Name</th>
<th>Univ.</th>
<th>ERA</th>
<th>KMS</th>
<th>RePEC</th>
<th>Bauwens</th>
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<td>W</td>
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<td>Hans-Jurgen</td>
<td>M</td>
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</tbody>
</table>

Conclusion

In this paper we have attempted to show the impact of using the draft journal weights of the ERA scheme on the reported performance of New Zealand’s economics departments and individual researchers. The results are then contrasted with those generated by alternative weighting schemes arbitrarily selected to represent so-called ‘high-’ and ‘low-powered’ schemes. The findings suggest that the outcomes generated by the draft version of the ERA weights
for economics journals (ERA) are quite similar to those generated by our ‘low-powered’ schemes: EQUAL and Bauwens. This suggests that the ERA scheme does not aggressively differentiate between high- and low-quality journals.

Rephrased, articles in journals that are traditionally ranked highly in the economics literature continue to be highly ranked by the ERA, but they are joined by a number of other journals. Indeed, we found that over 50 per cent of the articles published by New Zealand economists over the 2001–2006 period were in what ERA deems to be ‘A+’ or ‘A’ journals.

Our analysis was retrospective: we applied the ERA scheme to past research activity. If, on the other hand, researchers are aware of the rankings and target submissions accordingly, the percentage of publications in the top classifications should increase. Although this may be socially useful in that more research on domestic issues is likely to be forthcoming, departmental scores will become more compressed and the rankings less stable.

At this point we must stress two major qualifications to our work. First, we have arbitrarily converted a letter grading scheme to a numerical one: recall that we assigned an ‘A+’ a grade of ‘4’, an ‘A’ a grade of ‘3’ and so on. Clearly this may not be the implicit grading scheme used by the Research Assessment Committee of the ERA, but word of mouth will eventually occur to give academic researchers some idea of the prevailing norms. We have adopted a somewhat similar strategy: we have used the traditional conversion scheme used by many academic administrators to convert letter grades to numerical grades and vice versa. We believe our work is a useful starting point for evaluating the impact of using ERA journal weights on departmental and individual performance, and as an aid in helping administrators and researchers devise strategies to improve subsequent rankings.

Our second qualification is straightforward. Following universal practice in the departmental rankings game, we have defined research to be refereed-journal articles only. This approach is largely adopted for pragmatic reasons, and it undoubtedly penalises those who prefer to publish books and monographs, and engage in other scholarly activities.

Despite the above limitations, we believe our analysis is quite relevant to Australian economists and to department heads in Australian economics departments. As noted earlier, New Zealand economics departments may not perform as well as the top group of Australian institutions, but, on average, as calculated by Australian-based researchers, perform as well as their Australian counterparts. Furthermore, our findings suggest that some institutions that perform well under more conventional weighting schemes do not fare as well...
under the draft ERA journal-weighting scheme. Perhaps the traditional leaders in Australia may suffer a similar fate under the journal article component of the new national evaluation scheme.

References


Fiscal ‘stimulus’: a loanable funds critique

ANTHONY J. MAKIN

Abstract

This paper proposes an extended loanable-funds framework for examining the effects of fiscal stimulus on the budget balance, international borrowing, real interest rates, private saving, private investment and national income. It challenges the prevailing view that fiscal policy can be used effectively as an income ‘stimulus’ instrument, and proposes that discretionary fiscal measures that increase the budget deficit entail macroeconomic costs for significant external borrower economies, such as Australia, New Zealand and the United States.

Introduction

Within the G20 set of economies the size of the fiscal expansion in response to the current economic downturn has varied substantially from member to member. According to IMF estimates (2009: 38) the scale of Australia’s fiscal expansion when measured relative to GDP ranks among the highest within the G20 group, and close to that of the United States, the epicentre of the crisis itself.

For the first time in almost two decades, Australia’s policymakers have again automatically assumed that fiscal expansion is an effective means of countering a slowdown in economic activity, despite the lack of compelling empirical evidence from the international academic literature. As the IMF (2008: 164) concludes in a survey of the effectiveness of fiscal stimulus, the evidence is ambiguous, with estimates of the effects of fiscal policy on national output differing 'not merely in degree but in sign'.

Keynesian fiscal activism has been challenged previously on numerous theoretical and practical grounds. The Mundell (1963)–Fleming (1962) model

1 Griffith Business School, Griffith University; t.makin@griffith.edu.au.
3 See Barro (2009), Fama (2009) and Taylor (2009).
of an open economy, for example, concludes that, even during recessions, fiscal policy is ineffective in raising aggregate demand with a floating exchange rate and highly mobile international capital because it ‘crowds out’ net exports. However, the Mundell–Fleming model fails to treat international capital flows as discrete phenomena related to discrepant domestic saving and investment behaviour.

The following analysis aims to improve conceptual understanding of the nexus between budget deficits and the real economy by outlining a different approach to crowding out that extends the loanable-funds framework, as applied to advanced borrower economies, such as Australia, New Zealand and the United States. Critical to this extension is the assumption that borrower economies face a rising supply price of foreign capital, as would be expected under current international financial conditions, characterised by a general shortage of funds. An alternative diagrammatic framework is first developed, and then used to analyse the effects of budget deficit-raising stimulus in the form of increased government spending.

To preview our results, contrary to standard Keynesian analysis currently underpinning federal fiscal policy in Australia, which essentially assumes that fiscal stimulus confers macroeconomic benefits by boosting aggregate demand, the present analysis highlights the macroeconomic costs that stem from resultant budget deficits and borrowing.

Loanable Funds Analysis of Fiscal Stimulus with Interest Parity

Since domestic saving, domestic investment and foreign lending, are functionally related to the real interest rate, it follows from national accounting relationships identities that

\[
I(r) + BD = S_p(r) + L^*(r)
\]  

(1)

where \( I \) is investment, \( BD \) is the budget deficit, \( S_p \) is private domestic saving, and \( L^* \) is foreign lending.
The signs above the real interest rate indicate the effect of a rise in rates on the variable before the parentheses. Written this way, the expression also shows that the total domestic demand for funds must equal the total supply of funds forthcoming from home and abroad, with the real interest rate playing the equilibrating role.

If international capital mobility is assumed to be perfect, as is usual in most open-economy models including the Mundell–Fleming model, the domestic real interest rate, \( r \), is simply determined by the foreign real interest rate, \( r^* \). This assumes real interest parity always prevails, irrespective of the economy’s external indebtedness (to be relaxed subsequently).

Relationship (1) underpins an extended international loanable-funds framework for analysing the effects of various forms of fiscal stimulus on net foreign borrowing and national income. Figure 1 depicts a simple benchmark version where, in initial equilibrium, the budget is balanced, private saving and investment (and hence the current account) are balanced, and the stock of net foreign debt is nil.

The vertical private-saving schedule implies that the responsiveness of private saving to a rise in the domestic interest rate, for given national income and household consumption, is negligible, as presumed in conventional theories of consumption, such as the Keynesian, life-cycle, and permanent income approaches.\(^4\) Alternatively, this schedule could be drawn slightly upward-sloping, reflecting some sensitivity of private saving to interest rate changes in line with limited empirical evidence on this relationship,\(^5\) but this would have no significant bearing on the results.

On the demand side of the funds market, whenever domestic firms invest by purchasing new capital, the cost of which is approximated by the real domestic interest rate, \( r \), the demand for funds decreases as the real interest rate rises, in accordance with neoclassical and Keynesian investment theory.\(^6\)

\(^4\) See Keynes (1936), Modigliani (1986), and Friedman (1957), respectively.
\(^5\) Masson, Bayoumi and Hossein (1998) provide empirical evidence of a positive relationship between real interest rates and private saving in advanced economies.
\(^6\) See Romer (2005).
Figure 1: Budget Deficits and the Flow of Funds

With regard to Figure 1, let us first assume that private investment increases, which shifts the demand-for-funds schedule rightward. This extra investment adds to the domestic capital stock and, consistent with neo-classical foreign investment theory,\(^7\) enables extra production, or GDP, equivalent in Figure 1 to the sum of the upper triangular area and the rectangular area beneath it.

However, only the triangular area represents the net national income gain for the economy because the foreign borrowing to fund this investment has to be serviced at the prevailing world interest rate. Hence, the rectangular area, income paid abroad, has to be subtracted from GDP. This result implies extra foreign-funded private investment should be welcomed on the grounds that it enhances macroeconomic welfare, despite the accompanying rise in foreign

\(^7\) See, for instance, Makin (2004).
indebtedness. Such analysis has underpinned the argument that foreign debt incurred by the private sector in this way should not be a macroeconomic policy concern as it bolsters economic growth in net terms.

With fiscal stimulus, a move from budget balance to deficit increases the overall demand for funds, other things being the same, and also shifts the total demand-for-funds schedule rightwards. If the supply of funds from abroad is perfectly elastic (the perfect capital mobility assumption), this increases net foreign borrowing to the same extent, suggesting that budget and external deficits are identically twinned.

Yet fiscal measures which either increase public consumption directly, or represent spending on ‘social infrastructure’ projects that pay no rate of return (such as ‘free’ ceiling insulation for private dwellings), do not increase national output. Instead, budget deficits arising from such measures unambiguously reduce national income by the rectangular area, the servicing cost of additional net foreign borrowing required to fund them.

**Fiscal Stimulus with a Rising Supply Price of Foreign Funds**

So far, real interest parity has been assumed. Yet, under current global financial conditions, characterised by risk aversion on the part of international lenders, it is unrealistic to assume the economy enjoys unlimited access to world capital markets. We should more sensibly assume that the supply price of foreign funds is rising, due, for instance, to a risk premium, \( p \), increasing in the level of foreign debt, \( F \). Moreover, the willingness of foreigners to lend to the economy shifts due to other forms of risk, \( \varepsilon \), particularly the risk of future currency depreciation, such that

\[
r = r^* + \rho (F; \varepsilon)
\]

Accordingly, the economy is more likely to face an upward-sloping supply of foreign funds, as shown by the \( L^* \) schedule in Figure 2.

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8 That Australia’s long-term bond rates have been consistently higher than comparable rates in the US, the UK, and Japan — major sources of capital inflow — provides direct evidence of an interest risk premium.
Figure 2: Budget Deficits, Borrowing and Crowding Out

This more realistic extension of the standard loanable-funds framework may now be used to reconsider the effects of fiscal stimulus on real interest rates, private investment and national income. To do this, it focuses on fiscal expansion in the form of higher *unproductive* public spending.

**National Income Losses from Increased Government Spending**

Higher government consumption immediately widens the budget deficit which must be financed. Hence, the total demand-for-funds schedule shifts right, creating excess demand at the prevailing real interest rate. This raises the economy’s *ex ante* external financing requirement. At the same time, the debt-related risk premium rises, as foreign borrowing increases, other things being the same.
In turn, this higher interest rate feeds back to crowd out domestic private investment. Hence, unproductive public spending-induced deficits are matched \textit{ex post} by a combination of higher international borrowing and forgone private investment, as shown on the horizontal axis of Figure 2. This implies that budget and external deficits move in the same direction, but are no longer identically twinned.

![Figure 3: Explicit and Implicit Costs of Fiscal ‘Stimulus’](image)

Figure 3: Explicit and Implicit Costs of Fiscal ‘Stimulus’

Fiscal stimulus, either in the form of unproductive public spending or tax cuts and income transfers that lead to higher private consumption, confers both explicit and implicit national income losses. Income paid abroad is the explicit national income loss, and arises because additional borrowing has to be serviced at a higher equilibrium real interest rate following the fiscal expansion. In Figure 3, this explicit income loss directly resulting from the budget deficit (net of any private saving offset) is shown by the lighter shaded area. For an
external borrower country, any fiscal expansion deemed effective in stimulating consumption entails this hitherto acknowledged cost. But there is also an indirect national income loss. This is the national output forgone due to the loss of private investment crowded out by higher interest rates, and which is indicated by the darker shaded area.

Total national income lost due to consumption-enhancing fiscal stimulus is the sum of the two shaded areas.

**Conclusion**

This note has proposed an extended loanable-funds framework for examining the effects of fiscal stimulus on the budget balance, international borrowing, real interest rates, private saving, private investment and national income. It challenges the prevailing view that fiscal policy can be effectively used as an income ‘stimulus’ instrument, and proposes that discretionary fiscal measures that increase the budget deficit entail macroeconomic costs for significant external borrower economies, such as Australia, New Zealand and the United States.

Fiscal ‘stimulus’ in the form of unproductive government spending retards, not improves, national income growth for an economy reliant on international borrowing by raising the cost of capital, and crowding out private investment. The corollary for public policy is that cutting wasteful public expenditure will lower the foreign borrowing requirement and real long-term interest rates, thereby stimulating private investment and national income.

This is not to say that public spending on infrastructure can not positively influence national income in the same way as foreign-financed private investment does. However, additional public investment should be verified via rigorous project-by-project cost-benefit analysis and be as productive for the economy as the private investment it crowds out.

To further underline the need for productive investment, we need to realise that this critique of fiscal policy presumes the external borrowing and the matching current-account imbalance arising from ‘stimulus’ measures are sustainable in the sense that foreign lenders remain willing to lend the funds needed to satisfy the additional fiscally-induced demand. But foreign lenders’ perception of risk will eventually change at some point if external finance is persistently used to fund unproductive spending, defined as that spending that fails to create the additional output needed to service loans into the future.
At such time, foreign lenders could expect the exchange rate to depreciate. The foreign-lending schedule in Figures 2 and 3 would then abruptly shift upward, pushing long-term real interest rates even higher. This would further raise the servicing cost on existing and pre-existing foreign debt and crowd out more private investment, at greater cost to national income.

References


International Monetary Fund 2008, World Economic Outlook, September, IMF, Washington DC.


ARGUMENT
Abstract

Part IIIA of the Australian Trade Practices Act defines circumstances in which a facility owner may be required to provide a third party with use of its facility. This paper examines what Part IIIA might be doing from an economic perspective and criticises ‘monopoly leveraging’ arguments for third-party access. It argues that the transactions costs of access are potentially significant, and can exceed any efficiency gains third-party access permits. These contentions are corroborated by reference to the long-running dispute between the Fortescue Metals Group and BHP Billiton Iron Ore over access to rail track in the Pilbara region of Western Australia.

Introduction

In June 2004, the Fortescue Metals Group Ltd (‘FMG’) — then a purely speculative mining venture — applied under Part IIIA of the Trade Practices Act 1974 (‘the TPA’) for mandated access to a particular section of rail track in the Pilbara region of Western Australia. This track, referred to as the Mt Newman line, was to be used by FMG to transport ore from a prospective ore body that was too small to justify a dedicated rail link of its own. The railway facilities in question are owned and operated by BHP Billiton Iron Ore (‘BHPBIO’), and are used to transport millions of tonnes of iron ore from inland mines to specially-
built export ports on the Western Australian coast. BHPBIO’s total rail system in the Pilbara consists of over 1000km of track, and is capable of transporting in excess of 350,000 tonnes of iron ore every single day of the year.¹

Almost exactly five years later, FMG’s application is still undetermined, with the matter scheduled to be heard by the Australian Competition Tribunal towards the end of 2009. The time the proceedings have taken, and the enormous costs incurred in those proceedings, have created burdens on, and material uncertainties for, all the parties involved. In itself, however, it is neither exceptional nor reprehensible that such proceedings should be complex and prolonged: after all, the tracks are owned by BHPIO, and intruding on property rights is obviously a decision that should be taken with great care. But the proceedings have focused attention on the wide-ranging potential applicability of Part IIIA of the TPA, and the risks it creates for facility owners. It is therefore timely to examine the issue of third-party access, all the more so as Part IIIA is approaching the fifteenth anniversary of its enactment, meaning that sufficient experience has accumulated with its provisions to allow an assessment of its strengths and weaknesses to be made.

The objective of this article is to consider what it is that Part IIIA might be doing from an economic perspective, and what that tells us about when mandated third-party access might be efficient.

I start by considering the standard monopoly or ‘bottleneck’ explanations for refusals by a profit-maximising, vertically integrated monopolist to provide a more-efficient third party with access to a potentially shared input. I show that those explanations are rarely convincing, but that when they are, what is involved is a trade-off between productive efficiency gains the vertically integrated firm could make by ‘contracting out’ use of that input to the assumed more-efficient rival and a transactions costs loss associated with the monopolist’s inability to write contracts that could claim for itself the resulting gains from trade. I suggest that when that trade-off results in no access being provided (that is, a corner solution in which the monopolist sets the supply of third-party access services to zero), the most likely explanation is not monopoly, but rather that the transactions costs associated with access exceed any potential efficiency gains.

Assuming nonetheless that cases exist in which the monopoly explanation might hold water, I then examine third-party access from the perspective of the economics of property rights. This examination highlights how stringent are the conditions that must be met for the cure to be better than the disease. A particular focus of my discussion is on the extent to which access prices can

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¹ BHP Billiton, Annual Report, 2008: 37.
be relied on to support efficient, decentralised, decisions by the access provider and the access seeker about use of the shared facility; I show that particularly when access is to a facility that sits within an interdependent complex of facilities, no set of access prices may exist that can play that role. In those cases, there will be an ongoing need for centralised, administrative control of that shared use, much as would occur within a vertically integrated firm. I suggest that as a general matter those control functions will be most efficiently provided by the vertically integrated firm itself, but that creates risks that the firm will discriminate against (that is, ‘sabotage’) the rival. Attempts by the regulator to prevent such discrimination impose costs of their own, and in the presence of those costs, a welfare-maximising regulator would set relatively high access charges (as high access charges make discrimination less or un-profitable). The result is to further reduce the social gains from access, which are obviously even smaller if the regulator does not implement the welfare-maximising solution. The result is that mandated access can reduce welfare rather than enhance it. This suggests that stringent tests should be met before third-party access is granted. In a companion piece, I examine Part IIIA in the light of these findings and conclude that it does not provide a sufficiently stringent ‘filter’ against unwarranted extensions of mandatory third-party access.

At points in this article, I will illustrate my propositions by reference to material submitted in the lengthy proceedings between BHPBIO and FMG. I should stress that my purpose in doing so is merely to give some concreteness to the points made. I should also stress that I rely on that part of the material BHPBIO has filed that is in the public record. But, of course, that material has not yet been tested in court, at least as far as its economic substance is concerned. The reader should view this material with that caveat in mind.

**Part IIIA of the *Trade Practices Act 1974***

It is fundamental to our system of property law that a firm has a right to choose with whom it wishes to deal and on what terms. Thus, in *Colgate*, the United States Supreme Court stated that even a monopolist can ‘exercise his own independent discretion as to the parties with whom he will deal’. In this vein, the ownership of property brings with it a concomitant bundle of rights which include the freedom to exclude others from the property, to derive benefit from

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the property, to retain possession, and obtain legal redress for violations of that
possession. Of course, property rights have never been unqualified, and are
often abrogated for a public or private purpose.⁶

Part IIIA of the TPA is just such an intrusion into the property rights of firms.
Enacted in 1995, Part IIIA was one of several major competition law reforms
recommended by an Inquiry chaired by Professor Fred Hilmer.⁷ Given that I
discuss the detail of its provisions in the companion piece mentioned earlier,
suffice it to say that Part IIIA provides for mandated access to the facilities of a
firm where that access would meet a number of conditions and, in particular,
promote competition in a relevant market. That is, in broad terms, where
competition in a market is dependent upon access to a ‘bottleneck’ or ‘essential
facility’, the Part allows for imposing a right of third-party access to that facility
by means of ‘declaration’ of the service provided by that facility.

Obviously, declaring a service would seem of little use without concomitant
rights as to price and quality, as the access provider, who was being coerced
into providing access, would have incentives to increase the former and degrade
the latter. Thus, Part IIIA also establishes a mechanism by which the Australian
Competition and Consumer Commission (‘the ACCC’) arbitrates the terms and
conditions of access to declared services, should the access provider and the
access seeker be unable to reach a commercial agreement.

The stated objective of Part IIIA is to improve economic efficiency in the
provision of infrastructure inputs and, by doing so, promote effective
competition in upstream and downstream markets.⁸ Declaration, and the rights
and obligations that flow from it, are the key instrument by which it seeks to
achieve that objective.

To that end, what declaration does, in its substance, is to alter the relationship
in terms of legal rights in the supply of infrastructure inputs between the access
provider and the actual or potential access seeker. Thus, prior to declaration,
the extent of that relationship, if any, is based solely on commercial negotiation,
and the access provider has the option of entering or not entering into those
negotiations and, having entered into them, of agreeing or not agreeing to
access. In contrast, once the facility is declared, the access provider must enter
into negotiations over the supply of infrastructure inputs and is no longer free
to determine whether access will be provided and if so on what terms: in that

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⁶ For example, all legal systems have some mechanism by which the state can compulsorily acquire privately
owned land. Likewise, many legal systems, including Australia’s, have a form of private redress whereby an
owner of property can obtain an ‘easement’, by compulsion, over adjacent blocks — so as to provide access,
Drainage or similar.
⁸ The TPA, s 44AA.
sense, the option of access (that is, the right, but not the obligation, to make use of the facility) is shifted, at least in part, to the access seeker, albeit within the limits imposed by the outcome of any arbitration in the event of dispute.

As a result, the provisions of Part IIIA have two major effects. First, they create the scope to impose on owners of infrastructure inputs an obligation to supply third parties, with whom they might otherwise not have dealt, the services provided by those inputs. An owner and operator of a conveyor belt, which it uses in producing goods for sale to end-users, can, in other words, be obliged to supply ‘conveyor-belt services’ to a third party in circumstances where no such services might otherwise have been supplied.

Second, in imposing that obligation, Part IIIA replaces one mechanism or process generating outcomes (purely commercial negotiations between the potential access provider and the access seeker) with another mechanism or process generating outcomes (the ‘negotiate/arbitrate’ model that applies to declared services, in which the parties negotiate commercially for access, and should that fail, the ACCC can determine the terms and conditions of access through a compulsory arbitration).

**What is Part IIIA doing?**

As noted above, it is an important element of conventional property rights that they allow property owners to choose with whom they deal and on what terms. It is therefore worth standing back and asking exactly what Part IIIA might be trying to do, and whether that objective could be justified (and, if so, when).

In saying this, I recognise that to many readers, the answer will seem entirely obvious and, indeed, as having been stated above: Part IIIA is trying to address a problem of monopoly. The owner of the process referred to above — with the conveyor belt that it uses to produce goods (call them, as tradition requires, widgets) that it sells to final consumers — has, for some reason, a monopoly over conveyor belts (perhaps at a particular location); Part IIIA ensures that it does not unreasonably deny third parties ‘the right’ to use that conveyor belt; that is, that it does not use its monopoly in the upstream stage (conveyor-belt services) to exclude socially desirable competition in downstream supply (the sale of widgets). Seen in this perspective, the evil Part IIIA is designed to address is that of the incentive of monopolists to deny to otherwise efficient rivals access to ‘essential facilities’ that they control.

Of course, merely assuming that the widget supplier is a monopolist, simply because it refuses to supply conveyor-belt services, is completely unsatisfactory — for (as we will see below) there are many other reasons that might underpin
that refusal to supply, not least efficiency. And if it would be efficient to supply such services, then plainly a widget supplier that operated in a competitive market would have every incentive to do so: which means that if the market is competitive, then a refusal to supply can be presumed to be efficiency-enhancing. As a result, before falling back on the monopoly explanation, one would want to be convinced that there was indeed a monopoly facility there.

However, even if there was such a monopoly, the monopoly explanation is still unsatisfactory. In effect, no profit-maximising monopolist has a general incentive to refuse to supply: on the contrary, monopolists want to supply, albeit at a price that allows them to claim a greater share of the gains from trade than they could if buyers could turn to good alternatives. Why would a monopolist over conveyor-belt services refuse to sell those services at a monopoly price?

The answer that immediately suggests itself is that it would refuse to sell those services so as to support a monopoly price for the final good, in this case the widgets: put in the coloured language that is often used, the monopolist is seeking to ‘leverage’ its control over the essential facility into an unnecessary and socially undesirable monopoly in the potentially competitive downstream market. But this too seems puzzling.

It is puzzling because it suggests the monopolist forgoes potential gains from trade. Thus, one presumes that what we are interested in is efficient competition — after all, the objective of Part IIIA is to enhance efficiency, and if potential users of the conveyor-belt service are less efficient that the vertically integrated monopolist, then society can readily lose if that monopolist is forced to supply them with the service. But if the potential downstream rivals really are more efficient than the conveyor-belt monopolist in transforming conveyor-belt services into widgets, why wouldn’t the conveyor-belt monopolist simply charge those rivals a price for conveyor-belt services that captured at least some of the surplus from that superior efficiency? Why wouldn’t it, in other words, contract out to these more efficient ‘transformers’ the task of converting conveyor-belt services into widgets, claiming for itself as profit the resulting gain in productive efficiency?

One can construct situations in which the conveyor-belt services monopolist would want to exclude even efficient rivals from competing in parts of the widget market. The general structure of these situations can be illustrated by an example.

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9 There could, of course, be a trade-off here. Society might gain from an allocative efficiency improvement, if the entry of a competitor were to bring prices closer to marginal costs. However, if the entrant is less efficient than the incumbent, there is a productive efficiency loss. Impacts on dynamic efficiency could go either way. Usually, a productive efficiency loss will be larger than an allocative efficiency gain (rectangles versus triangles), so the trade-off would not favour access.
Thus, assume that due to differences in willingness to pay between end-consumers there are profits to be made from price discrimination in the market for widgets but that the monopolist cannot devise a non-linear price schedule for conveyor-belt services that fully extracts those profits through the sale of conveyor-belt services to potential downstream rivals. Even then, however, it is not apparent that the profit-maximising monopolist would generally refuse to supply such services (thus reserving for itself the entire downstream market). Rather, the logic would require it to segment the market by setting a high price for services sold to downstream competitors (the ‘access’ charge) while setting a low widget price to customers with a low willingness to pay, whom it would only serve itself, along the lines of the Alcoa case discussed by Perry (1980). In that way, the more efficient ‘transformers’ could at least serve the high-willingness-to-pay segment, with the conveyor-belt monopolist claiming through the ‘access’ charge some part of the additional profits from their superior efficiency, while the monopolist reserved for itself the low willingness to pay part of the market (and so did not entirely forgo whatever willingness to pay those customers had).

What is happening in this example (and is generally true in cases where some kind of exclusion of no less-efficient rivals by control over inputs is at issue) is that the conveyor-belt monopolist faces two distortions that prevent it from extracting all the surplus that might be available:

- The first is its own productive inefficiency, relative to potential downstream rivals, which makes those rivals more efficient ‘transformers’ of conveyor-belt services into widgets. The result of this inefficiency is that the monopolist, when it serves the downstream market, gives up some rents a lower cost monopolist could have obtained.

- The second is a transactions cost inefficiency, reflected in the monopolist’s inability to devise or implement the non-linear price schedule for the upstream input (in this case, conveyor-belt services) that extracts all the rents in the downstream market. (Transactions costs are the costs of search, information, bargaining, decision, policing and enforcement associated with rights and contracts that bear on rights. More specifically, transactions costs comprise the costs incurred by parties to a contract in order to find each other, exchange information, delineate the property rights to be transferred, draw up the conditions of the contract, signal preparedness to fulfil their obligations, monitor each other’s performance and otherwise see to it that obligations are fulfilled, and take action if obligations are not fulfilled.) The result of this inefficiency is that when the monopolist allows rivals to serve that market, it loses some rents that a no-transaction-cost upstream monopolist would have obtained through the optimal (profit-maximising) access contract.

Given these two distortions, the profit-maximising monopolist selects its own level of output, relative to that of these more efficient ‘transformers’ in a way that
balances the cost of each distortion at the margin. In other words, it increases sales of conveyor belt services up to the point where the gain it makes from claiming some of the cost reduction effected by the more efficient ‘transformers’ is just balanced by forgoing a share of rents it can obtain from serving the market itself (albeit at higher cost). Clearly, for the profit-maximising outcome of this balancing to be a corner solution — in which the monopolist sets sales of conveyor-belt services to the more efficient ‘transformers’ at zero, thus entirely forgoing the profits achievable through their superior efficiency — special assumptions are needed (for example, that the efficiency rents the monopolist can extract from the more efficient ‘transformers’ are not large enough to cover the product-specific fixed costs of supplying access to its conveyor belt as a marketable service: which suggests that requiring it to sell those services may not be efficient, a point I return to below).

As a result, the claim that the refusal to supply is an exercise of monopoly power should not be accepted without very close scrutiny. There is an alternative explanation, which in many situations will be more compelling (and require fewer special assumptions): the transactions costs of selling access exceed the potential efficiency gains.

Thus, all else being equal, wealth-maximising agents have incentives to replace higher transactions-cost contracts with lower transactions-cost contracts. The Nobel laureate Ronald Coase famously explained the formation and organisation of firms in these terms. Viewed through the prism of Coase’s formulation (Coase 1937), firms form when there is scope to replace high transactions-cost contracts for intermediate outputs (for example, a contract to operate a conveyor belt from A to B) with lower transactions-cost contracts for the primary inputs (including labour services) required to produce those same outputs. Once the firm has acquired the property right to those primary input services, it can direct the use of those services as flexibly as the contract for those inputs permits, which is usually assumed to be more flexibly than would be possible under an (arm’s length) contract for the intermediate services those inputs can be used to produce. This flexibility increases the wealth that can be produced from these inputs and in that sense creates a gain from trade.

However, primary input contracts also give rise to their own types of transactions costs, most notably principal/agent problems, with a classic example being shirking under labour contracts. This reflects the inherent incompleteness of contracts, which always leave some margins of use (or dimensions of the resources being traded) not fully specified and, in that sense, in the public domain. One

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11 Of course, this is provided that it does not give rise to other costs or reduce output. In other words, firms will economise on transactions costs in exactly the same way as they economise on other forms of costs, equalising the gains from doing so at the margin of cost-reduction efforts.
would predict that the bounds of firms’ activities will extend to the point where value of the increased flexibility from replacing higher transactions-cost contracts with lower transactions-cost contracts equals the increased costs associated with the ‘unexploited margins’ inherent in input contracts — see Barzel (1989) and Demsetz (1997).

It follows that if firms use primary inputs (such as labour, capital and raw materials) to produce intermediate input services (such as conveyor-belt services) that in turn serve to produce final goods (widgets), this may well be because producing those intermediate input services internally avoids transactions costs that would be incurred in buying them on the market — an inference that receives strong support from the empirical literature on the determinants of vertical integration, as surveyed by Lafontaine and Slade (2007). As a result, a candidate explanation for the refusal to sell ‘conveyor-belt services’ to third parties is that doing so would incur transactions costs penalties that exceed any potential efficiency gains.

However, even assume for the moment that the monopolist is in fact refusing to sell conveyor-belt services so as to support monopoly prices for widgets. This is still at best incomplete as an explanation or justification for Part IIIA.

In effect, the question that must be asked is why society would deal with the widget monopolist by forcing it to supply conveyor-belt services rather than by regulating the (assumed otherwise too high) retail price of widgets. There must be some efficiency gain from intervening in the upstream market, above and beyond whatever efficiency gains might be obtained by regulating downstream supply.

Presumably, this additional gain can take two forms. First, intervening in the upstream market may allow greater efficiency in the supply of ‘transformation’ services — that is, in the services of transforming conveyor-belt services into widgets. Second, it may be that it is easier to regulate the terms and conditions of supply for conveyor-belt services than for widgets — in other words, that the risk and cost of regulatory error is lower in setting prices and other supply conditions for conveyor-belt services than for widgets.

Whether either of these gains would be substantial is an empirical question. But one might well be sceptical that they would be. Starting with the social gains from allowing in more efficient ‘transformers’, surely the monopolist has every incentive to reduce the costs incurred by its own ‘conveyor-belt services’ division as much as possible. Moreover, if despite those incentives that division is materially less efficient than rivals, that would tend to make any refusal of supply unprofitable, as such a refusal would mean a greater sacrifice of potential profits. As a result, all else being equal, where there really are large differentials
in the efficiency with which ‘transformation’ occurs, refusals to supply would have to be unusual. This leads one to suspect that the extent of the first type of gain may not be all that great, at least where firms are indeed profit-maximisers.\textsuperscript{12}

As for the ease or difficulty of getting regulated upstream prices ‘right’ relative to the ease or difficulty involved in regulating the downstream price, typically, the supply of intermediate inputs produced within a vertically integrated firm involves higher transactions costs and contracting difficulties than the supply of that firm’s final goods and services. This follows directly from the standard explanation for the existence of firms just discussed. But if the firm is then obliged to sell those intermediate input services to third parties, presumably those transactions costs will need to be incurred (offsetting, and at least in some instances entirely negating, any gains from the scope for more efficient ‘transformers’ to enter the market). In contrast, the firm already sells widgets, and hence regulating the price of widgets (whatever other costs and distortions that may impose) will not require those transactions costs to be incurred.

Moreover, the risks and costs of regulatory error are not likely to be any smaller in regulating the supply of conveyor-belt services than in regulating the price of widgets — rather, the exact opposite would seem probable. Thus, with conveyor-belt services, the regulator will likely have less information and fewer benchmarks to go on, not least because those services are not traded. Moreover, the optimal charging structure for such services is likely to be complex, involving multipart prices that reflect the underlying structure of costs and of the downstream profit functions of the competing users.\textsuperscript{13} Devising both the level and the structure of such charges poses obvious challenges. And any errors in setting prices can cause social losses that are both high in themselves and greater than those arising from errors in setting final prices. This is because above and beyond any allocative inefficiency, which would likely also arise from price regulation of the final market, there will be an additional productive inefficiency loss across all of output when prices for intermediate inputs are incorrectly set (that is, a rectangle as well as the conventional triangle), as well as potential losses in dynamic efficiency from distorting the incentives for investment by both the access provider and the access seeker.

Additionally and importantly, mandated third-party access redistributes income between market participants — most obviously between the access provider (whose shareholders will generally lose from the mandated access requirement)

\textsuperscript{12} If firms are not profit-maximisers, as might be the case for government-owned businesses, then presumably the refusal to provide access is unlikely to be related to protecting monopoly profits downstream. That said, it might be due to protecting rents that are being taken in the form of unduly large ‘empires’, cross-subsidies to politically favoured constituencies or featherbedding in the labour market.

\textsuperscript{13} The downstream profit functions are relevant to determining the Wicksell-Lindahl prices that efficiently recover the common costs of the facility, assuming it has public or club good characteristics.
and the access seekers (which at least in the short run can hope to gain). The scope for such redistribution can create formidable incentives for ‘rent seeking’: that is, the making of investments aimed not at expanding society’s capacity to produce, but rather at securing for oneself a larger share of any economic rents that may be available. These incentives are especially strong where the redistributive effects involve narrow groups, as will be the case in instances involving third-party access (since at least in the first instance, the redistribution third-party access effects is a small numbers situation involving the access seeker(s) on the one hand and the access provider on the other), for then the risk of free-riding does not undermine the ability of the affected parties to mobilise resources and make rent-seeking investments. However, since those investments are a cost (they absorb resources that could have been put to productive use elsewhere), but themselves do not increase output, they amount to a pure waste of society’s scarce resources. Economic theory predicts that such rent-seeking can waste up to (and in some cases even more than) the available rents.

As a result, while all forms of regulation impose costs — so that the distortions arising from ‘government failure’ may be no less than those of ‘market failure’ — the costs of access regulation can be especially high. It would consequently be wrong to presume, much less act on the assumption, that access regulation will deal with any market failures at lower social cost than would arise from not regulating at all or (should regulation be absolutely required) from regulating only in the final product market.

In short, monopoly explanations, to paraphrase George Stigler, have powerful sway over untutored minds. But looked at closely, the monopoly explanation for Part IIIA is not all that convincing, and many assumptions need to be made before it seems likely that profit-maximising monopolists would refuse access entirely, and do so in circumstances where mandatory access would provide an efficient remedy.

**Another view of the cathedral**

As noted above, Part IIIA does not merely make it possible to impose on owners of infrastructure inputs an obligation to supply third parties, with whom they might otherwise not have dealt, with access to the services provided by those inputs. Additionally, in imposing that obligation, Part IIIA also replaces one mechanism or process generating outcomes (purely commercial negotiations between the potential access provider and the access seeker) with another mechanism or process generating outcomes (the negotiate/arbitrate model that applies to declared services).
As a result, another way of looking at what Part IIIA is trying to do (and whether and when it might be justified) is to ask: ‘Under what conditions will purely commercial bargaining between the potential access provider and the access seeker fail to achieve efficient outcomes, and justify being replaced by a mechanism based on some form of collective fiat?’

Now, the purely commercial bargaining between the potential access provider and the access seeker is based on the access provider’s property rights, including (to continue my earlier example) over its conveyor belt, and involves the willingness or otherwise of the access provider to sell some part of that property right to the access seeker. Whether that bargaining will yield efficient outcomes therefore depends on the factors that affect the efficient allocation and reallocation of property rights.

In considering these factors, it is useful to start from the economics of property rights, as it has emerged from the work of Ronald Coase.\(^{14}\)

From an economic perspective, a property right is a right to determine the use to which an asset will be put, including the right to transform or transfer the asset. In addition, it entails the right to the residual income generated by that asset. Clear property rights bring many benefits, most significantly the incentives to maximise the net wealth generated by an asset through expansion, contraction or disposal decisions (Demsetz 1967; Alchian 1977; Barzel 1989). At the same time, by vesting decision rights in an owner (or a clearly defined group of owners), properly specified property rights allow wealth-maximising decisions to be taken quickly as economic conditions change. They also create the conditions for rights to be traded, which permits collections of related assets to be brought under common ownership, minimising ‘spill-overs’ or unpriced interactions between separate rights owners (which would otherwise give rise to inefficient decisions, as decision-makers would not face the full costs and benefits of their decisions). The scope for such aggregation of rights is also crucial in permitting production at efficient scale and scope.

Following Coase (1960), if in a two-party framework a property right is well defined and the initial holding of that right is clear, then the right will end up with the party able to achieve the highest net wealth, regardless of whether that wealth-maximising party is the initial holder or someone who buys if from the initial holder, provided that there are no transactions costs and no wealth effects.\(^{15}\) This result is quite independent of market structure: a monopolist

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14 Coase compared a situation in which property rights were poorly specified, or (for particular aspects of a transaction, such as the sparks generated by a train passing on rail lines) not defined at all, with a situation where property rights were fully specified. Calabresi and Melamed (1972) extended the discussion to deal with different types of property rights.

15 This is the celebrated Coase theorem, put broadly in the form framed by Stigler (1966) and endorsed by Coase (1988a: 157ff). It follows that (assuming no transactions costs and no wealth effects) the use of the assets
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has every bit as much incentive to seek more efficient uses of resources as has a competitive firm and in a world with fully specified property rights and no transactions costs, full efficiency would prevail, regardless of market structure.

In practice, however, transactions costs are never zero. The presence of transactions costs means that contracts can never be ‘perfect’. It also means that property rights are never fully specified: there are always some goods or attributes that are left ‘in the public domain’, either because there is no practical way of metering them or because the costs of establishing and enforcing property rights over them exceed the benefits.16 These ‘unpriced margins’ (in the sense of goods that individuals can claim for themselves without facing the opportunity cost of their doing so) are then allocated by non-market means, such as the ‘first come, first serve’ competition for the best seats at a cinema. The resulting allocations — such as those that occur through queuing — may be inefficient, though there remains the question of whether the gains from attempting to cure the inefficiency by creating a property right over that ‘unpriced margin’ would exceed the costs (see generally Parish 1980, and Barzel 1982 and 1989). ‘Externalities’ and other third-party effects are merely one form of such an unpriced margin.

Transactions costs and unpriced margins can result in forgone opportunities for efficiency-increasing reallocations of rights. Familiar instances include the difficulty of negotiating to a wealth-maximising outcome in the presence of diffuse externalities, such as air pollution, noise pollution or road congestion. In these instances, the unpriced margins are dissipated by over-production, and involuntary over-consumption, of the relevant external effect, with transactions costs being too high to allow coalitions of the producers and consumers of those effects to negotiate their way to a more efficient use of resources. In conventional monopoly pricing, a related but somewhat different form of transactions cost leads to the inefficiency: the inability of the monopolist to determine and impose on customers prices that extract the entirety of their willingness to pay for the good the monopolist controls. The result, most evident when the monopolist is constrained to linear (that is, uniform) prices, is under-use and a deadweight loss, with some potential gains from trade being forgone and too little consumption of the monopolised good.

This suggests that there are two possible reasons why purely commercial negotiations between an access provider and one or more potential access seekers could fail to achieve an efficient outcome.

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16 In respect of some goods — such as one’s own body and elements thereof — there are also ethical (that is, non-consequentialist) reasons for not creating conventional property rights.
The first is that the parties at issue — the potential access provider and the aspiring access seeker — may not bring to the negotiation all of the social benefits and costs of a potential reallocation of property rights. There may, in other words, be third-party effects that are unrepresented in the negotiation, and that drive a wedge between the interests taken into account in the bargaining and society’s interests overall. The most obvious such third-party effect arises when the benefits of access would flow to final consumers, in the form of lower prices or higher quality, so that the total gains from access would exceed the gains accruing to the negotiating parties. Those parties might then fail to reach agreement (or agreement on reasonable terms), even though such an agreement would yield social benefits in excess of its costs. Of course, whether such additional gains are there to be had depends on all the issues reviewed above in discussing the ‘monopoly’ view of third-party access.

Second, even if there are no third-party effects, so that the interests represented in the bargaining capture all of the relevant gains and losses, other transactions costs may nonetheless prevent an efficient outcome being achieved. The transactions costs most relevant here are likely to be those associated with information asymmetries. These arise when one party to a (potential) bargain has more or better information than another. Information asymmetries will, as a general matter, limit the efficiency of bilateral bargaining (Wilson 1998). More specifically, the respective parties may not know the costs and benefits the other would secure from an agreement, and have incentives to misrepresent those costs and benefits in ways that impede, and can entirely prevent, agreement from being reached (Roth 1985). It is therefore not uncommon for ‘money to be left on the table’ in commercial negotiations, with the resulting losses taking the form of strikes, costly legal battles, or simply lost opportunities.

The question of how society might deal with these inefficiencies — when they engage wider social interests — was central to an important extension of Coase’s work on property rights by Calabresi and Melamed (1972).

In that article Calabresi and Melamed defined a ‘property rule’ as a rule which granted the owner of property the right to preclude others from impinging on that property. Thus, the beneficiary of such a rule would have a right to prevent (for instance, through injunction) another party from engaging in conduct that would impose on that property a cost or other adverse effect. Given that right, the owner would then have the option (but no obligation) to negotiate with the other party for compensation in exchange for giving that party a more or less limited right to impose that third-party effect; it would, in other words, have the ability to sell, in whole or in part, its right to be free of the third-party effect, but
would be under no compulsion to do so. If it did so, and set the compensation efficiently (so that, at the margin, it signalled the cost or benefit associated with the externality), this would align the parties’ respective interests.\textsuperscript{17}

However, as Calabresi and Melamed noted, the consequence of relying solely on such property rules is that some potentially wealth-maximising reallocations of rights might not occur, because the transactions costs to the parties of negotiating and implementing those reallocations are too high.

One response to this, they suggested, is to replace the property rule (which allows the party owning the property to enjoin the other party’s non-consensual use of its asset) with a ‘liability rule’. Calabresi and Melamed defined such a ‘liability rule’ as one which allows one party to act in a way harmful to another in exchange for a compensating payment as determined by a third party, such as a regulatory agency or a court. The option of imposing costs is then shifted to the potential infringer, but subject to a mechanism which requires a compensating payment; that is, faces that infringer with the equivalent of a market price for the cost-imposing action (such as emitting pollution, or running trains that set off sparks, occasionally causing fires in adjacent pastures). They then argued that such liability rules should, from an efficiency perspective, be relied upon when at least two conditions are met:

1. Transactions costs will prevent wealth-maximising reallocations of rights from occurring under an approach based on property rules alone; and

2. A liability rule, and especially the conditions associated with that rule (including payments for costs imposed on the rights-owner), can allow those transactions to occur in a way that, given the costs and benefits of the rule, on balance increases society’s wealth.

In other words, as Calabresi and Melamed stressed, the decision to rely on a liability rule requires an assessment of which of market transactions or collective fiat is most likely to bring the allocation and re-allocation of rights closer to the Pareto-optimal result the ‘perfect’ market for rights would reach.

Seen in the perspective of Calabresi and Melamed, third-party access regimes, such as Part IIIA, convert a property rule — under which the owner of a facility can choose whether or not to allow third-party use of that facility — into a liability rule.\textsuperscript{18} Under that liability rule regime, the option of using a facility is transferred from the property owner to one or more potential users

\textsuperscript{17} An important extension of Calabresi and Melamed that explains the shifting of rights that occurs through liability rules in terms of options contracts is in Ayres (2005).

\textsuperscript{18} See Ergas 2008.
under conditions that include liability to make a payment for that facility’s use. Such conditions would also include the procedure or mechanism whereby the payment is (in the event of a dispute) determined by an independent third party.

As a result, the question in assessing third-party access must be whether the conditions Calabresi and Melamed identified as justifying the imposition of such a liability rule are in fact met.

‘Market failure’ versus ‘regulatory failure’

Before turning to consider that question in the specific context of Part IIIA, it is worth paying closer attention to the second leg of the Calabresi–Melamed conditions: whether a liability rule, managed by a regulator or a court, can be expected to achieve the potential Paretian improvements in the allocation or usage of property rights when private bargaining fails to do so. The question to be addressed here, in other words, is: ‘Can the liability rule fill the gap efficiently?’ It is easy to blithely assume that regulatory processes, despite their recognised imperfections, can ‘clean up the mess’ in situations where private bargaining fails; but the reality is that numerous and important obstacles may prevent this from occurring.

The obvious obstacle to the liability rule succeeding in improving on private bargaining is the fact that information is inherently imperfect and asymmetric as between the regulator and the owner of the facility to be regulated. Indeed, though the regulator may be able to rely on its powers to compel the production of information, the underlying differences in knowledge and understanding between the regulator and the regulated are likely to be at least as great as those between the commercial parties.

It is a familiar result in the modern theory of regulation that from an efficiency perspective, an imperfectly informed regulator, operating in circumstances where a high weight must be placed on ensuring the regulated firm continues to produce, should set the cap that controls the firm’s prices in such a way as to allow the regulated firm the expectation of substantial economic profits (see Gasmi et al. 2002). Gasmi et al. also show (Table 7.12) that when the regulator is not certain as to costs (including the appropriate rate of return), price caps are the optimal regulatory mechanism, even though they allow firms to earn above normal earnings (p.180; a price cap with a profit tax is superior to a price cap on its own, but the main effect of the profit tax is to increase consumer welfare: it reduces the firm’s profitability only moderately). And the greater the gap in information between the regulator and the regulated, the greater the ‘information rent’ it is efficient for the regulator to allow the regulated firm.
For reasons noted above, these issues of information imperfections are likely to be especially acute in respect of intermediate input services, such as the conveyor-belt service our hypothetical widget monopolist supplied to itself. This sets inherent limits on the extent to which regulation can eliminate the vice of monopoly pricing in respect of such services. Moreover, it is plain that a reluctance by the regulator to allow those ‘information rents’ to be claimed by the regulated firm can be even worse than allowing the firm to set the unregulated, monopoly, price, as it can lead to regulated prices that undermine the incentives to produce and invest (and hence sacrifice both the consumer and producer surplus).

**Limitations on the price mechanism**

However, the difficulties facing the liability rule may be even more serious than conventional discussions of information imperfections suggest.

Especially important in this respect are the inherent limitations of price systems. Of course, economists are (quite properly) great admirers of the price system, and usually assume that reliance on price signals can allow decentralised decisions to secure efficient outcomes. That prices should be able to do so is central to the efficiency of the liability rule, as the rule essentially involves setting a ‘price’ that signals to the cost-imposer the social costs of its actions. For example, when a liability rule is imposed on a polluter, requiring that polluter to pay those adversely affected a ‘price’ equal to the marginal social cost of pollution, this allows the decentralised decision-making by the polluter on the one hand, and the victims of pollution on the other, to achieve efficient levels of pollution, thus securing the potential gains from trade in pollution rights. Equally, an efficient price for third-party access to an ‘essential facility’ supports decentralised decision-making about the supply and use of that facility, allowing the access provider to take efficient decisions about the level of investment in access-related facilities, while allowing the access seeker to determine its level of use of those facilities in the light of its own costs and downstream demands (which it knows but the other parties do not).

However, it is an obvious mistake to imagine that such an efficient ‘price’ mechanism always exists. Indeed, it follows from Coase (1937) that the fact that activities are organised within a firm — that is, through a system of contracts for input services, rather than through contracts for outputs — in itself suggests that devising a price system that could efficiently coordinate those activities is uneconomic. As an influential text on organisational control (Sunder 1997: 45) notes, this explains the very limited use firms make of transfer prices as a way of coordinating their internal activities:
The transfer pricing problem is often stated in a manner that ignores the circumstances that give rise to the problem in the first place. Integration of the two divisions [used in setting out the simplest version of the problem] into a single firm is predicated on the cost of market exchanges between them being greater that the administrative and agency costs. After integrating two divisions under this rationale, one cannot then turn around and wish the administrative and agency costs aside through an appeal to a costless but non-existent system of market exchange.\(^\text{19}\)

Part of the problem is that where demand and cost structures have particular characteristics, it can prove impossible to define a resource allocation process that is both:

(a) decentralised, in the sense of requiring only:

i. that each firm have information about its own production possibilities, as against also knowing the production possibilities open to other firms; and

ii. that each firm’s message at any step should concern its own proposed actions at that step, as against also concerning the proposed actions of other firms at that step; and

(b) will result in efficient use of the resources being allocated (Heal 1973: 142ff).

Thus, it is well known that where production systems involve chains of processes, with each link in the chain being ‘lumpy’, in the sense that investments involve minimum increments of fixed, often large, size, efficient investment and use decisions may not be made without some degree of coordination, above and beyond that provided by price signals (Heal 1973: 142ff; Schelling 1983; Roberts 2004: 51ff; and, for a specific application to rail networks, Quinet 2003).

This is because decisions taken under those circumstances depart from two crucial assumptions conventionally made in economic models of decentralised choice of output and investment:

• that the set of alternatives is convex, which means that if two choices are available, any combination of those choices (that is, any intermediate point) is also available; and

• that the objective function (that is, the function that measures how outcomes, such as profits, vary depending on the decision taken) is concave, which means that if two choices lead to the same outcome, then a combination of

\(^{19}\) Obviously, firms use transfer prices for other purposes, such as determining tax liabilities. However, according to Sunder, they play a limited role in guiding resource-allocation decisions.
these choices would lead to a higher outcome (so that the objective function looks like a smooth climb to, and descent from, a single peak).

As Roberts (2004) explains, when both these assumptions hold, there is a single optimum. Moreover, that optimum can be found by exploring small variations around the current point, as a simple rule can be followed: change any dimension of performance, and if that change improves performance overall, continue to change it in the same direction until the improvements become smaller than the costs. As a result, it is easy to decentralise decision-making through the price system, allowing each unit to explore the options and assess the impact on its performance, without losing overall efficiency.

However, where investment decisions are indivisible (one cannot continuously vary the number of tracks, mines or ports), the set of alternatives is non-convex. For the same reason (and because of increasing returns to scale associated with redundancy in capacity), the objective function is non-concave. Put in practical terms, this has two implications.

The first is that there may be multiple outcomes that are ‘local’ equilibria, in the sense that small variations around those outcomes will result in worse performance. As a result, any decentralised process that involves individual decision-makers ‘exploring’ whether performance would improve by making slight changes around an initial position will not be able to identify the global (that is, overall) optimum — that is, the configuration of assets that maximises the value of the system as a whole.

Second, changes in any one dimension of the system at a time may not suffice to indicate whether that dimension should in fact be varied; rather, finding the optimal configuration requires changing (or at least modelling changes in) all aspects of the chain at once.

As a result, there is a need for some non-price-based mechanism that coordinates investment, production and use along each of the links in the chain. It is this that administrative coordination through vertical integration within the firm provides.

**Contractual incompleteness**

Moreover, these difficulties in determining prices that can support decentralised decision-making are compounded by problems of contractual incompleteness. This refers to the difficulties of devising and enforcing agreements that would manage shared use of the firm’s common resource (that is, our hypothetical conveyor belt) efficiently. Three problems are likely to be especially acute:
(a) Any agreement may not be able to fully control for the quality of the access seeker’s use of the facility — the access seeker may, in particular, have the incentive and ability to reduce its own costs at the expense of degrading the facility or otherwise increasing costs to the facility owner. The impossibility of negotiating and enforcing complete or ‘perfect’ contracts and of setting fully efficient decentralised prices can, in other words, give rise to a ‘tragedy of the commons’, in which access seekers exploit any unpriced margins in a way that reduces the aggregate value of the shared assets (Barzel 1989).

(b) The relation between the access seeker and the facility owner may give rise to hold-up risks, particularly if the access seeker can impede the facility owner from responding to changes which require alteration to the pattern of facility use (Pirrong 1993). These hold-up risks can invite otherwise inefficient ‘counter-measures’ by the facility owner, such as investing in excess capacity (so as to have more of a ‘shock absorber’ in the event of disagreements about facility use) or, conversely, restricting capacity below efficient levels, if that allows the access seeker to be ‘rationed off’ the system.

(c) Further hold-up risks can arise in the investment process, to the extent to which that process becomes vulnerable to being hindered (for instance, through regulatory delays) by the access seeker. These risks are a form of what is now often referred to as the tragedy of the ‘anti-commons’, in which vesting veto rights in parties, each with incentives to act opportunistically in seeking for themselves a greater share of the joint pie, prevents efficiency-enhancing transactions from being undertaken (Heller 2008).

Controlling these risks, too, requires both considerable information — imposing an information collection, verification and analysis burden — and an authoritative process for resolving inevitably conflicting ‘stories’. Of course, similar needs arise, by the nature of the situation, within the vertically integrated firm; but there is, then, a greater alignment of interests between the parties, and a greater subjection by those parties to common hierarchical control, than is the case in the relations between the access provider and the access seeker.

20 This reflects the difficulty of defining the service in terms that are readily verifiable — the ‘state verification’ problem (Hillier 1997: 57ff), which then gives rise to wealth-reducing use (Barzel 1989: 13ff; Barzel 1982).
Problems evidenced in BHPIO/FMG

Both of these factors that can undermine the efficiency of the price mechanism (and hence of the liability rule) — the impact of non-convexities on the existence of a price-based, decentralised decision-making process, and the effects of contractual non-completeness — can be acute in the supply of intermediate input services. Indeed, BHPIO’s evidence in the proceedings engaged with FMG is suggestive of these problems, though it needs to be remembered that this evidence has not yet been tested in court.

There is, for example, evidence on the public record suggesting that the Mt Newman line and BHPBIO’s production system more generally are characterised by significant complementarities and indivisibilities:

- Interdependencies between the wheels of the rolling stock and the track profile point to the existence of cost complementarities between BHPBIO’s above- and below-rail inputs. This is consistent with the results of empirical studies of freight railways more generally, where similar cost complementarities have been identified (see, for example, Ivaldi and McCullough 2001).

- Other cost complementarities arise at an aggregate level between different activities that form part of BHPBIO’s integrated operations, such as mining, loading/unloading, railing and port operations. Complementarities between activities give rise to ‘system effects’, so that the whole is more than the sum of the parts

- Supply indivisibilities arise at all levels of the production system, so that investment can only take place in substantial, discrete increments. For instance, a train comprises a minimum number of locomotives and ore cars, and loading and unloading processes require substantial infrastructure units. Given these conditions, it is not obvious how any decentralised price system can be designed that will coordinate efficient use as between the access seeker and the access provider.

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21 The fact that there are interdependencies at the wheel–rail interface is apparent from discussion in the Ridley Affidavit, 4 October 2004, ¶4.3, which discusses wheel and rail interaction, as well as ¶6, which notes the related costs that would be incurred with third-party access. These interdependencies are also noted in CRA, FMG Application to Access Mt Newman Railway Line under Part IIIA, 3 June 2005, ¶259–260, and reflected in ¶269–271. Cost complementarities arising at the aggregate level are reflected in discussion in the Price Affidavit, 23 December 2005, ¶4–10, which describes the role of the Integrated Planning Group, as well as ¶11–14, which describes the integrated nature of BHPBIO’s operations; the Hoare Affidavit, 22 December 2005, ¶12–47, which describes BHPBIO’s mine, rail and port operations; the Monkhouse Affidavit, 23 December, 2005, ¶8–12, which discusses the strategic importance of integration of main, rail and port operations; and the Ridley Affidavit, 4 October 2004, ¶2.5–2.9. These complementarities are also noted in BHPBIO’s Submission to the National Competition Council, 3 June 2005, ¶60–70.
At the same time, BHPBIO has pointed to problems that, seen from an economic perspective, involve contractual incompleteness and suggest a risk that access would give rise to ‘unpriced margins’ that could be exploited by the access seeker to inefficiently impose costs.

Thus, issues related to quality monitoring arise at the wheel and rail interface, where careful management is central to improved operational efficiency — for example, as a result of reduced incidences of track defects and derailments, and longer-term efficiencies from reduced repair, maintenance and investment costs. Thus, BHPBIO may not be in a position to monitor whether or not a third party’s rolling stock conforms to BHPBIO’s wheel profile, or to monitor ongoing compliance over time. The inability to monitor key performance aspects of the third party’s train operations extends to other operational aspects of the Mt Newman line, such as maintenance standards, train-loading standards and train-driver conduct.22

Equally, in a day-to-day context, hold-up risks could occur because of the considerable external and component variability that characterises all aspects of the operations of the Mt Newman line.23 Irrespective of its cause, flexibility in the operations of the Mt Newman line, and in particular the flexible sequencing of trains, is said by BHPBIO to be central to managing system variability.24 As a result, a requirement to secure agreement from an access seeker to vary the transportation schedules would offer that access seeker ongoing leverage to extract ‘rents’ in return for agreement to such deviations.

Finally, further hold-up and hold-out risks could arise in areas where third parties are in a position to hinder investment initiatives that would deliver greater operational efficiency, reduce failures and delays and improve rail safety. Many research projects (such as changes to the wheel–rail interface, signalling or control systems, train management and scheduling) require the full cooperation of all third-party users in order to be effective.25 To the extent that some such advances involve disruptions to, or reorganisation of, the rail

22 The careful monitoring and management required at the wheel–rail interface, as well as in other aspects of the BHPBIO’s rail operations, can be inferred from discussion in the Ridley Affidavit, 4 October 2004.
23 Variability in mining operations arises from operational differences at the mines, such as limited stockpile space or longer load times. Factors that cause variability at port are ship arrivals, ship-loading constraints, stockpiling constraints, interactions between reclaiming and stockpiling equipment, or high demand for a specific product. The variability inherent in the BHPBIO system, and the implications for BHPBIO’s operations, are noted in the Ridley Affidavit, 22 December 2005, ¶24 and ¶43–53. The impact of variability on BHPBIO’s integrated mine, rail and port system are discussed in the Hoare Affidavit, 22 December 2005, ¶20–37.
24 The Price Affidavit, 6 September 2004, ¶5.1–5.40, describes the system used by BHPBIO to minimise and control variability. Section 6 of this affidavit notes the importance of maintaining flexibility in the rail component of the overall system. The importance of system flexibility is also noted in CRA, FMG Application to Access Mt Newman Railway Line under Part IIIA, 3 June 2005, ¶261.
25 That these types of research projects require the full cooperation of all third-party users in order to be effective can be inferred from discussion in the Ridley Affidavit, 4 October 2004.
system, they would require negotiations with, or even the consent of, third parties. Additionally, innovations such as the introduction of driverless trains could only be implemented if all users of the rail system incorporated the new technology.

The continuing need for central administrative control

Combined, these features limit the extent to which a pure liability rule, which centres on determining a Pigouvian charge that can support decentralised decision-making, could be made to efficiently ‘fill the gap’ (if there is one) relative to private bargaining. Rather, where supply-side non-convexities and contractual incompleteness limit the effectiveness of the price system, resource allocation will need to rely on some type of administrative mechanism that allocates capacity, authoritatively controls use of that capacity and determines investment decisions (given that those decisions have consequences for both parties). Whatever pricing mechanism there is, in other words, would have to be supplemented by extensive non-price direction and administrative control, much as happens within the vertically integrated firm.

However, the design of such a parallel administrative mechanism involves obvious problems of its own, including those of truthfully eliciting the information required and then enforcing whatever outcomes the mechanism results in. It also raises the difficult question of who should run this mechanism on a day-to-day basis. Clearly, the access provider seems by far the best-placed party to do so, both in terms of information and incentives (given that it has most at stake in the efficient management of the assets, which, after all, it owns). However, if the right to administer this process is vested in the access provider, then there must be the risk that the ‘system administrator’ will have incentives to discriminate against the access seeker, giving rise to further transactions costs as and when any conflicts occur and are dealt with, and to potential inefficiencies.

Dealing with these incentives for discrimination then brings us to another important finding of the modern literature on efficient regulation.

The standard analysis of the problem of vertical discrimination in access situations shows that whether vertical discrimination is profitable for firms depends on the specifics of the case (see Mandy and Sappington 2007, section 1, which provides citations to the literature):

• When the effect of the discrimination is to increase the costs of the (otherwise efficient) rivals to the vertically integrated firm, there is, at any given price, a reduction in output and part of the retail demand shifts toward the vertically
integrated firm (some of the retail demand may shift to a third party and some may be lost, as is the case if there is some product differentiation).

• However, this reduction in output also reduces demand for the vertically integrated firm’s wholesale services, but in general by more than the gain in retail sales.

The net effect on the vertically integrated firm's profits, assuming wholesale service prices exceed short-run marginal costs (that is, make some contribution to total costs), is ambiguous, and so specific analysis is required for each given situation (though, Mandy and Sappington (2007) show that in telecommunications at least the likelihood that demand-reducing vertical discrimination is profitable is small).

It is also the case that the vertically integrated firm’s revenue losses from engaging in vertical discrimination increase with the difference between the wholesale price and short-run incremental cost. Thus, the larger this difference, the less likely it is that a discriminatory action that causes a given increase in rivals’ costs (which reduces wholesale demand) is profitable, and, hence, the less attractive is discriminatory behaviour (as the effect of that behaviour is to increase rivals’ costs or reduce their revenues). If, however, the wholesale margin is negative, then there is no ambiguity — raising rivals’ costs, unless that is a costly exercise, is profitable. In short, the higher access prices are set, the less likely it is that vertical discrimination will be profitable (as that discrimination causes the vertically integrated firm to forgo some profitable wholesale sales).

This, however, is only part of the story. In the present context, the regulator wishes to achieve two objectives:

1. set a cap over access prices that provides appropriate investment incentives without granting the firm unnecessary profits; and
2. prevent (to the extent that this is an issue) non-price vertical discrimination.

It is likely that efforts spent on preventing excess profits and non-price vertical discrimination both have positive, diminishing marginal benefits and at least constant, if not increasing, marginal costs. At the same time, by the proceeding analysis, there is a natural effort substitutability between the actions the regulator can take. For example, a larger gap between access price and cost reduces the profit gained by discriminating against downstream rivals, and so reduces discrimination. In this circumstance, the important result derived by Holmstrom and Milgrom (1991) shows that an efficient regulatory response is to reduce the harshness of the controls over monopoly pricing so as to obtain optimal incentives to avoid vertical discrimination. In other words, in the presence of costly information about conduct, the risk of discrimination can be reduced by reducing the severity of controls over monopoly pricing, as higher access charges themselves are an instrument for preventing discrimination.
Two further factors reinforce this effect. First, the need to ensure appropriate investment incentives complements the regulator’s desire to reduce vertical discrimination, and this favours accepting more generous access-price regulation (such as a more lenient price cap). Second, many efficient actions may well appear discriminatory (for example, it is difficult to determine whether the vertically integrated firm faces lower costs because vertical integration is efficient, or because it discriminates against other firms). Distinguishing ‘discriminatory’ from ‘efficient’ responses to situations involving disputed use of shared facilities is likely to be even more difficult than securing accurate information about costs. As a result, there are likely to be high costs (including as a result of error) associated with enforcing non-discriminatory regulations, even in vertically separated firms (which may still discriminate through contracts and understandings).

It follows that the optimal stance of policy in these circumstances is to err on the side of allowing relatively high access prices (or equivalently, accept relatively lax access-price regulation), as such a stance:

(a) In itself, is a cost-effective approach to reducing the risk of discrimination while preserving efficiencies of vertical integration; and

(b) Is consistent with the need to provide credible incentives for investment and avoid or mitigate the risk of ex post expropriation of investors’ sunk costs.

The other way of putting this is that because a perfect ‘price only’ system for allocating the resource cannot be devised, some form of administrative allocation must also be used. However, that administrative allocation inevitably involves some risk of non-price discrimination. That non-price discrimination has an unavoidable efficiency cost, some part of which is most efficiently taken in the form of a higher access price than would prevail were there no possibility of discrimination. Combined, the higher access price and the remaining risk of distortions due to discrimination then whittle away at the net gains, if any, from the liability rule.

**Summary on ‘regulatory failure’**

In short, it is simply a mistake, from an economic perspective, to assume that the types of decisions that are taken administratively within the vertically integrated firm — in determining investment, managing asset availability and selecting efficient levels of output — can readily be solved in the liability rule by the device of a decentralised pricing process based on the access charge. While there may be instances in which that is possible, it will not be if the
production processes at issue are characterised by the non-convexities and imperfect contracting problems highlighted above. It seems reasonable to think that these features will be common in the sorts of situations that give rise to access disputes.

As a result, a liability rule, rather than allowing potential Pareto gains to be achieved, may well struggle to do no worse than private bargaining, even accepting that private bargaining will be imperfect. It may, in particular prove difficult to:

• Devise a price system for allocating the shared resource that is consistent with cost optimisation and efficient investment signals in the presence of imperfect information on the one hand, and indivisibilities and complementarities in asset structures on the other;
• Control the costs and distortions associated with ‘unpriced margins’ and opportunistic behaviour by the access seeker;
• Design an administrative system of resource allocation that both vests control of that system in the party best placed to control it, and avoids the high costs of possible discrimination over the non-price terms of access.

These difficulties, individually and together, give rise to real costs, which must be taken into account in considering whether social efficiency would be enhanced by replacing a property rule by a liability rule. There must, in other words, be a material likelihood that the ‘regulatory failure’ associated with mandated access will be more costly than the ‘bargaining’ or ‘market’ failure it is seeking to correct.

Conclusions

Seen in international perspective, Part IIA is unusual. No other OECD country has a generic, economy-wide, provision of this kind, though many impose third-party access requirements in particular regulated industries, and a few (essentially the US and to a limited extent the EU) have some scope for the courts to mandate third-party access as a remedy under the competition laws.

Moreover, mandatory third-party access is an unusual, and in many respects especially invasive, form of remedy. In particular, while most liability rules provide for occasional and largely incidental incursions on a property right (Ellickson 1993), third-party access effectively converts the access seeker into what might be regarded as a joint tenant with the access provider. However, it does so in circumstances where, almost by definition, the parties have sharply
divergent interests, differing views of the world, and (given the scope for gaming associated with ongoing regulatory intervention) limited ability to make credible long-term commitments to one another.

As a result, where efficient use and investment requires many joint decisions to be taken, a substantial — and potentially impossible — burden of conflict resolution is likely to be placed on the regulatory apparatus, which must seek to discharge that burden in a situation where each party can have strong incentives to distort the information it provides.

Overall, the profit-maximising monopolist that engages in anti-competitive and inefficient ‘leveraging’ of an essential facility is likely to be a rare bird indeed, should such a bird exist. And high risks and costs may be incurred in seeking to catch such birds, especially if in the process one mistakenly labels as anti-competitive conduct that actually protects and promotes efficiency, as refusals to allow access may. Consequently, before imposing mandatory third party access, one would want to be convinced that:

- The potential access provider must have control over an essential input, and use that control to extract monopoly rents in the downstream market;
- The refusal to supply access must be related to the protection of those rents by means of the exclusion of no-less-efficient competitors, rather than by the seemingly more plausible desire to preserve the efficiencies of vertical integration; and
- It must be more efficient to regulate the monopolist by mandating the supply of access than by directly regulating the supply of the final goods that it monopolises or simply not regulating at all.

In the companion piece, I argue that Part IIIA fails to properly test for these factors and creates a substantial risk of ‘false positives’ — that is, of mandating access when it should be denied. To that extent, our current access arrangements seem more likely to reduce efficiency than to increase it.

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A ‘no-returns tax system’ for Australia: Some inconvenient facts

SINCLAIR DAVIDSON

Abstract

It has been proposed that Australia adopt a ‘no-returns’ income tax system. One consequence of such a reform would be the standardisation, or even elimination, of work-related expense deductions. Using ATO data it is shown that in introducing a no-returns tax system and eliminating work-related expense deductions, the average Australian (making a claim) would save $268 on accountant fees but forgo $1860. In addition eliminating itemised work-related expense deductions would have a regressive impact.

Introduction

One of the issues canvassed in the Australia’s Future Tax System Consultation paper (the ‘Henry Review’) is the simplification of tax administration (2008: 169–181). Individual Australian taxpayers are presently required to lodge an annual tax return. In addition, many taxpayers use accountants or tax agents to lodge their returns. This situation suggests two possible reforms. One reform would be to relax the requirement that all individual taxpayers lodge a return (generally described as a ‘no-returns tax system’; see Gale and Holtzblatt (1997)). A second reform would be to simplify the personal tax system so that individuals would not normally require professional tax advice in order to comply with their tax obligations (‘tax simplification’).

At a conceptual level these two types of reform are distinct; at a practical level, however, they are closely related. For relaxing the requirement that all individual taxpayers lodge a tax return would also require significant standardisation of...
deductions. In his 2004 discussion of annual tax returns, Chris Evans (2004: 180) stressed this important point: ‘Without annual filing, the taxpayer would lose the ability to claim expenses and so would lose the all-important refund.’

This linking of the two types of reform is also suggested by the Henry Review (2008: 176–7) itself (emphasis added):

The ATO currently pre-fills some data into individual’s electronic income tax returns, making it easier for many individuals to complete their returns. With appropriate policy changes it may be possible to increase the amount of pre-filled data.

For example, introducing a standard tax deduction in place of work-related expenses and replacing the tax deductions for eligible gifts with a co-contribution to gift recipients would potentially mean that some individuals would need only to confirm the data in their pre-filled tax return at the end of an income year. Greater at-source withholding, complemented by policy settings that obviate the need for further assessment of tax, might further reduce the need for individuals to lodge returns.

As recently as 21 October, Steve Lewis (2009), writing in the Sydney paper The Daily Telegraph, suggested that the Henry Review would make such a recommendation:

Dr Henry’s reforms would result in taxpayers receiving a one-page summary from the Australian Tax Office which would include a standard ‘deduction’ for necessary work expenses as well as salary details. If taxpayers were happy with the ATO’s calculation, they would tick the form and lodge it via the internet — and wait for their refund. Benefits include taxpayers not having to make the annual trek to tax agents.

The idea of abolishing some deductions, or at least standardising those deductions, and simplifying tax returns isn’t new. Chris Evans of the University of New South Wales made a similar argument in 2004, while Andrew Leigh of the Australian National University wrote on this in 2007. Many other countries already operate a (largely) no-returns individual tax regime. New Zealand and the United Kingdom, for example, are only two of 36 countries that have a variant of this system in place.

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2 Evans then raises the question, ‘whether there would be significant taxpayer resistance if … taxpayers lost the right to claim work-related expenses (and hence their annual refund)’.

3 There are different types of no-return tax systems that operate around the world. The two major systems are known as the Tax Agency Reconciliation System and the Exact Withholding System. A hybrid of these two systems operates in the Nordic countries. See Gale and Holtzblatt (1997) for a general discussion.
But it is not immediately clear that Australia should forgo work-related expenses deductions in return for a no-return tax system. While the benefits are easily understood they may not be as large as is generally presumed. Furthermore, a change to a no-returns policy is not in itself a substitute for tax simplification, and should only be considered after simplification has already occurred. To the extent that a no-returns policy could generate additional fiscal illusion, it is possible that a no-returns policy would inhibit tax simplification.

In the next section, I set out the benefits and costs of a no-returns policy from a taxpayer perspective and in the third section I consider some Australian evidence that may inform our views of the benefits and costs of a no-returns policy.

I conclude that forgoing work-related deductions for a simplified tax-return system would not be in the financial interests of the taxpayers, and ‘buying them out’ would be very expensive for the authorities.

Benefits and Costs of a No-Returns Tax System

The primary benefit of a return-free system is the reduced tax compliance burden for those taxpayers who are able to use the no-returns tax system. In addition to the need for careful record-keeping, taxpayers expend time and effort when filling out tax returns.\(^4\) Andrew Leigh (2007: 85) suggests that the time could, rather, be spent working, or even relaxing. His argument is that the time saved not filling out a tax return would be equivalent to an additional public holiday. This is based on the widely accepted estimate that the average person takes 8.5 hours to fill out their tax return (Tran-Nam et al. 2000). Of course, most Australians do not fill out their own tax return but employ an accountant or tax agent to do so on their behalf. The direct costs of tax compliance would include the record-keeping costs, opportunity cost of filling out the tax return, and the cost of employing an accountant to do so.

There are also indirect costs of filling out a tax return. There may be significant emotional costs associated with dealing with tax matters. Many taxpayers may feel anxiety when confronted by somewhat complex tax documentation and the associated explanatory notes. Even those taxpayers who wish to fully comply with the tax system’s demands may be anxious that they have committed some

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\(^4\) It is important to note that the need for record-keeping is invariant to whether a no-returns tax system is adopted or not.
error or other. It is not clear, however, whether these costs are significant or how widespread they may be. To some extent they may be subsumed into the direct costs associated with employing an accountant.

An additional benefit revolves around tax simplification that may occur when introducing a no-returns tax policy. I return to this point below.

The costs of a no-returns tax system revolve around a shift in compliance costs away from individual taxpayers to their employers and the tax authorities. In particular the burden of accuracy is shifted onto the tax authorities. It is one thing to recognise that the ATO already has a lot of information about individual taxpayers; it is another to collate that information in a timely and credible manner for use in an annual process. At present the ATO has several years in which it can review a tax return and compare that to information it already holds. Under a no-return tax system, it would have a few months in which to undertake that task for the entire taxpaying population. While the legal obligation to provide accurate information to the ATO would remain unchanged — that is, the burden is on the taxpayer — the fact that the ATO could be sending taxpayers incorrect information could undermine tax morale throughout the economy. The information technology start-up costs for such a system are likely to be very high.

When comparing the setting up of such a system with countries that already have that system it is important to remember that many countries have had these systems in place for a long time. The administration of the tax system would constrain some aspects of complexity, and would have evolved as the complexity of the tax system evolved. By contrast, the introduction of such a system after the complexity of the tax system had evolved would involve substantial ‘reverse-engineering’ that adds to the implementation costs.

The introduction of a no-returns tax system could contribute to greater levels of fiscal illusion (see Davidson 2007). This occurs when misconceptions about the tax burden minimise taxpayer resistance to higher levels of taxation. For example, an argument against lowering taxes is that government spending may fall as a consequence. Yet the Australian experience is that tax revenue has increased even though taxes, especially on high-income earners, have declined over the past few years. According to ATO Statistics, in 1996–97 the top 25 per cent of taxpayers paid 60.8 per cent of net personal income tax while in 2006–07 the top 25 per cent of taxpayers paid 66 per cent of net personal income tax. The suggestion here is that a no-returns tax system would create an ‘invisible’ tax system that was ‘out of sight and out of mind’.

In correspondence Andrew Leigh argues that the tax share of the top 25 per cent of taxpayers has risen because their share of income has risen (see Atkinson and Leigh 2007 for further discussion). There may well be merit to this argument, but unravelling the various effects of tax policy will take this paper far beyond its
There is a common argument that taxpayers like receiving refunds. Many economists are suspicious of this argument because it implies that taxpayers are irrational. As Evans (2004: 179) asks: ‘What rational person overpays in order to get something back at a later stage?’ There is a potentially rational explanation, however, for this behaviour. Refunds reduce the size of the tax base. It is generally accepted by most economists that the more comprehensive the tax base, the lower the tax rate needs to be to raise a given amount of revenue. Consequently, from an economic perspective most economists would argue for broad bases and low tax rates. Geoffrey Brennan and James Buchanan (1980), however, have argued that taxpayers do not always trust government to deliver lower tax rates and consequently have a preference for narrower bases (see, especially, chapter three). This type of argument can reconcile a taxpayer preference for refunds and rationality. In this view, taxpayers are happy to trade off a loss of interest in the present against being over-taxed in the future. It would require careful survey analysis or even experimental techniques to provide evidence for this argument, and I provide no such evidence.

Some Facts of Costs of Managing Tax Affairs and Work Expense Deductions

In this section I evaluate the arguments for and against a no-return tax system using Australian data and experiences. This is done from the perspective of taxpayers and not from an ATO or tax-collection perspective. The data are drawn from the ATO Tax Statistics available on the web. The arguments put forward by Australian proponents of this type of tax system (for example, Andrew Leigh) usually emphasise the convenience factor of not having to lodge a return. The counter-argument to this view is that no-return tax systems only operate for taxpayers who have relatively simple tax affairs.

In the 2006–07 financial year only 27.54 per cent of Australia’s 11.8 million individual taxpayers prepared their own tax return. The vast majority of Australians employed an accountant or tax agent to prepare their return. The average cost for preparing the tax return in that year was $268.21. Figure 1 shows the average cost of preparing a tax return broken down by income groups. It also shows the average work-related expenses tax refund by income group. The overall average work-related refund was $1860.96 in that financial year. In other words, if making a trade-off between a no-return tax policy and work-related deductions, the average Australian (making a claim) would be asked to save $270 and give up over $1800.
Table 1 shows the average ‘cost of managing tax affairs’ — an allowable deduction and reported in aggregate by the ATO — over the period 1996–97 to 2006–07. The second column shows the percentage of taxpayers making this particular claim, while the third column reports the percentage of taxpayers the ATO reports as using a tax agent. The large number of taxpayers employing a tax agent or accountant implies that the Australian tax system is quite complex.

Indeed in a February 2006 speech, the Tax Commissioner, Michael D’Ascenzo, admitted that understanding tax law was beyond the comprehension of normal people (quoted in Roskam 2006). In short, this implies that the tax system itself is complex and would require substantial simplification before reform to the tax administration could be considered. It is an open question as to how many of these individuals would switch to a no-return tax system.
A ‘no-returns tax system’ for Australia: Some inconvenient facts

Table 1: Cost of managing tax affairs

<table>
<thead>
<tr>
<th></th>
<th>Average Fee</th>
<th>Proportion of taxpayers making claim for the cost of managing tax affairs</th>
<th>Proportion of Taxpayers using a tax agent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996–97</td>
<td>131.52</td>
<td>42.8</td>
<td>74.0</td>
</tr>
<tr>
<td>1997–98</td>
<td>136.34</td>
<td>45.0</td>
<td>75.9</td>
</tr>
<tr>
<td>1998–99</td>
<td>144.17</td>
<td>46.3</td>
<td>77.4</td>
</tr>
<tr>
<td>1999–2000</td>
<td>152.51</td>
<td>46.4</td>
<td>77.5</td>
</tr>
<tr>
<td>2000–01</td>
<td>179.34</td>
<td>46.1</td>
<td>76.7</td>
</tr>
<tr>
<td>2001–02</td>
<td>196.30</td>
<td>45.8</td>
<td>75.7</td>
</tr>
<tr>
<td>2002–03</td>
<td>209.59</td>
<td>45.3</td>
<td>74.8</td>
</tr>
<tr>
<td>2003–04</td>
<td>226.42</td>
<td>44.9</td>
<td>74.2</td>
</tr>
<tr>
<td>2004–05</td>
<td>242.51</td>
<td>45.1</td>
<td>73.5</td>
</tr>
<tr>
<td>2005–06</td>
<td>251.29</td>
<td>45.3</td>
<td>72.7</td>
</tr>
<tr>
<td>2006–07</td>
<td>268.21</td>
<td>44.7</td>
<td>72.4</td>
</tr>
</tbody>
</table>

Source: ATO Tax Statistics (2006-07), author’s calculations

What of the remaining taxpayers who currently prepare their own tax returns? What are the costs associated with their compliance? To calculate this cost I calculated the annual after-tax income for taxpayers in their income groups, and then translated that into an hourly rate (based on 24 hours in the day and 365 days in the year). I then multiplied that figure by 8.5 hours — the generally accepted number of hours taxpayers use to manage their tax affairs. The ATO has reported that the average time taken to complete a tax return is only 5.9 hours. To the extent that the ATO figures are correct, rather than the generally accepted figure, the calculations reported below are likely to overstate the costs of completing a tax return. Across the 27.54 per cent of taxpayers who lodge their own returns, this all adds up to $88.3 million in 2006–07. (The overall average, not taking into account the income distribution, is $112.2 million in 2006–07). The average cost for these taxpayers was $38.50 in that year or $41.59 if I ignore the income distribution. Even if my calculations are out by a factor of three, it would still add up to only $265 million. By comparison, taxpayers claimed $1.4 billion in the costs of managing their tax affairs. The cost of preparing a tax return for the proportion of taxpayers that prepare their own returns is between 6 and 19 per cent of the cost of the rest of the taxpaying population. That, of course, doesn’t indicate that no effort should be made to further reduce this cost, but it does suggest that the benefits of doing so are likely to be low.

6 In the analysis I have made two important assumptions. I assume that individuals across various income categories value their time equally as a function of their income. This is a common assumption, but I am not convinced that it is an accurate reflection of actual behaviour.
I now look specifically at the idea of trading off work-related expense deductions for a no-return tax system. Table 2 shows that the average claim has increased slightly over time, as has the percentage of taxpayers making work-related claims. At the same time, however, it is important to note that the economy grew very dramatically over the period 1996–97 to 2006–07. Increases in work-related expenditure are not unreasonable.

Table 2: Work-related expenditure

<table>
<thead>
<tr>
<th>Year</th>
<th>Total work-related expenses as % of total taxable income</th>
<th>Percentage of taxpayers making work-related claims</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996–97</td>
<td>2.4</td>
<td>60.6</td>
</tr>
<tr>
<td>1997–98</td>
<td>2.3</td>
<td>61.6</td>
</tr>
<tr>
<td>1998–99</td>
<td>2.3</td>
<td>62.9</td>
</tr>
<tr>
<td>1999–2000</td>
<td>2.4</td>
<td>63.6</td>
</tr>
<tr>
<td>2000–01</td>
<td>2.6</td>
<td>64.2</td>
</tr>
<tr>
<td>2001–02</td>
<td>2.8</td>
<td>62.6</td>
</tr>
<tr>
<td>2002–03</td>
<td>2.8</td>
<td>62.3</td>
</tr>
<tr>
<td>2003–04</td>
<td>2.8</td>
<td>62.7</td>
</tr>
<tr>
<td>2004–05</td>
<td>2.8</td>
<td>63.3</td>
</tr>
<tr>
<td>2005–06</td>
<td>2.8</td>
<td>63.9</td>
</tr>
<tr>
<td>2006–07</td>
<td>2.8</td>
<td>64.5</td>
</tr>
</tbody>
</table>

Source: ATO Tax Statistics (2006–07), author’s calculations

In 2006–07, work-related expense deductions comprised 41.54 per cent of all deductions in dollar terms, down from a high of 58.70 per cent in 1999–2000. Similarly, they comprise about 80 per cent of all deductions that are claimed. In other words, work-related expense deductions comprise a very large component of the ATO workload. Yet it is quite clear when looking at the income distribution of claimants that many lower income individuals benefit from having these deductions.

Figure 2 shows that individuals earning between $23,000 and $70,000 make the most use of work-related deductions, with this type of deduction making up more than 50 per cent of all deductions in this income group. As a rule of thumb this income group can be described as earning between half and one and a half times the average income for a full-time employee. Higher-income taxpayers tend to have deductions for gifts and donations, interest and dividends and for non-employer sponsored superannuation. Figure 3 examines who actually makes work-related deduction claims by income group. The single largest group of taxpayers making work-related claims earn between $30,000 and $35,000, while the largest monetary value of claim is for individuals earning between $60,000 and $70,000. Looking at information such as this indicates that work-
related claims substantially lower the effective tax rates for lower-income and average-income Australian workers. The graph also shows evidence that taxpayers use work-related deductions to reduce their nominal tax rates — the spikes at $70,000 and $150,000 closely match tax thresholds (in that year) from the 30 per cent to 40 per cent rate ($75,000) and the 40 per cent to 45 per cent rate ($150,000). Any policy to remove work-related deductions is likely to be regressive.

Figure 2: Work-related deductions as percentage of total deductions

Source: ATO Tax Statistics (2006–07), author’s calculations

7 Unfortunately the ATO data do not coincide with the $75,000 cut-off for the 30 per cent tax rate.
Figure 3: Who makes work-related claims?

![Graph showing proportion of taxpayers and dollar claims by income range.]

Source: ATO Tax Statistics (2006–07), author's calculations

Figure 4 confirms this view by calculating the cumulative proportion of taxpayers making a claim and cumulative dollar value of the work-related claims. As can be seen, over 50 per cent of all work-related claims are made by individuals earning less than $40,000, while 50 per cent of the dollar value of claims is made by individuals earning less than $50,000.
Figure 4: Cumulative work-related deductions

Source: ATO Tax Statistics (2006–07), author’s calculations

An argument that is often made is that itemised deductions could be replaced with a standardised deduction. It is quite likely that this would be very expensive; the deduction would have to reasonably compensate current claimants but also be accessible to those individuals who do not currently make work-related deductions. At the same time, a standardised deduction could be eroded by inflation (like the tax-free threshold has been eroded) or even eliminated altogether by a future government. A referee has suggested that a standardised deduction that is a function of employment income could be adopted in place of an itemised deduction. This proposal is superior to a standard one-size-fit-all approach, but nonetheless it does not take account of the regressive nature of the current work-related expense deduction.
Conclusion

The argument this paper alludes to is that simplification of the tax system itself must precede simplification of tax administration. Certainly the idea of trading off work-related deductions for a simplified tax-return system would not be in the financial interests of the taxpayers and buying them out would be very expensive for the authorities. Andrew Leigh (2007: 84) has argued in favour of a no-return tax system as follows:

Plenty of taxpayers may choose to forfeit deductions to which they are entitled in exchange for avoiding the hassle of filing a tax return. Indeed, the rise in tax revenue from these forfeited deductions is likely to outweigh any increase in administrative costs for the ATO in moving towards a system of pre-population.

The analysis presented in this paper, however, suggests that his argument is wishful thinking at best. Few taxpayers would want to give up their work-related deductions to save the cost of an accountant or tax agent.

References


SYMPOSIUM

THE SYDNEY UNIVERSITY POLITICAL ECONOMY DISPUTE

For four decades economics at the University of Sydney was stirred by the ‘Political Economy Dispute’. The recent publication of Political Economy Now! The Struggle for Alternative Economics at the University of Sydney (edited by Gavan Butler, Evan Jones and Frank Stilwell, Sydney: Darlington Press, 2009) provides an occasion for reflection upon this episode. Agenda here publishes some reactions to this history, encompassing both staff and students, as well as supporters and opponents of the cause of ‘Political Economy’.
‘The book cannot stand on its own as an accurate portrait’

PETER GROENEWEGEN

When some time ago I gave Frank Stilwell a copy of my draft fifth chapter (‘Turmoil in the Cloisters’) for the *History of the Faculty of Economics at the University of Sydney* (Groenewegen 2009) his only comment was that there are various ways of writing up events of this nature. How right he was. I can now easily admit the truth of his proposition, having just read his version of events, *Political Economy Now*, produced at length with two of his colleagues, Gavan Butler and Evan Jones.

In the introduction to *Political Economy Now* (xvi: n.9) my history of the Faculty, (and Bruce Williams’ memoirs) are ‘advertised’ as being by ‘principals of this story [who] have spoken at length for themselves’, thereby absolving the authors of this volume ‘from laboriously setting out’ the positions of Groenewegen and Williams. Since Bruce Williams’ authoritative account, as the Vice-Chancellor at the time, is on the public record, and my own faculty history will have been well and truly published by the time this review appears, I am quite happy to endorse their advice of the necessity of comparison if a more accurate picture of the events is to be obtained.

As a starting point for this review, the term ‘political economy’ needs some discussion. There is a considerable sleight of hand in selecting a quote from Sir Henry Parkes’ *Empire* for the frontispiece of this book. This is intended to draw attention to a very long association between the University of Sydney and a publicly proclaimed need for political economy among its branches of study. But little is said about the considerable change in meaning of the term, ‘political economy’ since its first use in the seventeenth century. The interested reader can examine a survey of these various meanings of political economy by looking at my article on the subject for *The New Palgrave Dictionary* (1987, vol. III: 904–7), while Parkes’ association with early economics education at the University of Sydney is more accurately presented in the prelude to my faculty history (Groenewegen 2009: esp. xiii–xviii). The satisfactory provision of relevant historical background is, generally speaking, not a strong point of the book under review.

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1 The Faculty of Economics and Business, the University of Sydney: peter.groenewegen7@bigpond.com.
The story of *Political Economy Now* is told over 12 chapters and an introduction. There is no index, but there is a chronology of principal events. The last, interesting to note, fails to mention my name, even if the text does so quite frequently when seeking to cast me as one of the major villains in this long saga. The first six chapters (pretty well half the book’s contents) purport to give an historical account of the early decades of the dispute. The final six chapters present broader topics raised by the dispute, namely, ‘What’s wrong with Economics’, ‘Pedagogy and Power’, ‘Intellectual Suppression’, ‘Market Forces’, ‘Dissent and Legitimacy’ and, the final chapter, ‘Whither Political Economy’. The last chapter brings events right up to date — that is, up to early 2009 — and comments on the 2008 shift of the PE group to the Faculty of Arts.

In general, the book presents an uneven account of the subject matter. Some of its contents are rather dishonest, by virtue of the material they omit. Many examples of such omission can be given, but the following instances, in all of which I was personally involved, suffice to indicate their extent.

Take first the references to the spray-painting of slogans on residences of opponents of the PE movement, mentioned first on page 44, and a tactic in the ‘struggle’ later described as ‘regrettable’ and ‘ill-considered’ (p.159). This method of ‘protest’, blamed on unnamed ‘political economy activists’, is confined on these pages to the (then official University) Residence of Bruce Williams at Hunters Hill, and to Professor Simkin’s Cremorne apartment. It fails to mention a similar, subsequent spray-painting of libellous slogans on the footpath and driveway of my house at Beecroft in March 1983, a period when the dispute had once again virulently erupted.

Secondly, in the context of the Joan Robinson visit and her public lectures at Sydney University (pp.33, 170–1), the authors fail to point out that Joan Robinson’s R. C. Mills Lecture did not appear in print until 2004, when I published it as the seventh Mills Lecture in a collected edition of these memorial lectures. Whether this earlier non-publication was accidental, or by design, is difficult to say, given Simpson-Lee’s strong dislike of Joan Robinson, dating back to his student days at Cambridge as (an unsuccessful) postgraduate student.²

Thirdly, and again in the context of my 1980 appointment to a chair, the authors concede that my teaching and research fully qualified me for this appointment, but imply that my ‘public service’ and referee’s report were inferior (p.142). This comment ignores my substantial writings on public finance and taxation policy, including submissions to governments on these issues, while referee reports

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² Moreover, in connection with my appointment to a chair and my intellectual position on the subject of Political Economy, the book fails to mention that my 1981 inaugural lecture was on the topic ‘History and Political Economy: Smith, Marx and Marshall’. This lecture was specifically dedicated to Joan Robinson, who indicated she greatly liked it after reading the copy I had sent her.
for university positions, as is well known, are confidential to the selection committee. Further, in their brief reference (p.17) to a debate between Warren Hogan, Gavan Butler, Frank Stilwell, and myself, they fail to mention that my opening remarks specifically stated that there often are more than two positions in a ‘great debate’ and that, on important points, my position differed greatly from that of Warren Hogan, just as it did from those of Gavan Butler and Frank Stilwell.

Finally, when quoting my rather generous remarks on Simkin’s teaching (p.7: n.12), they fail to point out these comments were part of my obituary notice for the University News, and hence quoted me out of context. I should explain here that I never experienced Simkin’s teaching but that my remark reflected the praise and appreciation of that teaching I had heard from many honours students over the years. It was not meant to apply to his rather short-lived, second-year macro-economics teaching at Sydney. This, on all accounts, was woeful, and based on his textbook Economics at Large: an advanced textbook in macro-economics, with its many misprints, particularly in the mathematics.³

In the context of teaching quality, I may also express some doubts, this time from personal experience, on the extravagant praise in this book for Ted Wheelwright as a teacher. When in 1960, my final year in the BEc degree course, I took two subjects (Economics IV and History of Economic Thought) in each of which Wheelwright was lecturing for a term, he then advised me (together with my fellow student Paddy McGuinness) not to attend his lectures since we both knew more about their subject matter than he did. Of course, we were required to attend his seminars for honours students. His History of Economic Thought seminar was based on Meek’s terrible book, Studies in the Labour Theory of Value, a book, incidentally, which Meek himself by then had disowned, particularly for its disgusting, sycophantic praise of Stalin’s views on the subject. Wheelwright’s Economics IV seminar discussed leading critics of capitalism, with special reference to their analysis of the business cycle, in work by Veblen, Hobson, Schumpeter, Hilferding, Baran, Sweezy and, at my suggestion, Rosa Luxemburg, on some of whose work Wheelwright was not greatly informed. Neither seminar therefore provided a valuable learning experience, and left me with the opinion that Wheelwright was not a good teacher. He had an eloquent delivery in lectures, but their content demonstrated that he was not, generally speaking, on top of his subject.⁴ On a smaller scale, the authors create icons

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³ Incidentally, in that very same year, he published his magnum opus, The Traditional Trade of Asia, a splendid economic history study.
⁴ However, when in 1961 I commenced research for my M.Ec thesis on Turgot’s economics, Wheelwright did offer me the opportunity to give three lectures on Turgot in his first term History of Economic Thought class, a very valuable initial teaching experience.
from unsuccessful students. An example is the late Michael Brezniak, where the authors' praise of his qualities as a student does not at all match my experience of his performance in seminars and examinations.

The book also creates villains and monsters, among whom the ‘principals’, as explicitly identified in the book, have already been mentioned. Two other villains, now both deceased, are Dave Clark and Paddy McGuinness, labelled on at least two occasions as ‘my journalist friends’ to imply that in this matter they could be regarded as my stooges. Their so-called anti-PE ‘campaign’, in the columns of the *Australian Financial Review* and the *National Times* (pp.xiv: n.8; 80; 153–4) dwelt on the employment implications for students of the PE courses. In connection with Dave Clark, there is also a somewhat ‘bizarre’ footnote (p.172: n.4) on mutual charges of attempts at kidnapping Galbraith, after his public lecture in the Merewether Building. Elsewhere (pp.31–2), ‘burly Dave Clark’ in the company of Peter Groenewegen, are portrayed as trying ‘to intimidate’ Jock Collins’ opening lecture on Marxist Economics in Economics I(P) by sitting ‘conspicuously in the middle of the front row’ of the lecture theatre. I emphasise in this context that Dave Clark and Paddy McGuinness were indeed long-term friends: the latter a friend from the start of my undergraduate days in 1957, and Dave Clark a good honours student and the first PhD student I had the pleasure to supervise from the late 1960s. I have to admit that (on the evidence presented on p.155 about the ‘demonstrably good jobs’ obtained by some PE graduates) their views about unemployment for such graduates may have been a trifle exaggerated. However, Darren Rodrigo’s recollection (p.156) of a ‘stack of job rejection letters’ until Frank Stilwell came to the rescue, should be noted in this context, together with the unnamed occupants of Ross Gittens’ many staff positions drawn from PE graduates (p.155). Whether PE students have extraordinary skills, as is also claimed on these pages, I find unproven, even if a small number of such graduates majoring in the PE courses were extremely good, critical, students.

In my faculty history, I briefly mention the costs and benefits of the political economy dispute. Here, costs, in my view, greatly outweighed the perceivable benefits. These costs include the high turnover of academic staff in the Department, particularly of some of the better and therefore more mobile staff, because they could not stand the long, often dreary, departmental meetings and the other disruptions to research and teaching the dispute so often generated. Secondly, the dispute considerably harmed the reputation of the Department in Australia, because it was seen, as in the 2001 biography of Richard Downing, for example, as ‘the complete disintegration of the Faculty’ (Brown 2001: 283). Thirdly, decisions about courses and degree structures, either ‘made on the run’, or ‘by exhaustion’, are frequently unsatisfactory, while fourthly, and perhaps most importantly, decisions about courses left to committees composed
of academics outside the discipline concerned, are generally unable to achieve quality outcomes. The divisive nature of the dispute, which invariably sought to separate some aspects of economics from the domain of the discipline, produced imbalances in both sets of teaching programs. Benefits from the dispute, in my view, are far more difficult to identify. Such benefits may include the value of rethinking key elements of the subject, as many members of the Department were encouraged to do during the dispute. Moreover, students were given a wider array of subject matter for study, particularly through the optional courses from second year onwards, which were introduced at the time. Finally, teachers in the PE group ultimately benefited from gaining their own little departmental empire. However, the PE group cannot claim an extensive research flow to major international journals. A few quality graduates from among their students are probably the major benefit bestowed by the PE group and their courses, at the substantial cost of an enormous amount of turmoil and disruption.

To conclude this review, let me reiterate that much can be criticised in this study of the Political Economy dispute by three of its major protagonists. This has been demonstrated by sampling a few of its many omissions, and by pointing to its exaggerated praises of some of the participants (now deceased), and the often unsubstantiated claims about the PE program’s merits. Nor, in the ‘oral history’ segment of the book, do the many brief testimonies from former students, satisfactorily substantiate these assertions. Moreover, the claim made for the book on its back cover — that it demonstrates the superior intellectual merits of the ‘alternative courses’ in economics — has, for this reader, not been satisfactorily carried out. Nor has the ‘them’ and ‘us’ approach of their perception of the dispute allowed them to concede the potential presence of a wide range of views in a subject as complex, as difficult and as important, as economics undoubtedly is.

For reasons already indicated, this book cannot stand on its own as an accurate portrait of this long dispute, still not satisfactorily resolved in some respects. The story of political economy at the University of Sydney, as told in this book, needs comparison with, and frequent correction from, other accounts. In particular, it needs the more critical approach to the evidence all too often missing in this book.

References


The permanent need for political economy

ROD O’DONNELL

... political science which does not at the same time include political economy is likely to be wide of the mark, and economic theory which is not based on live hypotheses is other-worldly.

Bruce Williams 1943

By trying to enforce conformity the university would endanger its essence.

Bruce Williams 1968

Four recent publications have discussed the long Political Economy (PE) dispute at Sydney University from the late 1960s to the present — a chapter in a former Vice-Chancellor’s memoir (Williams 2005), a section in a brief history of Sydney University (Williams 2006), a book by three PE staff members (Butler, Jones and Stilwell 2009), and a chapter in a history of the Faculty of Economics at Sydney University by a non-PE staff member opposed to the campaign (Groenewegen 2009).

My purpose here is to offer, in hindsight, an assessment of the significance of the dispute in terms of its two underlying issues — the nature of economics and the role of university ideals. I write as someone who was a student activist, both inside and outside official channels, from 1974 to 1977 during the first major phase of the dispute, who graduated with degrees in economics (BEC) and philosophy (BA) and who, supported by scholarships from Sydney University, took a doctorate in Economics at Cambridge prior to returning to Australia and an academic career. My views have matured over time, but apostasy has never tempted me regarding the principles of political economy. They appeared to me right then, and they still appear right to me now. I also believed, and still believe, that had those in administrative positions shown more leadership and less outright opposition, the dispute could have been resolved far more easily. Unfortunately, space limitations allow only brief and selective discussions of key issues.

1 University of Technology, Sydney; rod.odonnell@uts.edu.au.
2 See Williams (1943: iv–v), and Williams (2005: 83) respectively.
3 Given the highly charged circumstances in the Economics Department at the time (which included one bad discriminatory precedent), I judged it prudent to do my honours year in Philosophy rather than Economics, the outcome being first-class honours and a university medal.
Two important distinctions need to be drawn at the outset. One is between support for PE in principle, and support for the various means chosen in its pursuit. People can (and did) support the former without endorsing all of the latter.\textsuperscript{4} The other is between an ideal PE program/department and actual PE programs/departments that evolve under historical circumstances and compromises. In my view, the idea or principle of PE is central, and separable from the different (but still important) questions of means and realisation.

\section*{What is Political Economy?}

My answer, in brief, is that PE is the study of economic phenomena within a polity, where a polity is an organised society. Three implications follow, each connected to openness and progress.

Firstly, political economy is a social science that is open to, and engaged with, all disciplines relevant to the study of society — other social sciences, the humanities and even the natural sciences. This puts PE in fruitful, co-informing dialogues with history, politics, psychology, sociology, philosophy, language, thermodynamics, biology, climate science and so on. The contrast is with orthodox or neoclassical economics which, in viewing itself as self-sufficient and as ‘queen’ of the social sciences, isolates itself from learning from other disciplines. Secondly, given the permanence of controversy and debate in the study of economic phenomena over the last 250 years, PE recognises the existence and importance of competing schools of thought. This makes it intellectually pluralist in orientation. In the 1970s, the main schools that drew our attention were neoclassicism, (Post) Keynesianism, (Old) Institutionalism and (Western) Marxism. Nowadays, a more complete list also includes, \textit{inter alia}, Ecological, Behavioural, Neo-Ricardian, Austrian and Feminist economics, all of which have significant arguments about market economies and the social science of economics. Note that, then, now and in principle, PE includes orthodoxy, for students need it as much as other perspectives in order to engage with the world. Again, the contrast is with the monism or fundamentalism of neoclassicism which portrays itself as the one true route for economic science. Thirdly, PE embraces different modes of analysis so long as they are logical and intellectually rigorous, and their strengths and weaknesses appreciated. More specifically, both discursive and mathematical reasoning are welcomed. This avoids the excessive reliance of neoclassical theorising on mathematics as the

\textsuperscript{4} A prominent example was Ted Wheelwright, a senior PE staff member, who did not support strikes as a tactic in universities (Butler \textit{et al.} 2009: 51).
best way of distilling economic understanding. In sum, PE has an open, pluralist stance in which all schools, conceptual frameworks and modes of discourse are viewed as capable of contributing to economic analysis.\(^5\)

Dissatisfaction with neoclassical economics, and the way it was taught, were key factors initiating the PE dispute.\(^6\) From a student viewpoint in the 1970s, much of it lacked relevance to the real world, mathematical representation was over-emphasised, it was ideological in giving too much comfort to conservatism, it had little interest in self-examination, and it was antagonistic to the exploration of alternatives. With the passage of time, the critiques have sharpened, with several highly knowledgeable, eminent economists expressing their views in forthright terms. Coase (1992: 714) notes ‘the growing abstraction’ of analysis which does not call for detailed knowledge of actual economic systems: ‘What is studied is a system which lives in the minds of economists but not on earth.’ In Blaug’s judgment (1997: 3), ‘Modern economics is sick’, having become ‘an intellectual game played for its own sake and not for its practical consequences for understanding the economic world’. Krugman (2009) locates the source of the widespread failure to foresee the present global crisis deep within the theoretical edifice of orthodoxy — in its foundational propositions about agents and markets. And Colander et al. (2009) argue that the current crisis represents a systemic failure of the economics profession, the roots of which lie in orthodox models that exclude key forces in real-world markets and rule out macroeconomic behaviour independent of microeconomic foundations. This small sample (from a much larger set) indicates the need for economics to expand its boundaries by embracing alternative approaches.

Political economy, with its focus on the serious study of multiple economic perspectives, seeks to do just that, not merely at the level of research but also at the level of undergraduate and postgraduate curricula. Current and future generations of economists need to be better prepared for the unprecedented and alarming challenges ahead.

**University Ideals, Power and Authority**

In its early years, the PE movement learned a vital lesson. One may have excellent intellectual arguments, but when power in a discipline or institution overrides reason, rational argument can make no further progress unassisted. Where reason is necessary but insufficient, people with resolve also campaign

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5 Intellectually, Williams never understood PE at Sydney University, pejoratively viewing it as ‘politicised economics’ and of no relevance to ‘practising economists’ (2005: 103–7).

on the terrain of power and decision-making. The sources of power to which we turned for assistance lay outside the Economics Department — the power resident in some of ‘the official channels’ (the Economics Faculty, Academic Board and Senate), and the power of ‘the people’, the power of an organised student movement. Our struggle was on two fronts — that of reason and the intellect, and that of power and authority.  

Bruce Williams, the Vice-Chancellor (VC) at the time of the philosophy and PE disputes, entitled his memoir *The Making and Breaking of Universities*, strongly implying that he belonged to the ‘makers’ and the radicals opposing him to the ‘breakers’. This is a caricature. The protagonists in both disputes never sought to ‘break’ the university but sought exactly the opposite — to strengthen it by upholding the central ideals of free enquiry, independent thought and critical scrutiny. As a minor but indicative example, take my submission to the 1976 Academic Board Committee of Enquiry into PE which began with the following quote from Cardinal Newman on the idea of a university:

> [A University] is pledged to admit without fear, without prejudice, without compromise, all comers, if they come in the name of Truth; to adjust views and experiences, and habits of mind the most independent and dissimilar; and to give full play to thought and erudition in their most original forms, and their most intense expressions, and in their most ample circuit. ... It maintains no one department of thought exclusively, however ample and noble; and it sacrifices none. (Newman 1960/1873: 344–5)

The claims of PE fitted Newman’s remarks perfectly. Along with acquiring knowledge of orthodoxy, we wanted to study non-neoclassical perspectives, enter into debates over these schools and explore associated methodological issues. We were intellectually alive, active and hungry, desirous of exposure to broader ideas and paradigms than those we were expected to imbibe without deep probing. Which is the better way to engage intelligent people thirsty for knowledge? Is it to say ‘no’ and impose professorial/Vice-Chancellorial agendas; or is it, as befits a university, to engage in conversation and debate to work out sensible solutions that enrich educational experiences and professional expertise? From this standpoint, we were the ‘makers’ and those opposed the ‘breakers’. Had our intellectual aspirations been more respected and not so vigorously resisted, the dispute would not have endured and taken the forms that it did.

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7 A key figure in the dispute once argued that to have ‘knowledge of what needs to be done ... implies, in a healthy person, the will to action’, adding a line from Blake in support: ‘He who desires, but acts not, breeds pestilence’ (Williams 1943: v, 72). Knowledge and health we certainly had, along with no love of pestilence.
There was one thing, however, that we certainly did seek to change or ‘break’, and that was the use of administrative power which resisted legitimate disciplinary initiatives and deflected the university from its ideals. The PE movement could only be viewed as a destructive element by someone who equated the institution of the university with their own authority.

Williams’s accounts of the dispute (2005 and 2006) are unbalanced and one-sided. Firstly, he focuses on issues concerning power, authority and order and says little about the more important issues concerning intellectual disagreement and rational debate. There is little or no discussion of arguments for or against PE, or of the implications of the dispute for free enquiry and critical analysis. We saw these as the central issues but in his accounts they are relegated to the background. What we wanted, to borrow the title of Williams (2006), was ‘liberal education and useful knowledge’. Secondly, he writes from the administration’s perspective, with no attempt to understand the student viewpoint. This leads to a quite peculiar portrayal of student activists. On the one hand, we are presented as reasonable people — in his meetings with students, he recounts how, after a while, we drifted away, apparently ‘satisfied’ with his explanations (2005: 115). (In fact, we drifted away when it became clear he wasn’t serious about listening to us or resolving the dispute). Yet, on the other hand, we are portrayed as discontented, disruptive and uncivilised elements with a proclivity for force over argument, which is again far from the truth. Both his accounts display an unfortunate underlying tone of patronising mockery towards students.  

Thirdly, the saga is characterised as a process of ‘decision by exhaustion’, not a reliable basis for good decision-making (2005:118–9). This, however, raises questions of leadership. Do good leaders seek to resolve disputes before exhaustion arrives? Do they seek to uphold academic ideals and prevent their restriction? Do they put aside their personal views (as an orthodox economist) and pursue the goals of the university?  

Such struggles over power and governance may seem outdated nowadays. Universities have changed dramatically over the last few decades as managerialism and commercialism have displaced academic and educational values, and balances of power have shifted from staff and students to managers and executives. The question of whether liberal higher education can survive is on the table. Barnett has argued that the powerful forces currently undermining

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8 As a student and young academic, Bruce Williams displayed outspoken socialist tendencies, criticised orthodox economics, became angry at a negative university decision on a staff member’s promotion, had the courage to stand up to a Vice-Chancellor, favoured broadly-based first degrees and interdisciplinary work, and did not shrink from pioneering changes. Such attributes he shared with many later PE staff and students, and it is a pity, in dealing with the dispute, he did not recall his younger days. See Williams (1943) and (2005: 14–5, 19–23, 31–2, 42–4).

9 It seems the VC expected student activism at Sydney University to die out as quickly as it apparently had in the United States (Williams 2005: 80). In this, he badly misjudged the commitment of PE students because he failed to realise that the PE issue was quite separate from Vietnam War protests.
liberal higher education can be resisted, but only if robust educational strategies are implemented in which critical thinking, independent enquiry and student engagement play central roles; in his view, ‘the emancipatory conception of higher education is ultimately founded on the right to criticize, and on the right to dissent’ (1990: 205). By contrast, Williams believes that free enquiry and critical learning can flourish by conservatively following a set of past practices (2005: 314) — as experience has shown, however, these are insufficient.

Peter Groenewegen, for whom I have the greatest respect as a researcher, teacher and scholar, contributed many wonderful things to my education, including a love of the history of economic thought, respect for the importance of history, and an appreciation of the careful interpretation of ideas. Although on opposite sides of the PE dispute, we never exchanged a cross word, then or since. Yet to many students his stance was puzzling. On the one hand, his intellectual views indicated openness to, and acceptance of, the ideas of political economy.\textsuperscript{10} But on the other, he opposed the PE cause and supported a status quo dominated by orthodox courses. It seemed his opposition was based on other than intellectual grounds which were mysterious to most of us at the time. Unfortunately, despite the valuable contributions in many areas made by his history of the Faculty of Economics, I think these other grounds have influenced his portrayal of the PE episode. While not seeking to present a history of the dispute, Groenewegen (2009) discusses some of the key issues in ways which do not always lead to balanced understandings. Firstly, this was an unprecedented period in the faculty’s history — the combination of deep intellectual divisions, the quantum of dissident staff, the alliance between staff and students, the size and engagement of the student movement, and the 39-year duration of the dispute formed a remarkable, and probably unparalleled, episode in Australian university history. Secondly, there is little exploration of the intellectual roots of the divisions that emerged so strongly. Thirdly, the dispute is portrayed as imposing enormous costs and generating no benefits. On the one hand, it is claimed that the ‘full costs attributable to the dispute were in fact enormous’ (2009: 159, 139) while, on the other, no mention is made even of a single benefit; it is left to the reader to draw the inference that the benefit-cost ratio is zero. But whatever one’s assessment of this ratio, surely it is well above zero. Are there not large benefits in having programs of study, whatever they are called, which explore a range of important economic frameworks (both orthodox and non-orthodox) and which are open to interdisciplinary connections? Finally, questions may be raised about the origins of the costs — was it merely persistent PE advocacy, or was it institutional resistance and inflexible pedagogical agendas? In retrospect, there have also been huge costs in supporting orthodoxy. Quite apart from its antipathy to pluralism, the dominance of American-style neoclassicism in

\textsuperscript{10} See, for example, Dollery (2002) and Groenwegen and McFarlane (1990: ch. 10).
recent decades has led to the tragic eliminations of the history of economic thought, economic history and methodology from most economics degrees in favour of yet more formal analysis. These losses of historical perspective and self-awareness have suited the context-less, monist character of orthodoxy, but have imposed great costs on intellectual enquiry and humanity.

The Issue of Violence

In reality, violence was a very minor part of the dispute. However, since its role has been greatly exaggerated in some accounts and since it arouses strong feelings, it is important to put the issue into proper perspective. Williams’s memoirs, in particular, give violence a very prominent role, the two 1970s occupations being cited as prime examples. A brief, but more accurate account is as follows.

In the 1970s, roughly 99 per cent of the time and energy of the student movement was expended in constant talk, argument and promotional activities — meetings, debates, pamphlet-writing, poster-creation, politicking, signature collection, electioneering, advising students, educational events, pavement-chalking and so on. Only about 1 per cent of our time was spent in demonstrations or marches, nearly all of which were peaceful. Our main focus was on advancing the cause through argument and persuasion, not through physical violence. Demonstrations and occupations only occurred when anger reached high levels. Those in authority, who observed very little of the former but saw, or heard of, most of the latter, could easily form distorted pictures. The photographic record also biases the dramatic over the prosaic.

The following, I submit, is a more accurate portrayal of the issue of violence over the 39 years of the dispute:

i) Occupations by the organised student movement were rare events — only five occupations occurred, clustered into two periods (1975–76 and 1983).

(ii) In these occupations violence was done to property, with no staff being assaulted on any normal definition of the term.

11 Graffiti sprayed outside residences in 1975 and 1976 was not authorised or perpetrated by the organised student movement; see Butler et al. (2009: 44–5).

12 To my knowledge, only two people were hurt during PE occupations and demonstrations in the 1970s. One was Mrs Sim, the VC’s secretary, who sustained a slight arm injury in 1975 trying to prevent students from entering the VC’s office. Once the student leadership became aware of this, a card and flowers were sent the next day; our argument was with the VC, not his secretary. The other was a student whose arm was deeply gashed when a staff member forcibly closed a glass door on him. Contrary to the impression created by Williams (2005: 112), he never ‘suffered direct physical violence’ during the PE occupations of 1975 and 1976 as he was absent on both occasions. Nor does his memoir provide any details or evidence for his allegation that ‘threats of further violence’ were uttered.
(iii) Any damage done to property was relatively minor — only easily repairable/replaceable items were damaged (such as doors and grilles), not structural ones.\(^\text{13}\)

(iv) Violence only occurred in extreme situations when, after an accumulation of negative decisions by the administration on key issues, anger and frustration among students reached high levels. To focus on the issue of violence is to miss, and misrepresent, the central issues which always concerned intellectual differences over economics and university ideals.

Williams (2005: 109) claims the 1975 occupation of his office was a ‘commando-style operation’. In fact, the student movement had no premeditated plan for, or even prior discussion of, an occupation. The background and events were as follows. The preceding 15 months had seen, from a PE viewpoint, an accumulation of major grievances against the administration — the Mills Committee recommendation for a separate PE department and program was refused by the VC, a staff petition for an elected head of department was ignored, two PE tutors received discriminatory treatment, a PE student was suspended, the VC showed no intention of resolving the dispute at a public meeting, Ted Wheelwright was passed over in favour of an academically inferior orthodox candidate for an economics chair, and there were delays in approving the third-year PE courses.\(^\text{14}\) A front lawn meeting was organised in July, following which we marched to the VC’s office to present our motions. Knocking did not result in the door being opened and, in the heat of the moment, two angry students at the head of the procession broke open the two doors leading to the office. Students then occupied the office but did very little damage.

The 1976 occupation followed a similar pattern, the largest additional grievance being the VC’s refusal to implement the Academic Board’s recommendation to establish a separate (temporary) Unit of PE. We saw this as a highly provocative rebuff displaying an underlying determination to give nothing to PE. Our use of the proper channels had resulted in a considered compromise which gave the PE movement some benefits, but even this was rejected. Prior to the ensuing front lawn meeting, there was no prearranged plan to occupy any offices, and the meeting itself did not call for an occupation. At its conclusion, we marched to the VC’s office to deliver the passed motions but the door to a common thoroughfare near his office had been locked prior to our arrival. This further rebuff raised already high feelings. The lock was broken, and subsequently a group of students took matters into their own hands and occupied the

\(^{13}\) Groeneewegen (2009: 147) claims that in 1976 ‘considerable damage’ was done and that three senior administration figures were ‘assaulted’. The former is incorrect (no source is provided), and the latter, as indicated below, is incorrect if normal language is used.

\(^{14}\) For details, see Butler et al. (2009: ch.2).
Registrar’s office. Some other damage was done to property (not extensive) and some administration staff were jostled in crowded spaces. Initially, three students, including myself, were suspended and required to face Proctorial Board hearings. After submission of all the evidence and quasi-legal argument, I was acquitted on all charges. Despite my having the distinction of being the only suspendee named in the VC’s memoir, this outcome was omitted from his account.

Games are also played with the word ‘assault’ in the memoir. This has two meanings — a normal meaning in which physical contact is made in order to inflict injury, and a much broader legal meaning covering both the normal meaning and various other actions, including some not even requiring person-to-person contact. Williams initially (and dramatically) claims that staff were assaulted in the 1976 occupation, but more accurately later acknowledges that violence against persons ‘did not happen’; in his words, ‘the force was designed to push the porters out of the way but none of them suffered physical injury. There was even some humour involved.’ (2005: 111, 113). Jostling and pushing certainly did occur, this being inevitable in crowded areas as people tried to find places to stand or to move forward, but no attempts were made to assault anyone in any normal meaning of the term.

**Skill Sets and Employability**

In the early years, critics spread fears about the employability of PE students. These fears have proved to be unfounded as thousands of PE graduates have continued to develop successful careers. Indeed, Ross Gittins, the widely read economics editor of the *Sydney Morning Herald*, prefers to employ PE graduates because of their broader perspectives, greater understanding of the real world, and good communication skills.

Alongside their discipline knowledge, the skill sets that students take into the world are vital determinants of their achievements after graduation. Nowadays, employers, governments and universities the world over want graduates to develop specific skill sets, the desired attributes embracing creativity, critical thinking, communication skills, independent learning, problem-solving, teamwork and interpersonal skills. In economics, it can be shown that well-

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15 Groenewegen (2009: 147, 157) incorrectly states that both the VC’s and Registrar’s offices were occupied in 1976.

16 My recollection is that one other student was also acquitted on all charges, but this needs verification. Subsequently, another three students were suspended. It is currently impossible to access the university archives on the charges and outcomes for the other five 1976 suspendees because all Proctorial records at Sydney University are closed for 50 years.

designed pluralist courses are superior to orthodox courses in providing graduates with the full skill set, especially in relation to the fostering of creativity and critical thinking.\textsuperscript{18} Disciplinary openness, multiple perspectives and the rigorous exploration of alternatives provide learning environments which enhance creative and critical capacities, while Neoclassical economics, with its monism and self-sufficiency, generates environments which constrain them. Discursive reasoning also enhances communication skills more than mathematical reasoning, while reflective pluralism supports core university ideals such as free enquiry, critical thinking and the broadening of horizons.

\section*{Conclusion}

The final outcome of the dispute was the establishment in 2008 of a separate Department of Political Economy in the School of Social and Political Sciences in the Faculty of Arts. This would not have eventuated without the commitment of generations of PE staff and students in a protracted and sometimes arduous struggle.

Why is there a permanent need for political economy? At least five reasons may be given. Firstly, it is a powerful way of broadening, deepening and enriching economic understanding beyond the narrow confines of orthodox economics (which PE includes). Secondly, it is more open and welcoming to interdisciplinary exchange. Thirdly, the improved understanding that it generates leads to better decision-making in both public and private sectors. Fourthly, it has a greater potential than orthodoxy for developing highly desirable graduate attributes. And finally, it embodies vital university ideals such as liberal education, free enquiry and critical thought, none of which can ever be taken as guaranteed.

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\textsuperscript{18} See O’Donnell (2009).


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‘By the end of the book I was none
the wiser’

JOHN HAWKINS

In reading this account of the fight to establish courses in ‘political economy’ (PE) at the University of Sydney I was put in mind of the old adage ‘Academic politics are so vicious precisely because the stakes are so small’, variously attributed to Henry Kissinger, Wallace Sayre and Woodrow Wilson. However, this would be flippant. The authors state that over 12,000 students have taken the PE courses offered at the University of Sydney since the mid-1970s. They cite Greg Combet as a prominent PE graduate. So PE may have had a significant impact on a number of people now playing an important role in policy-making in Australia. Political Economy Now! is written by three of the leading academic champions of PE, and represents an expansion and update of Jones and Stilwell’s 1986 essay. As well as their own account, the book is augmented with the recollections of a number of former PE students, mostly now working as academics. These are interesting but uncritical. (Were there any students who regretted taking the PE options?) Overall the book is an interesting read, and the authors make no attempt to disguise that they are giving their side of the story.

As an Economics graduate (in the orthodox rather than PE stream) from the University of Sydney the book holds nostalgic appeal for me. By my time there tempers had cooled from the tumult of the mid-1970s, as the end of the full-employment era had focused students’ minds more on getting a useful qualification than changing the world. There were no student occupations, but the dispute between the two factions was still continuing.

Early in the book a good question about the PE dispute is posed by John Burgess: ‘Why did it happen only at Sydney?’ (p.xviii). By the end of the book I was none the wiser.

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1 Australian Parliament House; John.Hawkins@aph.gov.au.
2 The book has some interesting vignettes, such as the attempt by Malcolm Turnbull, then law student and student representative, to mediate between the PE and orthodox groups (p.40).
3 There are elements of self-criticism in the book. ‘No doubt there were regrettable behaviours by people from all camps during the confrontations that occurred, particularly in the 1970s and 1980s’ (p.134); ‘We are sorry now that we did not handle ourselves better on some occasions’ (p.183). But overall there seems pride in incidents such as the occupation of the Vice-Chancellor’s office. Such behaviour seemed embarrassingly juvenile to many at the time, and probably even more so now. It probably confirmed the prejudices of those like Kerry Packer who thought that a university education for his son would ‘just teach him to smoke dope and give him left-wing ideas’.
Was the teaching in economics at Sydney more mathematical, more politically biased, or narrower than at other universities? My own recollections are that the courses offered were not unusually theoretical. There was one course, ‘The Australian Economy’, taught by Sir Hermann Black, the chancellor no less. It was largely descriptive, could not have been more ‘real world’, and provided a good grounding for a working economist.

Or was it that there was bunched at Sydney (by chance?) a critical mass of like-thinking economists, while elsewhere they were isolated? Or were the professors more intolerant and less consultative than elsewhere?

Professor Warren Hogan is cast as the villain in this story. To my knowledge he has not written on what he regards as a ‘wasteful and difficult’ dispute, but the matter is raised in his interview by John Lodewijks (2007). In Hogan’s interpretation ‘the turbulence which lasted for so many years had its origins ostensibly in issues related to quantitative work, though the inspiration lay with other matters related to ideology and aspirations as well as personal ambitions of some involved.’ Hogan recalls after his arrival at the University of Sydney in 1968 moving to increase the quantitative work within the BEc degree, which he felt was much less than in comparable universities. In a possible dig at the PE movement, he said ‘if undergraduates cannot understand basic aspects of quantitative work, testing the applicability of theoretical constructs becomes very hard to resolve. A state of indeterminacy may well have been comfortable for some not wishing to seek preferences of one claim to validity over another in order to sustain unsubstantiated claims.’

My recollection of ‘freshers fair’ was that the PE options were marketed to newly enrolling students as much for being easier — since they had no maths — as for claims of greater ‘relevance’. The authors cite Geoff Harcourt as arguing ‘radical critics of economics need a thorough knowledge of the orthodoxy first’ (p.49). This is precisely the concern I had about the PE courses. I recall in the honours seminars one of the students who had come up through the PE stream had never encountered the expression ‘real interest rate’.

Cast as Hogan’s accomplice is Peter Groenewegen. He all but ignored the PE group in his history of Australian economics (1990). In his 1979 essay on radical economics, he opposed what he saw as a goal of ‘intellectual apartheid’, advocating that ‘radical economists should interact with their more orthodox colleagues (and vice versa)’. In his just-published history of the Economics Faculty at Sydney, Groenewegen naturally includes a discussion of the PE dispute. He concludes that ‘both faculty and department suffered enormously from it’ and remarks ‘nor can it be said that the involvement of non-faculty
persons in generating solutions for an academic dispute on how best to teach economics to tertiary students was a satisfactory means to produce academically acceptable course outcomes’ (p.159).

Unmentioned by the authors is the man who could be seen as their precursor, the first Professor of Economics at Sydney (indeed the first in Australia), William Irvine. One of the most prominent radical economists of the first half of the twentieth century, he epitomised many of the virtues to which the PE movement aspired, not just in being a radical but being described as an inspirational ‘magnificent instructor’. But he remained more truly relevant than PE ever has — prominent in public debate, author of numerous books and state government reports, a bank director, a witness at the basic wage hearing and an adviser to Depression treasurer Theodore. He represented a road not taken by the PE group, staying more engaged while still arguing for radical change.

Recent events may allow us to call the dispute closed. From 2008, the PE staff became a department in the Faculty of Arts, rather than the faculty of Economics and Business, and from 2009 were contributing to a degree in ‘international and global studies’. The authors regard this as a ‘win’. To me it is more an ‘own goal’ for them. It has ensured that students studying economics within the Economics faculty at Sydney will be exposed to a much less critical treatment of Neoclassical economics than before the separatist movement started. This is a shame. During my time there, an honours seminar was held which brought together the PE and mainstream students. I enjoyed the seminars chaired by Frank Stilwell. His approach was inclusive and friendly and it was stimulating being exposed to alternative views. While I certainly would not have wanted that to be the only style of economics I learned, it is a pity that it is now exiled to another faculty. The timing of the flight to the Arts faculty seems particularly unfortunate. Recent events should have increased interest in views about causes of instability in global capitalism and the Economics faculty is where such matters should be debated from a range of perspectives. The authors acknowledge that ‘hiving off political economy to a separate degree had, in effect, diminished the pressure for reform within the mainstream economics courses’ (p.82) but they do not seem to regret this.

In the end, the question is: how effective have the PE activists been in creating a better world and training better economists? Would they have been more effective trying to change the system from within? We await a more dispassionate outsiders’ account to assess this.

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4 Professor Groenewegen’s views are similar to those expressed by the then vice-chancellor Bruce Williams, who recalls in his memoirs ‘decisions by exhaustion are seldom satisfactory and the political economy decision in July 1983 was not’ and feels the protests around the issue ‘may even have affected ... the public reputation of the university’ (p.119). More hostile accounts of the PE movement are given in articles by Tony Abbott and David Clark.
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RETROSPECT
Seeking the elusive town and gown dialogue: the inaugural Australian Economic Forum

ROSS GUEST

Academic disengagement

The town and gown dichotomy sounds anachronistic. Yet in the field of economics there remains surprisingly little direct engagement between economists from business and academia. This disconnect was evident at the inaugural Australian Economic Forum held in Sydney on 19–20 August 2009.

The Forum was a laudable attempt to establish a more productive dialogue between economists from all sectors. As the brochure said:

Although there are a number of forums that focus on different aspects of the Australian economy, none provide the opportunity to discuss current and future economic policy or an open forum for rigorous economic debate across sectors. Under the auspices of the Economic Society of Australia (NSW Branch), the Forum will provide an annual opportunity for economists, business professionals, academics and public servants from all levels of Government to come together and discuss targeted economic issues.

Yet very few academics came. It was dominated by business and government economists, and economic consultants (I put these three groups under the umbrella ‘business economists’, representing economists from sectors other than academia). Of the 130 registrations, about 5 per cent were academics, 60 per cent were from government (mainly state and federal treasuries) and the remainder were from consultancies and other private organisations.

1 Griffith University; r.guest@griffith.edu.au.
2 The distinguishing role of academic economists is that of educating students and creating new knowledge as a public good. However, the day-to-day process of creating the latter, through research, can be quite similar to the work of some business economists.
This registration mix is true to form. By and large, academic economists go to academic conferences and business economists go to business forums such as CEDA\textsuperscript{3} events and now the Australian Economic Forum. Rarely the twain shall meet.

Is this a bad thing? If not, it should be of no concern to anyone, including organisers of such forums in future. On the other hand, if it is an undesirable state of affairs we should look to the causes and possible remedies.

There are reasons to think it is undesirable — that there should be more cross-fertilisation of ideas and perspectives among academic and non-academic economists through direct public dialogue.

We could start with the global financial crisis (GFC), one of the themes of the Forum. Almost all mainstream economists from all sectors were completely blindsided by the GFC — in particular, its depth and speed of contagion (The Economist, 2009). They relied on economic models, whether for forecasting or analytical purposes, that have their roots in the academic literature. The essential building blocks of such models, including assumptions, are created in academia and disseminated through academic journals and books. The reasons why these models failed to predict the GFC are beginning to be appreciated (see, for example, Colander \textit{et al.} 2009). They include the failure to properly model the implications of leverage, the mis-pricing of risk, financial market ‘imperfections’, and confidence. Regulatory shortcomings were also partly responsible, but these regulations or lack thereof were largely a product of the economic orthodoxy. Some prominent mainstream economists have been scathing. Eichengreen (2009) says: ‘The Great Credit Crisis has cast into doubt much of what we thought we knew about economics.’ One need not go that far (see the counter-view by Lucas 2009, in defence of economic modelling) to acknowledge that it is time for a more open, collaborative dialogue from economists from all perspectives and related fields such as finance, accounting and even management and psychology.\textsuperscript{4} It might therefore be helpful for the builders of economic models to engage more with the end-users: those developing policy in government agencies, consultants, bank economists, and so on.

\textsuperscript{3} The Committee for Economic Development of Australia holds regular events in various formats. The aim is to provide 'An independent, open platform to discuss and understand economic, business and policy issues. See http://ceda.com.au/public/events/about_ceda_events.html.

\textsuperscript{4} In fact, the views of Eichengreen and Lucas are not as divergent as first appears. Eichengreen acknowledges that the causes of the GFC can be found in the extant economics and finance literature — for example, agency theory, information asymmetry and behavioural finance. Lucas just goes further to argue that economic and financial crises are not inconsistent with the efficient markets hypothesis, nor is it reasonable to expect that such crises be predicted or prevented by the macroeconomic models used by central banks. These models provide 'forecasts of what could be expected conditional on a crisis not occurring'.
Closer engagement of academics with external stakeholders would also make sense from the universities’ point of view. In the last decade or so 11 Australian universities have sought and achieved international accreditation for their business/management education programs with one or more of the three major accrediting bodies: EQUIS\(^5\), AMBA\(^6\) and AACSB.\(^7\) The criteria for accreditation typically include evidence of an interface with the corporate world, especially the EQUIS criteria which include: ‘a balance between high academic quality and the professional relevance provided by close interaction with the corporate world. A strong interface with the world of business is, therefore, as much a requirement as a strong research potential.’\(^8\)

Accreditation is one driver of a relatively new desire by universities to engage with external stakeholders, especially (in the case of business and commerce faculties) business stakeholders such as future employers. Another driver is the AUQA quality-assurance process which requires, among other things, truth in advertising — if degree programs say they offer relevant and applied education then there must be processes in place to ensure this is achieved. Business Advisory Boards have an important role in this regard.

Also, as Australian universities nowadays typically receive at least 50 per cent of their income from fees and other private sources (OECD 2008), and have more freedom to set fees, the competition for students has become more intense. Students want to see that their education provides good career preparation for the ‘real world’ — hence we now have a university officially marketing itself as ‘the university for the real world’.

These drivers have led universities to encourage academics to engage more closely with their stakeholders. This is sometimes called, in the jargon of the annual performance review, ‘community service’ or ‘external service’. Academics earn ‘points’, implicitly or explicitly, for external engagement activities.

In fact, academic economists have responded to these incentives to some extent. For example, academic economists are now more inclined to express their views in the print media and through blogs. For example a number of them write occasional articles in the Australian Financial Review, The Australian and the Courier Mail, among other outlets. Not so long ago academic economists were all but invisible in the media and the public space. If a media outlet wanted a comment on the economic news story of the day they went to ‘market’

\(^{5}\) EQUIS (European Quality Improvement System) accreditation is managed by the EFMD (European Foundation for Management Development).

\(^{6}\) Association of MBAs.

\(^{7}\) Association to Advance Collegiate Schools of Business.

\(^{8}\) Available at: http://www.efmd.org/index.php/component/efmd/?cmsid=041004geyi. (Last accessed 29 August 2009.)
economists from banks and the like. This has changed to some extent due partly, one suspects, to the signals from university managers that this sort of activity is valued.

Economists are also trying to reach out to the ‘real world’ through books; and this is apparently an international phenomenon. There is a plethora of books in airport bookshops popularising economics, including The Undercover Economist, The Airport Economist, The Economic Naturalist, and Freakonomics.9 The university curriculum too has a more applied focus nowadays. Witness the number of courses in business economics, economics for managers, and specialist fields such as environmental economics, sport economics, tourism economics and media economics.

There is, however, one very important driver working in the opposite direction, creating disengagement. This driver is what Bruno Frey (2009) has called the PITS (Publication Impossibility Theorem System), which is a modern version of the old ‘publish or perish’ injunction. Frey’s variant derives from the relatively new phenomenon of journal rankings and the more explicit linking of rewards with publication outcomes in ‘A’ journals. He argues that this is a tournament in which by definition most academics will fail, implying a huge amount of wasted academic activity. Even the few that are published, with vast amounts of time and effort, are rarely cited — the median number of citations of economics articles is zero or close to zero (Laband and Tollison 2003, in Frey 2009). Frey argues that the excessive effort on fruitless research is driven in part by the inadequate measurement of, and reward for, other activities of academics that are purportedly valued by universities, including ‘informing and advising the public’ on pressing public-policy issues. This echoes Guest and Duhs (2002) who analysed the distortion of academic effort due to inadequate measurement of performance in other areas, notably teaching.

Productivity Commission Chairman Gary Banks (2009) recently lamented that academics nowadays don’t seem to be interested in consulting work with government agencies. Clearly they would prefer to devote their time to writing papers for ‘A’ journals. This is, of course, the very same reason they are not interested in participating in forums such as the Australian Economic Forum — it is perceived as unlikely to further their prospects of academic publication. Gary Banks recalls an era when:

the involvement of academics was instrumental in developing the evidentiary and analytical momentum for the first waves of microeconomic reform. Examples from the trade and competition policy

Seeking the elusive dialogue of town and gown

arena alone include Max Corden, Richard Snape, Fred Gruen, Peter Lloyd, Bob Gregory, Ross Garnaut, Fred Hilmer, among others. Where are the new academic generation’s equivalents in support of the ‘Third Wave’?

Banks argues that this is a crucial loss because public-sector agencies need to develop evidence-based policy, where academics offer certain advantages over private consultants to whom agencies have increasingly had to turn. For example, ‘consultants often cut corners’ and ‘their reports can be superficial’.

If Banks is right about a sub-optimal level of academic input into public-policy development, and if this is due to the incentives facing academics, then there is a case for public policy itself to redress these incentives. Research grants could play a role here. Targeted research-grant schemes would be one way of incentivising academics to work with government in public-policy development. One option would be to create a special category of ARC Linkage Grants to promote collaborative research between government agencies and academia. Of course, such projects can already be funded through the current ARC Linkage Grants system, but a special category with extra funding would be helpful. Another option would be to create a new ARC Special Research Initiative in public-policy development; or perhaps even an ARC Centre of Excellence. Priority areas for research collaboration could be aligned with the ARC National Research Priorities. A difficult yet important issue is how to know whether initiatives that shift the mix of economic research toward public-policy development yield net positive social value. Possible indicators might include better public policy and higher academic citation rates.

Business and government economists demonstrate a keen interest in academic work. When economists in government treasuries, government agencies such as the Productivity Commission, or private consulting firms, are faced with an issue to investigate the first place they tend to go is the academic literature. The literature typically provides them with the analytical framework and the extant empirical evidence, internationally and domestically, on the issue at hand. The Henry tax review is a good example. At the Australian Economic Forum, the Chairman of Australia’s Future Tax System review and Treasury Secretary Ken Henry talked about the ‘good, bad and ugly’ taxes. Stamp duty qualified as a ‘bad’ tax on both efficiency and equity grounds. He was drawing on tax theory, well established in the academic literature. It is clearly essential that academics create this literature. But it is also true that the social value of the research endeavour depends on the use to which it is put, which in turn depends on the relationship between the creators (academics) and the end-users. In this relationship one side, it seems, is not pulling its weight. That is not a criticism of individuals who are simply responding to the incentives facing them, but of the incentives themselves that drive the allocation of academic time and effort.
Format of the sessions at the Australian Economic Forum

The aim of the two-day Forum — ‘the opportunity to discuss current and future economic policy or an open forum for rigorous economic debate across sectors — is worthwhile in filling the gap between academic conferences and events run by organisations such as CEDA, the CIS, the Melbourne IAESR, NATSEM and Australian business economists. Their events have narrower themes that reflect their particular missions. Under the auspices of the Economic Society of Australia, the Forum was able to cover a wide range of subject matter (see the section below).

Overall, the Forum was a success. However, it could have been even better. Apart from the noticeable absence of academics, the other disappointment was the format of the sessions, which were generally rather sterile. With one exception, the sessions were run like conference sessions. This applies to both the plenary sessions and the streamed sessions. The presenter stood at the lectern and delivered a Powerpoint presentation, followed by about 10 minutes of questions from the audience. This can be an efficient format for delivering information to an audience. But it is not very stimulating or engaging — not the best forum for achieving ‘rigorous economic debate’.

The one exception, which in my view turned out to be the best session, was the final session: ‘The Premier’s Panel’. This panel session was chaired by Quentin Dempster, whose media experience and expertise enabled him to get some lively interaction between the panel members and also to engage the audience. More sessions like this would have provided variety and more stimulating debate. The very first session on the fallout from the global financial crisis, with a panel of speakers, was an attempt to generate debate but didn’t quite succeed.

Having said that, the traditional presentation format can work well if the speaker is sufficiently engaging and well-prepared. Special mention in this category goes to two people: Stephen Mayne, founder of Crikey.com, and Tim Harcourt, Chief Economist at Austrade. Both gave thought-provoking and entertaining presentations, although different in style. Stephen Mayne spoke virtually without notes, while Tim Harcourt had elaborate slides.

10 The Committee for the Economic Development of Australia, the Centre for Independent Studies, the Melbourne Institute of Applied Economic and Social Research, and the National Centre for Social and Economic Modelling, respectively.
11 Tim Harcourt presented on Australia’s export performance in recent years (presentation available at http://www.australianeconomicforum.com.au/LinkClick.aspx?fileticket=5P%2bhJWFLw%2fM%3d&tabid=56); and Stephen Mayne spoke about lessons from the GFC for shareholder activism (electronic copy was not available on the Forum website as at 10 September 2009).
There were one or two poor presentations in which speakers simply read out a prepared speech verbatim, with head down for most of the time. Some high-profile speakers seem to think that simply being there is sufficient — no need to engage the audience who are enthralled by their very presence.

In future, a mix of formats among the sessions would probably work best and this might include one or two more traditional keynote addresses. Two alternative formats that might be worth exploring are to be found at the annual ‘Consilium’ run by the CIS, and the debates held by Intelligence Squared Australia. At the Consilium, more than a hundred participants sit around a very large table. In a given session a number of participants are given three minutes to speak on an invited topic. A general moderated discussion follows under Chatham House rules. The advantage of this is that a greater number of people have an opportunity to present their message and there is more time for debate, with Chatham House rules being less inhibiting. At Intelligence Squared Australia, the format is a debate led by prominent speakers but with audience involvement.

**Subject matter**

The subject matter itself was well-chosen. Most of the important and controversial public-policy issues in Australia today were on the agenda: the GFC, climate change, tax policy, infrastructure reform, housing affordability, water security, and policy issues in education, health, energy and transport. International trade policy was perhaps a notable omission (except for the export opportunities from climate change). In fact, there was a lack of international perspectives on other policies, climate change being an exception. All of the speakers were Australian; one or two international speakers would have provided a useful perspective. The subject matter was so wide-ranging and topical that it presents a challenge for next year’s forum, assuming there is one. Many of the above issues will no doubt remain prominent in the public debate, so it would be appropriate to revisit them. The challenge will be to find a fresh perspective and some different yet high-profile speakers. An alternative format would do the trick.

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12 See [http://www.iq2oz.com/](http://www.iq2oz.com/). Intelligence Squared Australia is an initiative of the St James Ethics Centre and is based on the program which began in London in 2002. The Australian program is produced in partnership with *The Sydney Morning Herald* and is supported by the City of Sydney.
References


REVIEWS
(Princeton University Press, 2009)  
REVIEWED BY SELWYN CORNISH

After asking [Alan] Greenspan a few questions, the chairman of the House Committee on Government Oversight and Reform, California Democrat Henry Waxman, summed up. ‘In other words,’ he said, ‘you found that your view of the world, your ideology, was not right. It was not working.’

‘Precisely,’ replied Greenspan. ‘That’s precisely the reason I was shocked, because I had been going for forty years or more with very considerable evidence that it was working exceptionally well.’

Justin Fox 2009

The financial and economic crisis through which the world is passing has brought a renewed interest in the 1936 masterpiece of John Maynard Keynes, *The General Theory of Employment, Interest and Money.* But this does not herald the return of the false version of Keynes that prevailed in the 1960s and 1970s, which alleged that his argument is dependent on the assumption of sticky wages, or that his policy position can be represented by the so-called Phillips Curve. Rather, the present interest is focused on what he had to say about uncertainty and its relation to decisions to invest, best summed up by Keynes himself in the words ‘animal spirits’.

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1 Research School of Economics, College of Business and Economics, The Australian National University; Selwyn.Cornish@anu.edu.au.
3 In response to this interest, three leading scholars of Keynes have written new books — Peter Clarke, *Keynes. The Rise and Fall and Return of the 20th Century’s Most Influential Economist*; Paul Davidson, *The Keynes Solution. The Path to Global Economic Prosperity*, and Robert Skidelsky, *Keynes. Return of the Master*. 
Akerlof and Shiller have drawn upon this phrase and the ideas associated with it to promote their view that contemporary macroeconomics is deficient because it is based on the assumptions of rational thinking and economic motives, failing as it does to take account of certain psychological or behavioural propensities that are also responsible for economic decisions. According to the authors:

The real problem...is the conventional wisdom that underlies so much of current economic theory. So many members of the macroeconomics and finance profession have gone so far in the direction of ‘rational expectations’ and ‘efficient markets’ that they fail to consider the most important dynamics underlying economic crises. Failing to incorporate animal spirits into the model can blind us to the real sources of trouble. (p.167)

The aim of their book is to reconsider the ‘fundamental message of The General Theory’ — that ‘the economy is not just governed by rational actors, who “as if by an invisible hand” will engage in any transaction that is to their mutual economic benefit, as the classicists believed’ (pp.viii–ix). Instead, like Keynes, they assert that ‘much economic activity is governed by animal spirits.’

In The General Theory, Keynes dealt with the issue of ‘animal spirits’ — he mentions the term on three separate occasions — in Chapter 12, which is headed ‘The State of Long-Term Expectation’, surely the most important chapter of the book. There, Keynes spoke of:

…the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits — of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities. (p.161)

And he went on: ‘if the animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die; though fears of loss may have a basis no more reasonable than hopes of profit had before.’ (p.162) Keynes wrote:

We should not conclude from this that everything depends on waves of irrational psychology. On the contrary, the state of long-term expectation is often steady...[but]...We are merely reminding ourselves that human decisions affecting the future, whether personal or political or economic, cannot depend on strict mathematical expectation, since the basis for
making such calculations does not exist; and that it is our innate urge to activity which makes the wheels go round, our rational selves choosing between the alternatives as best we are able, calculating where we can, but often falling back for our motive on whim or sentiment or chance. (pp.162–3)

What do Akerlof and Shiller mean exactly by ‘animal spirits’? ‘People’, they contend, ‘have noneconomic motives. And they are not always rational in pursuit of their economic interests…these animal spirits are the main cause for why the economy fluctuates as it does.’ (p.ix) The authors present the essence of the problem in the following arresting way:

Picture a square divided into four boxes, denoting motives that are economic or noneconomic and responses that are rational or irrational. The current model fills only the upper left-hand box; it answers the question: How does the economy behave if people only have economic motives, and if they respond to them rationally? But that leads immediately to three more questions, corresponding to the three blank boxes: How does the economy behave with noneconomic motives and rational responses? With economic motives and irrational responses? With noneconomic motives and irrational responses? (p.168)

For Akerlof and Shiller, ‘the answers to the most important questions regarding how the macroeconomy behaves and what we ought to do when it misbehaves lie largely (though not exclusively) within those three blank boxes. The goal of this book’, they proclaim, is ‘to fill them in.’ (p.168)

In Part One they nominate five categories of animal spirits: confidence, or the lack of it; fairness; corruption or bad faith; money illusion; and ‘stories’. These ‘irrational’ and ‘non-economic motives’ are claimed to be major influences in the determination of economic decisions. Confidence (or its reverse), they argue, tends to grow as the momentum of activity builds in one direction or the other and soon dominates economic decision-making; a sense of fairness as to how well people are treated can also influence economic decisions, as in wage negotiations; corruption relates to how people take advantage of others, as in the case of the sale of sub-prime mortgages to persons who have no possibility of servicing their debt; money illusion is when decisions are made on the basis of nominal values rather than upon the basis of real values; and economic decisions are often based on stories, such as the common assertion that house prices will continue to rise, as they had in the past.

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Those with a knowledge of the history of economic thought will recall at this point the famous article by J. H. Clapham, published in the *Economic Journal* in 1924, which bore the title ‘Of Empty Economic Boxes’ [Clapham 1924].
In Part Two — which contains the substance of the work — the authors apply their examples of animal spirits to various macroeconomic situations, the intention being to demonstrate the significance of animal spirits for particular market outcomes and historical events. They examine eight questions which, they claim, cannot be answered satisfactorily without invoking the idea of animal spirits. The questions (p.6) are: ‘Why do economies fall into Depression?’ ‘Why do central bankers have power over the economy (insofar as they do)?’ ‘Why are there people who can’t find a job?’ ‘Why is there a trade-off between inflation and unemployment in the long-run?’ ‘Why is saving for the future so arbitrary?’ ‘Why are financial prices and corporate investment so volatile?’ ‘Why do real estate markets go through cycles?’ And ‘Why does poverty exist for generations among disadvantaged minorities?’ When applying animal spirits, for example, to fluctuations in share prices, investment spending and prices for real estate, the authors claim that a combination of confidence (optimism and pessimism), stories (house ownership is the best investment a person can make, and prices for houses never fall) and bad faith (teaser loans that are reset after a year or two) needs to be highlighted.

The government, Akerlof and Shiller argue (as Keynes did earlier), must be called upon to tame the ill-effects of our animal spirits. ‘We have forgotten’, they assert, ‘the hard-earned lesson of the 1930s: that capitalism can give us the best of all possible worlds, but it does so only on a playing field where the government sets the rules and acts as a referee.’ (p.173) ‘Such a world of animal spirits’, they claim, ‘gives the government an opportunity to step in. Its role is to set the conditions in which our animal spirits can be harnessed creatively to serve the greater good. Government must set the rules of the game.’ (p.173)

But what form should government intervention take? Here the authors are somewhat vague, eschewing ‘detailed answers’. One concrete proposal is that the monetary authorities should set a target for the growth in credit, the object being to contain both irrational exuberance and pessimism. ‘This target’, they argue, ‘should correspond to the credit that would normally be given if the economy were at full employment. The target should not be merely a mechanical credit aggregate, but should reflect the more general condition that credit be available for those who, under normal conditions, would be deserving of it.’ (p.89)

Akerlof and Shiller have written a book that deserves to be read widely. It is not a long book — some 176 pages of text, with another 40 pages of notes and references — and is written in a style that will appeal to non-economists, devoid as it is of jargon and mathematics. Yet there are aspects of the argument that are not beyond criticism. For what is offered is a series of examples of how the idea of animal spirits can be applied to issues of concern in macroeconomics, rather than a coherent and integrated model of the dynamics of the macroeconomy.
Above all, there is a tendency to argue by definition: a decision is often simply asserted to be irrational or based on a non-economic argument. Others, however, might equally assert that the action taken was entirely rational or based purely on economic considerations. In short, this is a prospectus for further research, rather than a comprehensive treatise that establishes a new and integrated apparatus for thought and analysis.

Reference

Rationality in Economics is based on Vernon Smith’s 2002 Nobel lecture, and five of his previously published papers. But it is emphatically not just a ‘greatest hits’ collection of his major work. Rather, this work is just a starting point for a book that tries to fill what Smith sees as a major failing of the field of study with which he is inextricably identified: experimental economics. ‘Experimental economics,’ says Smith, ‘is good at measurement, testing, and discovery … It has not been good at integration and interpretation within the broader context of human social and economic development.’ His goal is ‘to obtain a larger vision of meaning in social and market behaviour’.

The subtitle, Constructivist and Ecological Forms, refers to the distinction between two kinds of rationality: the logic of a single mind or organisation working rationally and consciously towards an explicit goal; and the logic of unintended consequences that can result in emergent order despite the lack of any overarching design. Examples of the latter are frequently found in nature, such as snowflakes and the evolution of life. Following Hayek and Adam Smith, we have also learned to see such emergent order in the complex of social interactions we call the ‘market’ or the ‘economy’.

The first part of the book is mainly devoted to elaborating the above distinction. The second and third apply it to market and personal exchange respectively, covering topics such as auction design and ultimatum games, while the fourth tackles the more ambitious subjects of philosophy of science and the workings of the mind.

Vernon Smith’s overarching theme is that these two types of logic are not necessarily in opposition. In particular, constructivist logic is good at generating new ideas (or in evolutionary terms, variation), but ‘selection … is
better left to ecological processes’. (p.38) This applies in academia as well as in the marketplace: although individual theories and experiments are the result of constructivist thought, the cumulative results that we call ‘science’ are the product of a complex process of ecological selection, which is why all attempts to construct a cut-and-dried philosophy of science have failed.

It is impossible in this space to give an adequate summary of the vast range of subjects, opinions, asides and conjectures contained in this book. I will merely mention a few of the more intriguing.

On why we are poor Bayesian statisticians: Life is not Bayesian; we can draw a yellow ball from the urn despite only having priors on white and black, and we are adapted to deal with this kind of situation. In other words, we are adapted to deal with surprises, rather than optimal sampling from a set of pre-defined states. A consequence is that our intuitions are less than optimal in situations which are susceptible to more ‘rational’ Bayesian calculation — that is, where there really are only white and black balls.

On loss aversion: We are evolved to survive, not maximise profits (or utility). Double or nothing below a certain income is perfectly rational.

On behavioural economics: ‘Our bounded rationality as economic theorists is far more constraining on economic science than the bounded rationality of privately informed agents is constraining on their ability to maximize the gains from exchange in markets.’ (p.159)

This last hints at a quirk which Smith shares with Hayek: an allergy to state regulation, and a willingness to take extreme risks in dismantling it, which sits oddly with a philosophy that emphasises the limits of human reason. It makes sense, in economics as in medicine, to say that we are dealing with a very complex system that we do not fully understand. Since there are many more ways to be dead than alive, this would seem to encourage extreme caution when tinkering with the status quo. Yet in their antipathy to state regulation, they were willing to take extreme risks in dismantling it. Thus Hayek wanted Thatcher in pursuing her cause to tolerate 20 per cent unemployment rather than a mere 10 per cent. And Smith confidently argues that the Californian electricity crisis was caused by not deregulating enough. A respectable view, perhaps, but the confidence with which it is held is an incongruous with an evolutionary mindset.

In a similar vein, I think Smith is prone to conflate the ability of his experimental subjects to generate efficient outcomes under conditions of ‘incomplete information’ as to the overall market supply and demand, with the ability of markets to deal with ‘incomplete information’ with respect to the quality of the good being purchased. Thus his attempt to redefine ‘market failure’ as merely
a failure in our theory of markets, and his criticism of Akerlof and Stiglitz for pushing policy views beyond the scope of their academic findings, comes off as a little forced, not to mention ironic.

But to Smith’s original goals, it would be hard to argue that the man does not have vision. But I find it equally hard to see this book as a vehicle to communicate this vision to a wide audience. Anyone without a strong background in experimental economics, game theory and the philosophy of science will quickly find themselves struggling with both the level of assumed knowledge and the frequently dense prose.

It is beyond the powers of my narrow constructivist rationality to predict whether this book will be seen as a magnum opus or simply the indulgence of a great man nearing retirement. I will leave this judgment to the far greater ecological wisdom of the profession.
A Toorak mansion in the city's inner-east has set a Melbourne record, selling for more than $20 million. Melbourne's previous record for a free-standing house was Steve Vizard's Toorak abode, which sold for $17.5 million in 2007 after a buyer knocked on the door. But while the sale may be a high for Melbourne, it is well below the Australian record of $45 million paid for Allco founder David Coe's Sydney harbour-front mansion last year.

Australian Financial Review, 19 November 2009

The South Australian government has spent $56 million on consultants and staff on four public–private partnership projects, the state opposition says.

Australian Financial Review, 10 November 2009

The Pharmacy Guild of Australia has released a new report which strengthens its argument that the PBS should not be a target for further cuts. The latest analysis of the sustainability of the scheme, commissioned by the Guild and conducted by Access Economics, has found that the cost of the system to taxpayers will continue to come in much lower than the estimates put forward in the Federal Government's 2002 and 2007 Intergenerational Reports. In 2002, Intergenerational Report 1 projected PBS spending as a percentage of Gross Domestic Product would increase to 3.4 per cent by 2041–42. However, an analysis by Access Economics in March put it at 1.6 per cent.

Pharmacy News, 6 October 2009

Taxpayer-funded subsidies to the aluminium industry will remain secret after the Victorian Government rejected a call for transparency from the state-appointed environmental watchdog. The Age last month revealed Alcoa smelters at Portland and near Geelong were likely to cost Victorians $4.5 billion by the time contracts expire in 2014 and 2016. The Government said energy contracts were commercial-in-confidence and established more than 20 years ago.

The Age, 27 November 2009