Desirability of Regulating Political Parties

Gary Johns

Australia’s major political parties have generally been held to be private associations of political activists who freely determine their own activities. As such, they should not be subjected to government regulation. The scrutiny of their behaviour is a matter for their members and the electorate should only assess the parties’ public performance. However, and more recently, the parties have developed into professional machines with head offices and organisers, and they receive funds from the taxpayer and from sources other than their members. In these regards, the parties have a degree of freedom from the membership by way of professional advice and non-member sources of funds. Furthermore, the parties’ status has changed to the point where their history — ideological, a large membership presence in the electorate and self-supporting — belies their current role. The present parties are brand names with a nominal membership presence in the electorate, where the market for political activism has shifted to interest groups and where they are heavily supported by the state. For example, Gary Gray (1997), the former national Secretary of the Australian Labor Party, estimates a third of all funds available to the ALP comes from taxpayers. The new status of registered political parties is semi-public. Ideally, then, they should be beholden to the public, both electorally and in a more direct proprietorial way, as well as to their membership. The issue is to decide the regulatory mix that would preserve free political association and satisfy the taxpayer’s investment.

The way these questions are addressed depends on the extent to which the party system relies on public trust. For example, the British parties are subject to a minor degree of regulation and almost no scrutiny. This is because the argument that parties ‘are an essential part of civic society and the state should be kept at a distance’ (Seyd, 1988:204), has won the day. The sentiment was elegantly put in a report (Houghton, 1976:75) on public funding, ‘we think it mistaken and possibly dangerous to suggest that any work can be required of a political party—by the State, by Parliament or by anyone other than its members’. Further, ‘(d)irect state aid would breach the established British constitutional practice that organisation for political ends is a strictly voluntary activity’ (Houghton, 1976:78). It appears that British political life will remain ‘based strongly on trust’ (Oliver, 1997:543). Is Australian political life, specifically those parts run by the parties, based strongly on trust? Do the voters trust the competition between the parties as a sufficient form of regulation or do they require as well, scrutiny of the internal operations of the parties?

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There is a strong case to suggest that the still predominant feature of Australian electoral politics, loyalty to the major parties, depends on the electoral system of single-member electorates, compulsory preferential voting and public funding, all of which are props for the major parties. Each prop also tends to be a barrier to the successful entry of new parties and Independents. The desire to regulate Australia’s political parties arises from the fact that the three major parties (Labor, Liberal and National) have formed every Commonwealth and state government since 1941. In other words, it is a response to an oligopoly. Minor parties, such as the Australian Democrats and Independents, are keen on regulation of the majors in the name of enhancing competition. The difficulty with this view is that the oligopoly may arise from a stable political climate and the electoral system, and not be amenable to a party regulation solution. Nevertheless, it has not stopped the calls for legislative regulation (JSCEM, 2000:177). A second source of support for regulation comes from the parties themselves. They have devised systems of financial support, public funding, and consequently are subject to scrutiny in the administration of those systems. A third source of support for scrutiny comes from party members seeking to resolve disputes by litigation. A fourth source comes from the Premier of Queensland, who, as an exercise in winning favour with the electorate, intends to legislate to have the Queensland Electoral Commission scrutinise preselection ballots.

Each of these sources suggests that competition between the parties alone constitutes insufficient scrutiny. Each implies a different form of regulation. Some relate to the expenditure of public funds for elections, others to the internal operations of the parties, particularly with respect to the selection of candidates. For example, Somes (1996:157) argues that the requirement to register parties that seek public campaign funds may change their status from private to public. The implication is that the parties’ behaviour per se should be subject to scrutiny. On the other hand, Forbes (1996:11) cautions that registration ‘govern[s] a single external affair between the Commonwealth and the party as a whole’ implying that the behaviour of parties at large should not be subject to scrutiny.

The suggestion from the regulators is essentially to impose internal democracy on the parties, as some form of compensation for the perceived shortcomings in the competition between the parties. The view ignores the long history of self-regulation, which is a major and unseen task of political parties. For example, they spend a great deal of their time managing the contest between party members for preselection. A recent comprehensive study of the parties (Johns, 2001) suggests the management of their procedures appears orderly and mature, in-as-much-as they each hold regular forums within which rules are discussed, often based on investigations and reports that involve the opinion and sanction of members. Their machinery for deciding preselection contests and settling disputes is in some cases extraordinarily highly sophisticated, in others rudimentary, but in all cases suggest that the parties are able to manage the processes reasonably well and in the main fairly.

How much regulation is too much? Finding the appropriate type and degree of regulation and scrutiny of Australia’s political parties lies in an analysis of three
phenomena: the nature and extent of government assistance; changes in the propensity of members of private associations to assert their right to fair internal processes; and, in the judgement of party leaders as to electorate’s sensitivity to party behaviour. For each, aspects of the internal behaviour of the parties are becoming more public. Together, they constitute an increased level of regulation not necessarily warranted by the behaviour of parties and may be a response to a wider climate of distrust in political process (for a comprehensive analysis of this phenomenon see Nye, Zelikow and King, 1997). The parties, however, as the most visible vehicle for political activism, will reap their share of the urge by the public, the media and other political activists to know more about them.

**Taxpayer Assistance and Consequent Regulation**

The taxpayer assists political parties in various ways. These are not always distinguishable from those that assist non-party members of parliament, but as political parties, indeed the major parties, dominate parliament in Australia it is reasonable to regard the assistance as beneficial to the parties. Indeed, of the 703 members elected to the House of Representatives between 1941 and 1998, only seven were not nominees of a major political party (Department of the Parliamentary Library, 1999:586).\(^1\) Moreover, in the thirty-one Ministries formed during the period no member of parliament who was not a member of the major parties has ever been a part of the government. It is unlikely these parties, Labor and the Coalition, would devise legislation to assist members where they did not become the principal beneficiaries.

Based on party returns to the Australian Electoral Commission (AEC), Horvarth (1999:56) calculates that Federal election funding between 1994 and 1997 constituted 19 per cent and 15 per cent respectively of ALP and the Liberal Party of Australia declared receipts. The figures do not include other forms of state assistance. If those other forms of assistance were included Gary Gray’s observation of ALP finances would likely be accurate and valid for the other parties. The primary form of assistance to parties that are registered with the AEC is public funding for election campaigns. Registered parties spent $33.5m of public funds at the 1998 Federal election at $1.62 per vote (AEC, 1998:App. 2) and millions more at state and territory elections. Reflecting their lack of votes, only $276,000 was spent by Independents. This level of funding is so generous that the AEC concluded, ‘following the 1996 federal election most of the major parties were able to retire debt. Or to put it another way, most of the major parties made a profit out of contesting the first federal election following the increase in public funding … The positive cash flow effects of public funding on party finances continued into the 1998 federal election.’ (AEC, 2000:18).

Another form of assistance is the benefits, apart from salaries, members of parliament receive in order to pursue their work. The total outlays in 1999-2000

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\(^1\) Excludes those who resigned from their party while in parliament, and those who subsequently stood as an independent.
for the provision and administration of Commonwealth parliamentarians’ entitlements were estimated to be at least $354 m (Auditor-General, 2001:11). The difficulty with these entitlements is that members have to pursue a number of objectives. The money they expend on printing and travel for parliamentary and electorate purposes for example are not always easy to separate from party business. Moreover, the Auditor-General (2001:21) noted:

A number of reviews of the administration of Parliamentarians’ entitlements have identified the need for clear guidance as to the definition of the terms ‘parliamentary business’, ‘electorate business’ and ‘party business’... [G]iven the key role the terms play in determining Parliamentarians’ eligibility for a number of otherwise largely unlimited entitlements, the transparency and accountability of the entitlements management framework would be improved by the provision of enhanced guidance to Parliamentarians on the activities likely to be considered to represent parliamentary, electorate and party business … A particular need for greater clarity and certainty relates to the use of entitlements by Parliamentarians during periods of by-elections and general elections.

A third area where parties may seek to use funds for party purposes is in the employment of staff. A recent case before the NSW Industrial Relations Commission, concerning a former staff member of a NSW state member of parliament provides an insight into the use made by members of their staff. The staff member is suing the NSW Speaker for compensation for a harsh and unfair employment contract. Part of the allegation is that she had been expected to gather names and ALP membership forms, while an unidentified third party — who was neither an employee nor a volunteer — paid the membership dues. ‘The consequence of this activity, called branch-stacking, was one that was clearly directed from [the member] to [the staffer].’ (The Australian, 2001:2). Clearly, this is taxpayer assistance to a political party.

Another area where a party, in government, seeks to use public funds for electoral advantage is advertising. The Auditor-General reported expenditure on government advertising on the changes to the taxation system, the GST in particular, in the lead up to the 1998 election:

In contrast to some other jurisdictions, there are no Commonwealth guidelines or protocols on information and advertising campaigns which would inform members of the Parliament and the Government on the framework to be applied, covering matters such as distinguishing between government and party-political advertisements, the distribution of unsolicited material and conduct of campaigns in the lead up to an election … [H]istory shows it is not uncommon for Government advertising to increase in the period immediately preceding an election (Auditor-General, 1998:para 25).
Further, the audit noted:

As at 31 August 1998, the date the Community Education and Information Program [the advertising for the new tax system] formally ceased due to the caretaker convention, $14.9m had been expended and committed on the Community Education and Information Program. (Auditor-General 1998:para 1.14).

While a party in government will continue to argue the right to inform the electorate of changes to the law and programs, Opposition will continue to criticise such expenditure as party-political right up until the time it is their turn to govern! Nevertheless, the opportunity for parties to sell their message at public expense provides a significant advantage over competitors and begs some form of regulation.

These four areas of expenditure are significant — they assist incumbents to retain their seats and given most incumbents are party members this is a considerable advantage to the parties. Nevertheless, the fact that the expenditures are on the public record and subject to audit indicates that the advantages that parties may derive from such expenditures are subject to a regime of scrutiny. Whether such scrutiny does more than legitimise the use of public funds for party-political purposes is open to debate. What is clear is that information about the sources and extent of assistance, including disclosure of donations is publicly available. Less clear is the means to distinguish the ability of parties to ‘piggy-back’ party and electoral/parliamentary/government activities. If such distinctions are well managed, that is, where the public is well informed, it is reasonable to conclude that further regulation of the parties at large is not warranted.

Member Agitation and Legal Scrutiny of Parties

Another form of party scrutiny has emerged from the courts and involves members of political parties. This has arisen from a more general community trend to assert the rights of members of associations and to have disputes resolved by litigation. Whether it is an effective means of providing individual members with a voice and a remedy is problematic. In 1991, Mr Baldwin, a member of the Liberal Party of Queensland, claimed that he had been improperly excluded from the Selection Council process by the Division executive, and consequently had failed to win preselection for the federal seat of Moreton. He took the matter to court (Baldwin v Everingham, 1993). For the first time a judge distinguished the Cameron v Hogan (1934) High Court decision which had regarded parties as no more than voluntary associations and as such not within the jurisdiction of a court. The dispute was justiciable because the rules of the Liberal Party, although a voluntary association, were registered under the Commonwealth Electoral Act 1918 (the Act). ‘There is now a significant public interest in the enforcement of the rules of registered political parties’ (Baldwin v Everingham, 1993:24). The
decision of the party executive was held to be contrary to the party constitution, and consequently the selection process had miscarried. A new preselection took place. Baldwin did not stand however, so his was a pyrrhic victory.

A second case (*Thornley v Heffernan*, 1995), involved the Liberal candidate for the Federal seat of Macquarie. In 1995, Jeanette Thornley was disendorsed and the party executive selected a new candidate without a plebiscite of local members, claiming that there was insufficient time to hold one because of the possibility of an imminent Federal election. Thornley claimed that this was unconstitutional and took the matter to court. The subsequent hearing determined that the executive acted within its powers and Thornley had to carry costs of $70,000 (*Thornley*, 1998 and 1999).

Gerald Sullivan, Labor MLA for Wollongong, lost a preselection ballot in 1999 and took the NSW ALP to court (*Sullivan v Della Bosca*, 1999). Sullivan alleged the improper use of the N. 40 Rule whereby, under prescribed circumstances, the Labor Party NSW Administrative Committee may forgo a local plebiscite and, in combination with branch delegates, select a candidate. The judge found that the Administrative Committee’s suspension of the ballot was within the rules and that although the credential protest should have succeeded, the delegate numbers would not have varied sufficiently to change the outcome of the ballot. Sullivan had to carry his costs for the action.

In July 2001, Bob Tucker, the Queensland Liberal Party candidate for Ryan, sought relief from the courts (*Tucker v Herron and Ors*, 2001) because he faced a preselection panel consisting of essentially the executive and excluding the local membership. Tucker was successful, the court granted an injunction, with costs to Tucker, and directed the Division to hold a plebiscite in accordance with the party rules. Unfortunately for Tucker, he lost the subsequent preselection. One reason for the loss was the party rule that allowed one of his opponents to have new applicants for party membership constitute a majority of a party meeting. The not yet accepted members were able to vote to waive a rule allowing them to become eligible to vote in the plebiscite. Under other circumstances, there would be a period of qualification for eligibility to vote. Incompetent rule-making is a matter for the parties.

These few cases hardly inspire an aggrieved member to take a political party to court. In addition to the financial risk involved, the courts have only looked to the application of the rules. They have not looked to see if the rules have been applied fairly, or indeed if the rules themselves are fair. These are matters reserved for cases involving the interpretation of legislation or the decisions of public authorities, or indeed to contractual relations where equity is a consideration. For example, in the Thornley case, the discretion that the NSW Liberal Executive reserved for itself under the rules was extraordinarily wide. McLelland CJ found that public law principles such as the fair application of rules had no application to voluntary associations (*Thornley v Heffernan*, 1995:9). This left him with a literal interpretation of the rules such that so long as the executive believed that there was insufficient time to hold a new vote it was within its powers to use the emergency procedures. The decision in fact entrenched a very
broad power of the executive to disendorse a candidate and endorse its own without reference to the membership.

Indeed, the situation before Clarke v Australian Labor Party (1999) was not a major breakthrough in asserting the rights of members to fair dispute processes or democratic outcomes. The Clarke cases, however, have opened to public scrutiny the integrity of membership recruitment and of the processes afforded members for the resolution of disputes. The dispute arose over an attempt to defeat Ralph Clarke, a former deputy-leader of the South Australian Parliamentary Labor Party, at preselection. Clarke alleged that 70 new members in his area joined the party on 26 January 1999 but did not pay membership fees personally nor, when invited to, did they attend the local sub-branch. The same occurred in other parts of the South Australian Party. In all, 2,000 members were ‘joined’ on 26 January, which, in a party with a membership of just 3,500, was a veritable stacking spree. The cost of these memberships was $42,000, which by extension means that ‘the entire South Australian branch [division] could be purchased for less than $100,000’ (Clarke 1999). The question that arose was whether the struggle for power within the South Australian Labor Party was played out according to the rules of the party. The court found a number of serious deficiencies in the way in which those responsible for the administration of the party had handled the issues.

There are a number of outcomes from the Clarke victories. There were rule changes to ensure that members ‘must earn their stripes’ (Clarke, 1999) before being eligible to vote in a preselection. The policy behind the proposed rule changes is to encourage a more transparent process of membership recruitment and renewal. The effect may be to slow and regularise the battle for preselection through recruitment. There is also a more serious second matter, the protection of the integrity of association of the party. For example, an association that consists of a large number of people who are unaware of their membership, or who have that membership paid for by others, or who have joined without any apparent adherence or knowledge of the objectives of the association, will not instil a great deal of confidence that it is an association of free individuals. In such cases, the integrity of the association would be severely threatened. Unfortunately for Clarke, he lost the subsequent preselection, but the legal victories have alerted parties that they are vulnerable to court scrutiny in the application of their rules and to public scrutiny, indeed ridicule, on the integrity of their membership.

In the matter of public funds the regulation and scrutiny of parties is relatively straightforward. However, the knock-on effect of the acceptance of funds has been to expose the parties to the scrutiny of the courts. This scrutiny has not proved directly beneficial to individuals but has encouraged the parties to offer some verifiable means of dispute resolution within their rules.

More Direct Forms of Regulation

That scenario may well change if another, more direct form of regulation of parties succeeds. The Premier of Queensland has vowed to introduce legislation into the Queensland parliament to ensure that the Queensland Electoral
Commission supervises preselection ballots for registered parties. The legislation was devised to respond to the crisis of confidence in the ALP caused by the conviction of three party members for electoral fraud, and the resignation of three Labor MPs and a number of party members for witnessing or enrolling voters falsely. These transgressions of public law occurred in pursuit of advantage in preselection contests. Justice Shepherdson, who conducted the Inquiry into electoral fraud for the Queensland Criminal Justice Commission, agreed with the Beattie view in his recommendations (Shepherdson, 2001:171). The legislation is in the tradition of the public supervision of trade union ballots. In the Commonwealth sphere for example, the Workplace Relations Act 1996 has specified since 1988 (and decades earlier in some circumstances) that, unless exempted, all elections for office in registered organisations, trade unions and employer bodies, must be conducted by the AEC.

The trouble is the Beattie and Shepherdson solution for the public scrutiny of private ballots will confirm a lack of trust in all parties. The Shepherdson analysis does not justify public intervention in internal ballots. The Premier’s motivation to involve the Electoral Commission is to spread the blame and the shame of intervention to all parties. This, despite the fact that no other member of any other party has been found to breach public law. Moreover, few, other than members of the Australian Workers’ Union faction of the ALP have been found to breach public law. A problem predominantly in one faction, in one party, which is itself a small component of events affecting the overall standing of parties in the electorate, becomes every party’s problem.

The defrauding of the electoral roll by Labor entities was a response to a particular set of party rules. The fact that the measure of preselection eligibility was enrolment to vote in an election created an opening to win preselection by stacking the electorate through false enrolments. Such behaviour is not necessary, for example, in the Queensland Liberal Party where a voter in a preselection does not need to be on the roll in the relevant electorate. If the National Party opts for a non-electorate qualification for preselections, the ALP could end up as the only party whose preselections are supervised by the Commission. Perhaps that would be a fair outcome, given that only ALP members breached public law.

The Beattie proposals are almost as invasive as those proposed by the Australian Democrats. The Joint Standing Committee on Electoral Matters (JSCEM) report into the 1998 Federal Election (JSCEM, 2000) discussed matters that relate to the internal operations of parties as they affect preselection. In particular, the Committee noted the AEC’s view that ‘most political party constitutions are scant, and inadequately address the internal functioning of membership-based organisations’ (JSCEM, 2000:160). In fact, many of the parties’ constitutions are not ‘scant’ at all; a recent audit of the rules of the major parties indicates their complexity and sophistication (Johns, 2000:401ff). They may, however, not be adequate as guides to good democratic practice. The issue is, who should determine, if not the parties, what is good democratic practice? Indeed, it was the view of the Commission and agreed by the Committee that the Commission should not have the power to impose itself upon the internal
The key constitutional principles of political parties should include: the conditions and rules of membership of a Party; how office-bearers are preselected and elected; how preselection of political candidates is to be conducted; the processes that exist for dispute resolution; the processes that exist for changing the constitution. The relationship between the party machine and the membership requires better and more standardised regulatory, constitutional and selection procedures, which would enhance the relationship between the party hierarchy, office-bearers, employees, political representatives and the members. Specific regulatory oversight to include: scrutiny of the procedures for the preselection of candidates in the constitutions of parties to ensure they are democratic; all important ballot procedures within political parties to be overseen by the AEC to ensure proper electoral practices are adhered to (JSCEM, 2000:177).

The Democrats are particularly scathing of the ‘scourge of branch-stacking and pre-selection abuse’ and suggest that a ‘Member or Senator who has won their seat through branch stacking or pre-selection abuse can be seen as morally corrupt’ (JSCEM, 200:178). To counter the problem, they recommend Committee and AEC scrutiny of branch stacking and pre-selection abuses. In particular, they seek to use the public principle of ‘one-vote, one-value’, and further recommend that the Act be amended to ensure the principle of ‘one-vote one-value’ be a prerequisite of political party processes. They suggest that application of such a principle in political parties would mean that one member’s vote would not count more than another’s and may rid parties of ‘undemocratic and manipulated pre-selections, delegate selections, or balloted matters’ (JSCEM, 2000:179).

What is a democratic weight of balance between branch members and unions, a key issue in the ALP, or between local branch members and members in other districts, a key issue in the Liberal and National parties, or for each party, between members and the central executive? The Democrats, for example, have so few members that they often have no local branch structure in most districts. Is there a minimum number of members in a local district that would persuade the Democrats state executive to select the candidate by consulting only the locals? It may be possible to specify in the Act some of the basics of procedure and some
elements of free association, such as the self-payment of a joining fee, but the balance or weight of votes is very difficult. The notion that the AEC should oversee ‘important ballot procedures’ is a very large step indeed, and certain to cement the view that the electorate does not trust the parties. Still, the fact that the discussion is abroad stems directly from some considerable weaknesses in the integrity of the association of some parties and follows closely the discussion of the public funding of parties. For example, a former Commonwealth Electoral Commissioner, Professor Colin Hughes, has suggested to the Committee that, where ‘candidates [of parties] registered with the Australian Electoral Commission are to be chosen by membership votes, those elections should be conducted by the officers of the Australian Electoral Commission’ (*The Sydney Morning Herald*, 2000).

The major political parties have legislated to ensure the scrutiny of the democratic process in the key voluntary associations in industrial relations. They have done so, it appears, to enhance the confidence of the community and members in the conduct of ballots. There can be few more important ballots than those which determine who is to carry the party label of a major Australian party. It is almost the only road to parliament. Why then would the parties not do the same for themselves? Clearly, the Democrats want the parties to be scrutinised by the courts using a highly prescriptive legislative model. Such a model would incur all of the debate not only about the freedom of the parties to govern their own associations, but also the issues about the measures of democracy. It is highly unlikely that the parties will agree to such an intrusive regime, though a government at some point, needing the support of the Democrats, may begin to allow further specification in the process of party registration.

**An Acceptable Remedy?**

An obvious way for the parties to escape the recent enhanced scrutiny of their operations is to reverse the acceptance of public funding. If they ceased to accept public funds, in essence to reprivatise, would the grounds for public access to their internal regimes be any less compelling? In the first instance, almost certainly so. Apart from the rudiments of complying with electoral procedures, nothing is required of the parties by way of legislation other than that arising from their registration for public funds. It is clear that some of the work of the parties — public information and voter registration — have been taken over by the state through government advertising and compulsory voting. They no longer have to get out the vote; they do not even have to raise many of the funds that sustain them. The education system and the media have taken up their role of educating the electorate. The parties are performing less but being paid more from the public purse. They barely represent the old class system cleavages of the electorate. It is more likely that the electorate is squeezed into an old shoe, one that fits the electoral system rather than the electorate.

Nevertheless, entering the confines of essentially private organisations, albeit when they are playing a public role, is difficult. It is made easier because the
parties produce legislation that delivers them considerable public benefit. The strict contract between the registered parties and the Commonwealth may only require a proper accounting for election expenses, but there may also exist an assumption that their candidates, specified under the Act and shown on the ballot paper, arrive under fair circumstances. A possible remedy recognises both the right of private association and the harm that public control of preselections (for example, primaries) can do to the organisational integrity of parties, but seeks greater public scrutiny of the internal affairs of party candidate selection.

Presently, the parties registered under the Act, only have to lodge a copy of their constitutions with the AEC. These documents are not available to the public. A reasonable compromise on the tension between the external scrutiny of parties and the maintenance of the privacy of association would be, as a condition of registration, to make the party constitutions available to the public. If the parties’ rules were to be made available to the public so that voters may judge for themselves the fairness of the processes, the parties would, as far as their formal practices are concerned, be more likely to comply with basic democratic standards. Of the possible options open to Australia’s major parties — reprivatise, introduce a highly prescriptive regime of external scrutiny, continue court scrutiny of disputes, or make public their rules as a condition of registration for public funds — the last two seem the most practical. It would enhance democratic practice, maintain the trust in parties and ensure their freedom of association, itself an important element of democracy in Australia.

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Review of New Zealand Monetary Policy

Arthur Grimes

In May 2000, Professor Lars Svensson was invited by the then newly-elected New Zealand Minister of Finance ‘to review the way in which New Zealand's monetary policy is conducted and its effectiveness in contributing to broader social and economic objectives’. The report of the Review was published recently (Svensson, 2001). Professor Svensson, based at the Institute for International Economic Studies, Stockholm University, has published widely on both monetary theory and monetary policy (for recent examples, see Svensson, 1999 and 2000). He had earlier gained a close understanding of New Zealand monetary policy practices while visiting as a Professorial Fellow of Monetary Economics at Victoria University of Wellington in 1997. Professor Svensson received 30 written submissions to the review and discussed relevant issues with Reserve Bank officials, directors and others outside the Bank. Submissions to the review are available at: www.monpolreview.govt.nz.

The review was commissioned ten years after the Reserve Bank of New Zealand Act 1989 came into force. That Act introduced to the world inflation targeting with an explicit Policy Targets Agreement, and introduced central bank independence to New Zealand. Through the course of the subsequent ten years, the legislative framework for New Zealand monetary policy remained essentially unchanged, but monetary policy practice evolved in some notable directions.

One direction which aroused concern in some circles within New Zealand and occasioned comment in Australia and elsewhere, was the adoption of a Monetary Conditions Index (MCI) as an intermediate target by the Reserve Bank of New Zealand (RBNZ) in June 1997. The subsequent behaviour of the exchange rate and interest rates, combined with earlier volatility in monetary and economic variables and combined with continued lacklustre performance of the New Zealand economy relative to Australia and the United States (especially after the Asian financial crisis), led the then opposition Labour Party to promise an enquiry into monetary policy practices if it won the 1999 general election. Although the MCI had been discontinued as a (front-line) monetary policy intermediate target in March 1999 (prior to the election), the new government felt bound by its election pledge to hold the monetary policy review.

The goal of the review was to examine the legislative framework and the practice of monetary policy after ten years ‘to ensure that the monetary policy framework and the Reserve Bank’s operations within that framework are appropriate to the characteristics of the New Zealand economy and best

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international practice’ (Svensson, 2001:67). The terms of reference (TOR) required the review to consider:

1. The way in which monetary policy is managed in pursuit of the inflation target.
2. The instruments of monetary policy (including instrument adequacy and whether current instruments are used effectively).
3. The information used by the Reserve Bank in its decision-making.
4. The monetary policy decision-making process (and accountability structures).
5. The co-ordination of monetary policy with other elements of the economic policy framework (including relationship between monetary and prudential policies).
6. The communication of monetary policy.

Svensson reported on each of these matters, with the most far-reaching recommendations relating to decision-making and accountability structures. Considerable analysis of the first three terms of reference was also contained in the report. Subsequent to the report, each of the Treasury, the Reserve Bank, and the Non-Executive Directors' Committee of the Reserve Bank made (publicly released) submissions to the Minister of Finance regarding the review's findings and recommendations. Following consideration of the review plus the three submissions, the Minister of Finance and Opposition Finance Spokesperson agreed a bi-partisan policy response, also outlined below.

The remainder of the article is devoted to a critique of the theoretical frameworks that lie behind Svensson's key findings and a review of their application to the matters raised by the terms of reference and Svensson's key findings. Some of the insights raised in the review are applied to current Australian central bank arrangements, in order to contemplate how a review — based on similar approaches — might judge aspects of Reserve Bank of Australia (RBA) performance and governance structures.

**Monetary Framework**

The terms of reference require frameworks both to consider issues of monetary policy (TORs 1, 2, 3, 5 and 6) and to consider issues of governance, decision-making and accountability (TOR 4). The former is clearly laid out, and is reviewed below. The latter, as discussed further below, is by contrast lacking. In this section, we lay out the monetary framework used by Svensson.

Firstly, it is important to indicate a key 'given' for the review. The TOR explicitly stated that the goal for monetary policy in New Zealand 'directed to the economic objective of achieving and maintaining stability in the general level of prices’ was not part of the review. Government had no wish to change this goal, nor lessen the Bank's accountability, or its operational autonomy, in pursuing this goal.

Nevertheless Professor Svensson (2001:8), addressing these issues, stated:
there is overwhelming international support, based on theory, empirical results and practical experience, for the general view that the optimal monetary policy framework is characterised by (1) a goal of price stability, (2) operational independence of the central bank and (3) clear accountability of the central bank for achieving the goal. The monetary policy setup in New Zealand is a prime example of such a framework and has been a model for monetary policy reform in many other countries.

This finding is consistent with the monetary policy framework which he presents. Svensson starts from the presumption that the ultimate objective of economic policy is ‘to guarantee and enhance the citizens' welfare’, which includes goals such as ‘efficient resource utilisation, full and stable employment, high economic growth, price stability, equitable distribution of wealth and income, regional balance and environmental protection’ (p. 11). While these may all be goals of economic policy, it does not follow that they are goals for monetary policy per se. Monetary policy objectives, Svensson notes, must be consistent with the broader economic objectives but must also be limited to goals which can feasibly be obtained via monetary instruments. This approach, based on Tinbergen (1952), is uncontroversial.

The approach means that it is crucial to specify what can be achieved through monetary policy. In turn, this requires a specification of the transmission channels of monetary policy through to goals such as real output and inflation. Svensson discusses these in the context of a central bank (such as the RBNZ and the RBA) which uses a short-term nominal interest rate as its monetary policy instrument. In New Zealand's case, this interest rate is referred to as the Official Cash Rate (OCR). With sticky prices, adjusting the OCR also results in a real short-term interest rate movement in the same direction. Nominal and real long-run interest rates also generally shift in the same direction, as (normally) do nominal and real exchange rates, ceteris paribus.

Given these relationships, Svensson lays out a number of transmission channels of monetary policy to output and inflation:

- direct exchange rate channel to CPI inflation;
- real-interest-rate channel to aggregate demand;
- exchange rate channel to aggregate demand;
- credit channel to aggregate demand.

Each of the first three is conventionally recognised by monetary economists (the first being most apparent in a relatively open economy in which the exchange rate impacts on the prices of importables and exportables). The fourth channel relies on balance sheet effects, or bank lending effects initiated by interest rate changes (see, for instance, Mishkin, 1996 and Claus and Smith, 1999). In the case of a rise in interest rates initiated by monetary policy, the balance sheet channel
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works through a reduction in firm or household balance sheet strength as equity declines in the face of rising interest rates. This causes credit margins to expand and investment (including housing investment) to decline. The bank lending channel works through a weakening in banks’ ability to lend in a setting with imperfect substitutability between bank credit and other forms of credit.

The credit channel is downplayed by Svensson, who subsumes it into the second channel. In some circumstances this may be justified, although Mishkin stresses that the credit channel primarily reflects a nominal (rather than real) interest rate channel to aggregate demand. It is important to follow through the implications of this difference. If, for instance, a supply shock causes inflation and inflation expectations to rise, interest rates must rise by more than the rise in inflation expectations to have a downward impact on aggregate demand (and thence on inflation) via the real interest rate channel. Nominal interest rates may not have to rise to the same extent to have a downward aggregate demand impact via credit effects. Explicit consideration of the credit channel may also be relevant if, as considered later by Svensson (and in this critique), there is conflict between the objectives of price stability and financial stability.

A fifth channel — wealth effects caused by asset price changes (other than exchange rate changes) — is not mentioned in the review, but is also now generally recognised as a potentially potent monetary policy transmission channel (Mishkin, 1996; Claus and Smith, 1999). In this case, given that the asset price changes under consideration are generally driven by interest rate changes, they can in part be subsumed under the second of Svensson’s stated transmission mechanisms.

The second, third and fourth channels (plus the wealth channel) all impact on aggregate demand. Svensson notes that aggregate demand, in turn, impacts on inflation. Thus he outlines three key ways in which monetary policy impacts on inflation:

• aggregate demand channel to domestic inflation;
• production-cost channel to domestic inflation; and
• expectations channel to domestic inflation.

The second of these includes the direct exchange rate effect as well as impacts on the setting of wages and other production costs caused by changes in interest rates. The third, which gains some importance in Svensson’s schema, stems from individual forward-looking wage and price setters being influenced by their expectations of future generalised inflation (for a survey of recent literature relating to this approach see Clarida, Gali and Gertler, 1999).

Importantly, these three channels, as well as those linking interest rate changes to aggregate demand, operate with different lags and potency. The most immediate is the direct exchange rate channel (although its speed and strength depends on the ‘pass-through coefficient’, which in turn depends on the state of the cycle and degree of competition). Effects which come about through changing aggregate demand, and hence the output gap, tend to be longer term (normally
with a lag of at least a year). This makes it nearly impossible to operate monetary policy mechanistically. This has implications — discussed by Svensson and others such as Stevens (1998) — for mechanistic use of an MCI. It may also have implications — which Svensson does not discuss — for the use of direct exchange rate intervention as an adjunct to other monetary policy interventions. This point is highlighted further below.

While Svensson adopts the standard neo-Keynesian view that monetary policy affects real variables in the short-term as a result of price stickiness, he also maintains the conventional position that monetary policy is neutral with respect to the long-run level and growth rate of real output. Thus while a short-term trade-off may exist, there is no long-term trade-off between price stability and the level or growth of output.

However, in keeping with Clarida et al and with his own earlier work, Svensson outlines a trade-off between variability in inflation and variability in output (around its potential level). Briefly, if the monetary authorities attempt to implement strict price stability in the face of cost shocks, they will have to vary interest rates and the exchange rate substantially, so causing considerable volatility in output (especially in traded goods output). Correspondingly, if they try to stabilise output in the face of such shocks, they will have to be prepared to experience considerable inflation variability. This observation leads Svensson to the issue of appropriate specification of monetary policy goals.

**Monetary Policy Goals**

From the preceding analysis, Svensson argues that long-run output growth cannot constitute a sensible goal for monetary policy, which instead is best targeted to serve a ‘nominal anchor’ role — that is to achieve long run price stability. Inflation targeting (designed to achieve low or zero inflation) is thereby appropriate, as indicated by the earlier quotation from the Review. However Svensson's analysis also demonstrates that strict or short-term inflation targeting is not generally warranted. This has major implications for the specification of monetary policy targets.

Figure 0.1 of the Review (reproduced as Figure 1 below) depicts a trade-off between output-gap variability and inflation variability. As Clarida et al. demonstrate, such a trade-off occurs principally in the face of supply shocks. For instance, a negative supply shock (for example, an intermediate import price increase) may cause output to contract while simultaneously raising inflation. An anti-inflationary monetary policy response in this circumstance will aggravate the shock’s effect on output while reducing the impact on inflation. Similarly, a central bank aiming to stabilise near-term inflation will respond with an expansionary monetary policy to a positive supply shock. In contrast, a negative (positive) demand shock requires an expansionary (contractionary) monetary policy response that helps to stabilise both output and inflation. Thus the trade-off is less likely to be applicable when demand shocks occur.
In Figure 1 (in the face of supply shocks), at one extreme, strict inflation targeting (SIT) yields the minimal feasible variability in inflation, but at the cost of high output variability. At the other extreme, strict output targeting (SOT) minimises volatility in output but with ever increasing variability in inflation. Flexible inflation targeting (FIT) represents a more moderate version of inflation targeting than does SIT. It is consistent with long run targeting of price stability within a framework that does not require a particular inflation target to be met at all times. Svensson (1997) has argued elsewhere that the New Zealand framework embodies a FIT approach and, as discussed in the Review, the RBNZ has moved even further towards flexibility in its implementation of inflation targeting since that paper was published.

Figure 1: The tradeoff between inflation variability and output-gap variability

Source: Svensson (2001:Figure 0.1)

The choice of where one should be on the curve is a matter of policy-maker preference. In New Zealand, this is implicitly — or explicitly — spelt out through the Policy Targets Agreement (PTA) signed by the Minister of Finance and the Reserve Bank Governor. However Svensson points to a dynamic issue that may affect the choice and, to this, another country-specific angle can be added.

The dynamic angle relates to the credibility of monetary policy. Svensson considers a country (like New Zealand) that begins with a history of prolonged high inflation and hence high expectations of future inflation. Further, he assumes that inflation expectations will remain high until a central bank establishes a track record of reining in inflation on a sustained basis. A credible central bank may face the trade-off line depicted in Figure 1, while a less credible bank faces a less favourable trade-off line to the north-east of that depicted. A central bank may
then seek to establish credibility by adopting a strict inflation targeting approach at a point to the east or north-east of the marked SIT. As its credibility in controlling inflation increases, the entire curve shifts downwards and to the left, presenting a more favourable trade-off for future policy-makers. At a point where credibility has been established, the central bank may shift to the marked FIT point which exhibits both lower output-gap variability and lower inflation variability than at the initial position. Without the initial fastidiousness in fighting inflation, no such beneficial gain on both fronts could have been achieved.

This analysis is a reasonable description of the New Zealand experience. Initially, the RBNZ adopted a fairly strict approach to inflation targeting (although never at the extreme SIT point). It did so by placing emphasis on the direct exchange rate channel to contain near-term inflation, targeting inflation 6 to 24 months ahead (Grimes and Wong, 1994:180; Grimes, 1996: 260). As inflation fell and credibility rose, the degree of flexibility that the Reserve Bank was prepared to tolerate around the inflation target mid-point expanded. Grimes (2000) notes that this development was anticipated at the time inflation targeting first began, consistent with the Svensson analysis.

There is one political economy aspect which Svensson does not discuss: If a point at or close to SIT is chosen initially, with resulting high output variability, confidence in the longevity of the monetary policy framework itself may be undermined leading to an expectation that the framework will be replaced by one which places greater emphasis on output stability (or output growth), leading to expectations of higher inflation and a rightward shift in the trade-off curve. Arguably, given early criticisms of the Reserve Bank’s tight policy (see, especially, Whitwell, 1987) this expectation may have been prevalent, at least through the early years of the new framework, causing the RBNZ to operate along an unfavourable trade-off curve.

The country-specific angle is touched on by Svensson (2001) but can be developed further. He comments (p. 18) that there will always be some variability in both inflation and the output gap, but that the variability is likely to be substantial for small, open, less diversified and commodity-dependent economies like New Zealand and Australia. Developing this point, imagine two countries with identical policy-maker preferences concerning variability in output and inflation, but where the small country is assumed to face a trade-off curve to the north-east of that of the larger country. Given identical preferences and the assumption that both forms of variability are ‘bads’, the small country will choose to have both higher output-gap variability and higher inflation variability than the larger country. This observation is important when making cross-country comparisons of performance in terms of volatility of outcomes. Future research could examine the performance over time of a range of countries, given the macro-economic shocks which they face, to infer the position of the curve (reflecting credibility) and the position on the curve (reflecting policy-maker preferences).
Monetary Policy Recommendations

The Review made observations and recommendations pertaining to each of the six TORs. In this section we discuss the recommendations pertaining to the five TORs which relate to monetary policy per se (thus excluding TOR 4, dealing principally with the monetary policy decision-making process, which is discussed in the next section).

In discussing the management of monetary policy in pursuit of the inflation target (TOR 1), Svensson discusses what he views as relatively minor but ex ante understandable policy ‘mistakes’ in the pre-MCI period. In particular, he notes a period of excessive easing in 1992 and 1993. He presents a graph of the 90 day interest rate and the trade-weighted exchange rate (TWI) over 1991-2000 to illustrate the cycles in monetary policy settings over this period (although relativities of New Zealand interest rates with international rates, especially in Australia and the United States, would also have been instructive). It would also have been helpful to have presented this graph over a longer setting dating back to the float of the exchange rate in 1985, since the cycles at the start of the 1990s can be shown to have had their genesis in settings as early as the immediate post-float period, which arguably engendered excessive tightness. With the benefit of hindsight it is apparent that this period of initial tightness was followed by a period of excessive easing, followed by excessive tightening again in the late 1980s and early 1990s, after which came the episode of excessive easing to which Svensson refers.

By adopting a longer time horizon, Svensson may have been forced to investigate more deeply whether there has been a systemic problem with the New Zealand monetary policy framework (before and after the passage of the RBNZ Act) that has caused an over-reaction to perceived overly tight or loose conditions. In particular, the cycle of excessive easing followed by excessive tightening over much of the fifteen year period 1985-2000 may imply that monetary conditions have had to be altered too drastically in the face of current imbalances. Possibly, this has been because of the nature of the inflation target which emphasises control of CPI inflation over annual time intervals. If the time interval for the accountability framework were longer (possibly the course of the cycle as in Australia) there may have been less need to engender such sharp swings in interest rates and the exchange rate as has occurred in New Zealand. Investigation of this issue, together with the reasons for the faster than expected disinflation over 1990-1992, is, to a large extent, downplayed in the Svensson report.

Svensson finds considerable fault with the adoption and application of the MCI over the June 1997 to March 1999 period. Over this period the RBNZ adopted as its main signalling tool (and intermediate target) a weighted average of the 90 day interest rate and the TWI with a fixed weight of 0.5 on the exchange rate. In explaining the system (Reserve Bank of New Zealand, 1998), the Reserve Bank emphasised that the relative weightings of the two indicators were not precise and that the correct ratio may well vary over the course of the business cycle. Hence the MCI should not be viewed mechanistically; rather, it was a
means of signalling the Bank’s view of the appropriate stance of monetary policy without taking a specific view on either interest rates or the exchange rate. In practice, however, the Bank’s subsequent use of the MCI (at least in the public arena) gave the impression of a mechanistic application of a fixed weight index.

Relating his comments back to his earlier discussion of the variable lags inherent in the range of transmission mechanisms, Svensson analyses why a relatively mechanistic application of an MCI constructed in this way can be an unreliable guide for monetary policy. This is particularly the case when unusual shocks — such as the Asian financial crisis that occurred during this time — arise.

Following the onset of the Asian crisis, New Zealand interest rates rose despite the recognised depressed demand for New Zealand exports. This policy response was occasioned by use of the MCI in face of a substantial TWI fall. The quarterly average 90 day interest rate rose by 81 basis points between the second and third quarters of 1997 and peaked at 195 basis points above its pre-crisis level one year after the crisis. In conjunction with a number of other factors (including drought), this contributed to a sharp slowing in the New Zealand economy. By contrast, the RBA reduced short term interest rates through explicit monetary policy actions. The Australian quarterly average 90 day interest rate fell by 80 basis points between the second and third quarters of 1997, and remained at approximately this new level for the succeeding two years. This policy response helped to cushion the Australian economy against the adverse external shock.¹

With the adoption of a narrow corridor for the overnight cash rate as monetary policy instrument in 1999, New Zealand adopted a conventional monetary policy implementation approach. Svensson finds both this approach, and its subsequent application, to be in line with best practice. This approach is in line with that of Australia, which had adopted it much earlier. By implication, therefore, Svensson finds that the monetary policy implementation in Australia is in line with best international central bank practice.

Svensson also analyses the specification of the inflation target, currently based on the maintenance of inflation within a target band of 0-3 per cent per annum. Reflecting earlier RBNZ internal discussions, he questions whether this range should be interpreted as a ‘range of indifference’ for the Reserve Bank or as a point target of 1.5 per cent (the mid-point of the target band) and, if the latter, how hard-edged the limits of the range should be. He judges 1.5 per cent to be a reasonable mid-point for the target: ‘I am not aware of any strong evidence to suggest that 1.5 percent would not be an appropriate level’ (p. 44). Reflecting his theoretical advocacy of flexible inflation targeting, Svensson prefers a point policy target which ideally would read: ‘the policy target shall be 12-monthly increases in the CPI of 1.5 percent over the medium term’ (p. 43) with 0 per cent and 3 per cent being interpreted as soft-edged limits for the target range. This differs from

¹ While the short-term interest rate responses to the crisis were quite different between New Zealand and Australia, recent research by Ellis and Lewis (2001) suggests that other financial market price reactions — measured by share prices, 10 year bond rates and bilateral exchange rates versus the United States dollar — were similar.
the existing range target with specific (although not necessarily hard-edged) boundaries.

Implicit within Svensson's recommendation, given that it differs from the current specification, is a call for even softer-edged boundaries to the 0-3 per cent target than at present, but with a more explicit point target. However, he pays less attention to an alternative specification that emphasises a point target over a longer period. As discussed above, the annual focus in New Zealand may have caused problems for inflation targeting so that a longer time interval — possibly the length of the economic cycle as in Australia — may be a preferable way of specifying the target, especially once central bank credibility had been established.

In his response to the Review, the Minister of Finance chose not to adopt the change mooted by Svensson. However, since this is not a legislative matter, it is open for a future Minister and Governor to agree to a policy target in line with Svensson's specification.

Svensson's recommendations in this respect can be applied to the Australian situation. The Australian target — an average inflation rate of 2-3 per cent p. a. over the course of the cycle — is neither a point target nor a range specific to a particular time period. It embodies the soft-edged properties desired by Svensson but lacks an explicit point target to anchor expectations. To the extent that the mid-point of the target can be viewed as an expectations anchor, one might expect Svensson to decide that this is slightly on the high side (given his view of the appropriateness of a figure nearer 1.5 per cent as a point target). Thus a re-examination of the level of the Australian inflation target (perhaps to a point target of 2 per cent per annum to maintain consistency with the lower end of the existing range) may be appropriate. However, given the earlier discussion, the specification of the Australian target as being an average over the course of the cycle may lead to less volatility in monetary policy outcomes and to better long term economic performance than has New Zealand's annual specification. This remains a topic for further research.

Svensson's conclusions with regard to the instruments of monetary policy (TOR 2) have been indicated above: the use of the overnight cash rate as principal monetary policy instrument is regarded as consistent with best international practice. The MCI is seen to have been a 'significant departure' from best practice. Svensson finds no benefit in adopting supplementary monetary policy tools such as reserve ratios, capital controls, other tax or regulatory interventions and foreign exchange interventions. He finds such tools to be either redundant (for example, reserve ratios operate also through the short-term interest rate channel) or inefficient (for example, administrative credit controls distort lending patterns).

One finding relevant to Australia, based on 'much research and practical experience', is Svensson's view that sterilised foreign exchange interventions 'normally have only small and short-lived effects'. He notes that they can be effective if viewed as signals of monetary policy intentions, but there are other more transparent ways of sending such signals. Thus he considers there is 'no reason why a transparent inflation-targeter should undertake foreign-exchange
The Reserve Bank of Australia, which periodically still undertakes such interventions (Reserve Bank of Australia, 2001), would thus be seen by Svensson to be employing a redundant and potentially sub-optimal instrument. One possible reason for retention of this instrument could be that Australia’s inflation target is not quite so transparent as that of New Zealand.

However there are other reasons which Svensson does not discuss but which, given the variety of transmission mechanisms that he outlines, could provide grounds for retention of foreign exchange intervention. Consider, for instance, an immigration surge which causes a sharp increase in house prices and in consumer prices more generally. The response of a CPI inflation targeting central bank will generally be to raise short term interest rates to place downward pressure on inflation through the various channels already outlined.

If, as suggested by Svensson, the direct exchange rate effect is of primary importance over the initial year after the tightening, the bulk of adjustment will take place through traded goods price changes and through a downward shift in activity in the traded goods sector, rather than through a reduction in domestic demand (in which the inflationary surge initially began). A central bank that is not constrained to target annual inflation, but which targets inflation over the course of the cycle, may wish to spread the transmission mechanisms over a number of channels. At the same time as raising interest rates, the central bank may then undertake foreign exchange intervention to reduce near-term appreciation of the exchange rate, leaving the longer term domestic demand channels to be the more important conduits of the anti-inflationary policy.

For example, consider the policy-induced reduction in domestic short-term interest rates in Australia over the first half of 2001 in response to the weakness of the international economy. Following these reductions, the Australian dollar came under downward pressure and, at times, there was a policy response: ‘The Bank has intervened in the market from time to time to provide support when market sentiment seemed to be unreasonably bearish’ (Reserve Bank of Australia, 2001:2). Thus, despite a desire to cushion the domestic economy from the international downturn, the RBA chose to limit the exchange rate’s downward path, so placing greater relative emphasis on the interest rate transmission channel.

This practice is not necessarily inconsistent with Svensson’s view that foreign exchange intervention has only short term effects. Indeed, the purpose of such interventions is to have only short lived effects, mitigating the temporary impacts on the traded goods sector of a monetary tightening (or, conversely, the excessively favourable effects on the sector of a monetary loosening). In a world incorporating significant hysteresis effects, such short term smoothing may be a material contributor to longer term beneficial economic outcomes.

Svensson (TOR 3) comments that some important data (for example, the CPI and industrial production) are available only at quarterly frequencies and recommends that Statistics New Zealand make these available at monthly frequency. In subsequent comments, the Reserve Bank of New Zealand, Treasury and the Minister of Finance all downplay the relevance of this issue to a small, commodity-dependent economy such as New Zealand (or Australia). They note...
that monthly data for such a country would be highly volatile and produce little in
the way of signal relative to noise.

One other finding in this area is more relevant. Svensson notes that the Reserve Bank and a number of other (mainly private sector) agencies collect data on inflation expectations, but none do so systematically. Given the importance that Svensson places on expectations in the transmission mechanism and as an indicator of policy credibility, he recommends that the Reserve Bank commission Statistics New Zealand to collect and publish series for medium and long-term inflation expectations.

In the Australian context, the Reserve Bank of Australia (2001) quotes inflation expectations derived from surveys conducted by the Melbourne Institute, the Australian Centre for Industrial Relations Research and Training, the National Australia Bank, and an informal survey of financial economists conducted by the RBA itself, but again there is no official source for inflation expectations data. As for the New Zealand situation, there is a case for the RBA to commission the Australian Bureau of Statistics to undertake a formal expectations survey.

With regard to monetary-fiscal policy co-ordination (TOR 5), Svensson is satisfied with the New Zealand set-up whereby the Reserve Bank Act specifies a clear role for monetary policy and the Fiscal Responsibility Act produces clarity with regard to overall fiscal policy. The type of co-ordination seen in Australia (in which the Secretary of the Treasury sits on the RBA Board and officials from the RBA and Treasury meet to discuss policy) is not seen to be necessary or particularly useful once these structures are in place.

More contentiously, Svensson (2001) also sees little problem with co-ordination between monetary policy and policies designed to prevent financial instability. In particular he states (p. 60):

In times of financial crisis, there may sometimes be a conflict between price stability and financial stability. A typical conflict situation is when the appropriate monetary policy calls for a monetary policy tightening, but such a tightening might further damage already weak balance sheets in the financial sector and possibly trigger a collapse of the financial and payment system. Such a situation would, however, typically arise in a situation with already high or rapidly rising inflation.

He sees such a situation as unlikely. However, history demonstrates a number of examples of such policy incompatibility. New Zealand, and to a lesser extent Australia, faced a situation in the late 1980s where monetary policy needed to remain tight to reduce inflation but where financial stability may have demanded greater easing. Japan's prolonged financial crisis calls for monetary easing, which currently is consistent with the need to fight deflation, but which potentially could become inconsistent with a subsequent requirement to contain a material rise in inflation.

Monetary policy communication (TOR 6) is an important art for central bankers to master. Svensson finds little to criticise in the Reserve Bank in this
regard and is particularly complimentary about the Bank’s transparency in its communications. A key feature of this transparency is the Bank’s quarterly publication of three-year forward projections for the crucial macroeconomic and financial variables. These detailed projections, in his view, ‘give the Reserve Bank an edge relative to other inflation-targeting central banks’ (p. 62).

The key issue to which he points is how best to communicate uncertainty of published central bank projections to the public. He notes the importance of emphasising the conditional nature of projections (based on certain assumptions). He also points to the usefulness of displaying widening confidence intervals over time in relation to projected variables. He does not favour a recent ‘unsophisticated’ RBNZ practice of rounding projected numbers to the nearest half percent to indicate uncertainty.

These observations regarding projections are relevant also to the Reserve Bank of Australia. The RBA provides very little forecast detail relative to that provided by the RBNZ, and what is provided is relatively vague. Consider, for instance, the RBA’s Statement on Monetary Policy, in which virtually the only forecast pertaining to any macro variable is expressed as: ‘On balance, the Bank’s expectation is that, net of taxes and petrol prices, underlying inflation will remain around the top of the 2 to 3 per cent medium-term target band for the rest of 2001, before easing gradually in 2002 … CPI inflation is likely to be a little lower than this.’ (Reserve Bank of Australia 2001:60). No forecasts for the real economy or for any financial variable are provided. The lack of forward-looking detail provided within the RBA Statement makes the RBA’s approach considerably less transparent than that of the RBNZ. The RBA may accordingly wish to consider Svensson’s recommendations on this matter.

**Decision-Making and Accountability Recommendations**

Svensson devotes a considerable proportion of the Review to discussing TOR 4 which covers the monetary policy decision-making process, governance issues and accountability structures. This takes him to organisation theory. In a recent paper, Williamson (2001) recommends that economists pay much more attention to the organisation theory literature in examining suitable governance and accountability structures. Such analyses need to recognise a multitude of factors affecting incentives of individual agents that economists frequently ignore. Unlike his treatment of monetary policy, however, Svensson does not outline a framework for governance and accountability investigations, relying instead on intuition and international precedent. This omission leaves his findings plausible, but no more plausible than other recommendations based on different intuition or precedent.

The key issue under examination is whether there should be a single decision-maker (as is the Reserve Bank Governor in New Zealand) or a committee (as with the Reserve Bank Board in Australia) for monetary policy decisions. Svensson notes that the latter is more normal, although Canada is another country where legislation stipulates a single decision-maker. In practice, however, the current Bank of Canada Governor has agreed to be bound by the decision of the
Governing Council comprising the Governor and five Deputy Governors (Archibald, 2001). If a committee structure is chosen, a separate issue is whether the committee should comprise solely monetary policy experts (as with the Bank of England Monetary Policy Committee) or should also include non-expert members (as with the Reserve Bank of Australia Board).

Svensson lists some advantages of a single decision-maker: strong accountability, coherence in decision-making, and clarity in communications. Disadvantages include: dependence on the qualities, knowledge and experience of a single individual, and issues of legitimacy arising from vesting so much power and responsibility in the hands of a single individual.

Svensson notes that the term of the current Governor (Dr Don Brash) has not been subject to the disadvantages listed, in his view because of the Governor's personal qualities, including openness and willingness to take advice. However, the existing structure may not work as well with an alternative appointment. This leads Svensson to favour a committee structure. He notes however, that ‘the wrong committee’ could result in a worse outcome than would reliance on a single individual. Any committee structure would need to maintain sufficient accountability and coherence in decision-making and communications to be preferable to the single decision-maker model.

With this caveat in mind, in designing a Monetary Policy Committee (MPC) structure, Svensson recommends that this decision-making committee (as opposed to a monitoring committee) should consist solely of people with monetary policy expertise. Monetary policy targets have already been set (by the Policy Targets Agreement in New Zealand), thus making monetary decision-making primarily a technical rather than political task. Consequently, Svensson(2001:52) concludes:

This also implies that appointments to an MPC with a purpose of sectoral, political or other special-interest representation would be mistaken. Not only is it unnecessary, but it would bring special-interest conflicts into the committee, cause deadlocks or risk policy serving special interests rather than the country as a whole.

Further, because of what he perceives as the limited supply of monetary policy experts outside the Reserve Bank who do not have a conflict of interest (for example, by virtue of working within the financial sector), Svensson recommends that an internal MPC be adopted. He proposes a committee comprising the Governor, two Deputy Governors and two nominated senior Reserve Bank staff, with votes and non-attributed minutes published with a two to three week lag.

Significantly, Svensson (2001:53) recommends that this MPC take responsibility for all monetary policy decisions, but that: ‘In all other areas, the Governor would remain the single decision-maker of the Bank’. This recommendation creates a number of issues.

Firstly, what is defined as monetary policy? In the financial crisis example discussed earlier, is the interest rate decision a monetary policy decision or a financial stability decision? If it is the latter, Svensson's recommendation points to
the Governor alone making the decision; but the MPC might object that the decision is inappropriate for monetary policy purposes. Some form of resolution is required, but is not forthcoming in the report. Secondly, the weaknesses of single decision-making pointed to by Svensson are as relevant for non-monetary decisions as for monetary decisions. If a single decision-maker is not thought appropriate for the monetary policy function, why should it be appropriate for other central bank functions? Svensson does not answer this question.

These quandaries highlight the lack of a framework within the Review for analysing organisational issues. There is no analysis, for instance, of the suitability for central banks of the standard corporate model of a decision-making Chief Executive, subject to Board monitoring (essentially the New Zealand Reserve Bank model). Nor is there analysis of the nature of public sector reform in New Zealand under the Public Finance Act that created accountable Chief Executives of government departments. Without doubt, these issues are difficult to analyse and there is unlikely to be a single ‘right’ structure, but these difficulties make a framework for analysis more, rather than less, necessary.

Given his approach, Svensson ranks a number of structures in terms of his judgement as to their suitability for monetary policy decision-making from best to worst as follows:

- MPC comprising solely internal members;
- MPC with expert external members;
- Expert Governor as single decision-maker;
- MPC with some expert and some non-expert external members (the more non-expert members, the worse the structure).

Thus, while advising against retention of the existing New Zealand decision-making model, Svensson is even more critical of the current formal Reserve Bank of Australia decision-making structure largely comprising a non-expert Board of Directors, many chosen on the basis of sectoral interests. This had been the decision-making structure of the Reserve Bank of New Zealand prior to the 1989 Act. Given his criticisms of the inclusion of non-expert decision-making directors, especially once monetary policy goals are clearly specified (as they now are in Australia), Australia may wish to revisit the decision-making structures of the RBA, to focus decision-making more formally on monetary policy experts either within the Bank’s staff or within an expert sub-committee of the Board.

A further important accountability recommendation by Svensson relates to the nature of Board monitoring. In New Zealand, as in many other central banks, the Governor is both the Chief Executive and Chairman of the Board of Directors. Svensson finds this problematic for Board monitoring, especially in the case of a single decision-maker, but also with the proposed MPC format. He favours a Board made up solely of non-executive directors (or as a possible compromise, with the Governor as a non-voting member) — Deputy Governors would not be Board members. To protect against political intrusion, the Chair would be elected by the (non-executive) directors. This contrast to the current New Zealand and
Australian structures where the Governor chairs the Board of Directors. Further, the non-executive directors would be required to contribute an independent report on monetary policy within the Bank’s Annual Report. This structure, albeit with the inclusion of the Chief Executive as a director, is closer to the standard corporate model. However, this again questions why a single decision-maker supplemented by a monitoring Board, is not favoured by Svensson.

Responses to the Svensson recommendations have generally favoured the move to an independent chair and the adoption of a separate non-executive directors’ report, but have rejected a committee decision-making structure. Interestingly, the current Non-Executive Directors’ Committee favours retention of the Governor as single decision-maker for all Reserve Bank decisions, but favours an independent chair chosen by the non-executive directors. They also favour retaining both the Governor and the Deputy Governors as directors. Retention of the Chief Executive on the Board is regarded by the non-executive directors as ‘usual corporate governance practice’. Retention of the Deputy Governors is favoured in order that non-executive directors can obtain greater insights into policy discussions, the Governor’s management practices and potential successors to the Governor (noting that the Act requires the Board to nominate a Governor to the Minister of Finance). Consistent with this view, both the Deputy Governor and the Governor are members of the RBA Board.

The Minister of Finance's response to the recommendations under this TOR echoed the non-executive directors in most respects: retention of the Governor as single decision-maker and board member; and changing the Act to introduce a non-executive chair elected by the non-executive directors. It differed from their recommendation by deciding to remove Deputy Governors as directors. As an additional response which partly acknowledges that wider input into monetary policy is desirable, the Reserve Bank subsequently appointed two part-time external advisers ‘chosen for their broad knowledge of the New Zealand economy’ who ‘will be expected to participate in the Bank’s internal decisions in the monetary policy process and … to provide the Governor with advice in relation to OCR decisions’ (Archibald, 2001). This response by the Bank, however, appears to be at odds with Svensson’s recommendation which was designed to increase the role of monetary policy experts (rather than individuals with a ‘broad knowledge’ of the economy) in monetary policy decision-making.

The decisions of both the Minister and the Bank in relation to this TOR — unlike the monetary policy areas that echoed the Review's recommendations — were considerably at odds with the Svensson report. The Minister's decisions reflected more closely the form of the 1989 Act that was partly informed by New Zealand's public sector reforms (especially the Public Finance Act) on personal accountability of the Chief Executive of government departments. The key new feature added to the accountability framework will be the appointment of a non-executive Board Chair chosen by the non-executive directors. This feature, which is in keeping with ‘best practice’ corporate governance, combined with the newly adopted non-executive directors’ report within the Bank’s Annual Report, could be considered as potential enhancements by the RBA.
Conclusion

Ten years after its inception, the Reserve Bank of New Zealand Act 1989 is largely intact after the Svensson review and the Minister of Finance's responses. The single price stability target for monetary policy, the Governor as single decision-maker and a monitoring (non decision-making) Board of Directors have all been upheld, albeit with the second of these at odds with Svensson's recommendation. However, an important accountability change will be made to the Board structure, with non-executive directors electing an independent Chair.

In terms of monetary policy implementation, the current practice of setting an OCR in response to a forward-looking inflation projection relative to the 0-3 per cent target is retained. The 0-3 per cent range target is also maintained, although Svensson had a preference to convert it to a point target of 1.5 per cent plus or minus 1.5 per cent. In effect, however, there is practical agreement that 1.5 per cent annual inflation is the central target for monetary policy with soft edges around the 0-3 per cent range.

If the same review were applied to the current Australian arrangements, one would expect approval of the monetary policy implementation regime based on a short-term interest rate. The soft-edged nature of the inflation target would be regarded as reasonable, although possibly a little vaguely expressed and the central target of 2.5 per cent may be regarded as somewhat higher than necessary. Further, an improvement in transparency could be sought through the provision of more detailed forecasts for macroeconomic and financial variables. The most notable recommendations are likely to pertain to governance and accountability structures. In particular, the decision-making structure involving a board of largely non-expert outsiders would be regarded as close to the worst available arrangement. In addition, as with the New Zealand recommendations, a non-executive Chair for the Board would be recommended, with the Board having a monitoring, rather than decision-making, role.

In New Zealand, legislative changes to effect the necessary changes following the Review are likely in the near future. Across the Tasman, close analysis of the Svensson report, and its implications for Australia, could also establish a need for legislative changes to effect improved governance and accountability procedures for what is one of the most important economic institutions in the modern economy.

References


I wish to thank Graeme Wells for suggesting that I review the Svensson report and two anonymous referees for their comments on an earlier draft. I alone am responsible for the views expressed
Cannabis Transactions and Law Reform

Chris Wilkins

The New Zealand government recently announced that a Parliamentary Select Committee would investigate the most effective public health strategies to reduce the harm of cannabis, including its legal status. Public hearings of submissions began on 30 May this year.

Those in favour of the legalisation of cannabis in New Zealand have pointed out that if cannabis were legalised buyers and sellers of the drug would have full access to the legal and consumer protections currently enjoyed by all other consumers (see Drug Policy Forum Trust, 1997 and 1998; www.norml.org.nz; www.alcp.org.nz). Under drug prohibition, drug users and drug dealers cannot call on the police and courts to enforce the terms of transactions, and are unlikely to report incidents of victimisation to the police for fear of prosecution. (Barnett, 1987; Kleiman, 1992; Miron and Zwiebel, 1995).

The reliability of black market cannabis transactions has a number of implications for cannabis law reform. It impacts on how socially costly the present policy of prohibition is, and hence, in part, the extent of the case for cannabis law reform (Field and Casswell, 2000). If large numbers of people are physically or economically harmed when purchasing cannabis from the black market, this consequence, along with any other negative consequences of prohibition, should be weighed up against the positive benefits of maintaining prohibition.

The issue of transactional reliability of the black market also impacts on the extent of the social benefits that can be expected if cannabis were legalised. A very unreliable and violent black market would suggest there might be significant social benefits from the legalisation and regulation of the market. Alternatively, a relatively reliable and peaceful black market would suggest the social benefits from legalisation and regulation of the market may be small.

This paper investigates the reliability of black market cannabis transactions in New Zealand, and discusses the implications for cannabis law reform. It begins by using economic theory to develop a simple model of the reliability of illicit drug transactions. It then presents the findings of a survey of members of the Aotearoa Legalise Cannabis Party (ALCP) about the reliability of their cannabis transactions. The conclusion explores the implications of the model and survey have for cannabis law reform in New Zealand.

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Reliability of Illicit Drug Transactions

A problem shared by all exchange parties in illicit drug markets is that they cannot call on the police and courts to enforce the terms of transactions (see Moore, 1977). The absence of third party enforcement means exchange parties are vulnerable to a range of opportunistic behaviour from exchange partners, including quality fraud (that is, misrepresenting low quality drugs as high quality drugs), product fraud (that is, selling phoney drugs), robbery, and assault.

Studies of stateless economic systems have identified a range of informal institutions that constrain opportunism and encourage reliable economic exchange when third party enforcement is absent (see Eggertsson, 1990; North, 1990). These include informal institutions such as dense social interaction, loyalty, credible physical retaliation, compensation and arbitration, social conditioning, personal reputation, conditional co-operation, and ongoing interaction. The description of illicit drug markets in the literature suggests the presence of many of these informal institutions will be the exception rather than the general rule of the market (see Moore, 1977; Michaels, 1987; Kleiman, 1992; Long, 1988; Reuter and Haaga, 1989).

The possibility that exchange in illicit drug markets might involve ongoing transactions between the same two exchange partners appears to offer a promising mechanism for encouraging reliable exchange. In many markets buyers often choose to repeatedly return to the same seller to take advantage of particular benefits unique to a seller, such as access to credit or convenient location. Repeat exchange relationships have been found to be common in illicit drug markets where drug dealers actively try to cultivate regular customers (Jacobs, 1999). Exchange parties in illicit drug markets have the added incentive to return to someone they have dealt with in the past because an exchange partner who has already completed a transaction is generally perceived to be less likely to be an undercover agent than a complete stranger.

Axelrod (1981 and 1990) has shown that the likelihood people will honour agreements in the absence of third party enforcement increases when they know they are going to meet the same person repeatedly in the future. Cheating at any one meeting will mean the mutual benefits from all future meetings will be lost forever. It will usually pay to honour a transaction in these circumstances because the one-off benefit of cheating will generally be less than the ongoing benefits of future exchange. In the context of illicit drug markets, a drug dealer may not cheat their customers because they know they will not return for future sales, and alternatively a drug user may not cheat their drug dealer because they know they would not be able to return for future purchases.

However, there is a serious objection to the application of the ‘ongoing interaction’ solution to illicit drug markets. A key assumption of the ongoing interaction solution is that all future interaction is with the same person. It is not possible to cheat on an agreement and then exit the relationship with the ‘winnings’. This assumption does fit many real-world situations. For example, in politics, adversaries such as political parties, nation states, and long serving
political representatives, know they are going to meet each other again and again in the future, and this knowledge often convinces them to cooperate in the present in the hope of extracting reciprocal behaviour in the future.

Market relationships, on the other hand, are often transient and ephemeral. The efficiency of the market comes from the ability of buyers to change sellers whenever superior terms are offered elsewhere or performance becomes unacceptable. The incentives to honour transactions with one exchange partner break down when it is possible to easily transact with others. A drug dealer could cheat one drug user and simply begin selling to a new drug user. Alternatively, a drug user could cheat their drug dealer and then simply find a new dealer to buy from. The benefits of cheating could be captured without losing any of the benefits of future trading.

This objection to the ‘ongoing interaction’ solution assumes exchange parties are able to costlessly and instantaneously switch exchange partners. Economists have come to realise there are real costs associated with arranging, specifying, and negotiating exchange successfully (Coase, 1960 and 1988). In some situations these ‘transaction costs’ are so high that they prevent any exchange from taking place (Demsetz, 1964). The transaction costs, or more specifically the search costs, of finding a replacement exchange partner will reduce the benefits of cheating a current exchange partner. If search costs in a market were high enough cheating would not pay in many instances. Drug dealers may not cheat drug users because it is costly to search for replacement buyers, and drug users may not drug dealers because it is costly to search for a replacement seller.

The literature on illicit drug markets suggests search costs are likely to be high in these markets compared to legal markets. Exchange partners are secretive and suspicious, and there are no market institutions to assist exchange parties with finding exchange partners, such as advertising, published information directories, or prominent store locations. Inquiries about contacts in the market must be selective and cautious to avoid the attention of the police and public embarrassment. The process of ‘asking around’ friends and social acquaintances about the identity of buyers and sellers is inexact and time consuming. Even when a drug dealer is identified, a new buyer may have to demonstrate their authenticity before the dealer will agree to sell drugs to them.

High search costs, in the context of an ongoing exchange relationship, may provide an explanation for why exchange parties in illicit drug markets choose to honour the terms of transactions even though there is no third party enforcement of transactions. Unfortunately, existing crime statistics and victimisation surveys in New Zealand are not detailed enough to identify incidents directly related to the purchase and sale of illicit drugs (see Wilkins, 1999). Gaining an understanding of the reliability of these transactions requires original data collection. With this purpose in mind, a small-scale survey of the reliability of cannabis transactions in New Zealand was undertaken.
A Survey of the Reliability of Cannabis Transactions in New Zealand

Surveying buyers and sellers in illicit drug markets presents two central methodological challenges:

(1) overcoming participants’ fear of prosecution and public embarrassment; and
(2) ensuring the safety of researchers employed to interview participants.

Previous studies of illicit drug markets (see Reuter, MacCoun and Murphy, 1990; Reuter and Haaga, 1989; Goldstein et al., 1989) have used specific institutional settings to overcome these barriers, such as probation meetings, prison populations, and neighbourhood field stations.

The ALCP was chosen as the institutional setting for this survey because it had a national membership who were likely to use and purchase cannabis, and it had an organisational structure to distribute a questionnaire by mail. The ALCP is a political party formed to create legislative pressure to liberalise cannabis laws in New Zealand.

A detailed description of the survey methodology can be found in Wilkins (1999). Briefly, a total of 1,313 questionnaires were posted out between 8 April and 13 May 1998. Questionnaires were mailed to eighteen different locations throughout the North and South Islands of New Zealand, including the four main centres and a host of smaller towns. The survey’s response rate was 30 per cent (n = 357). This level of response was fairly good given that distribution and return of the questionnaire was by post, and there was no opportunity to follow up respondents. One hundred and thirty-four questionnaires were returned through the post marked ‘return to sender’. It is likely many more questionnaires were sent to old addresses and were merely thrown out rather than sent back.

Summary of Survey Results

Some characteristics of cannabis transactions

A number of questions were asked about the characteristics of participant’s cannabis transactions, including frequency of purchase, number of years of purchase, and the amount spent per transaction.

Many buyers in the ALCP sample purchased cannabis fairly frequently. Over half of the buyers (59%) purchased cannabis once a week or more often.

Many buyers had been purchasing cannabis for a number of years. Just over two-thirds of buyers (69 per cent) had been buying cannabis for more than 5 years, and nearly half (43 per cent) had been buying cannabis for more than 10 years.

The amount spent on cannabis per transaction clustered around common units of cannabis sale in New Zealand (see National Drug Intelligence Bureau, 2000). Many buyers (47 per cent) spent $25 or less per transaction, and most buyers (60 per cent) spent under $50 (common prices for a bag of cannabis). Some buyers
(22 per cent) spent $200–$500 per transaction, (the common price for an ounce of cannabis).

**Number of times buyers were cheated ever**

Buyers were asked to write how many times they had ever suffered from quality fraud, product fraud, robbery, and assault while purchasing cannabis in New Zealand.

Table 1 presents the percentage of buyers who had never experienced a type of cheating, and the percentage of buyers who experienced a type of cheating less than three times ever. The categories presented in the table are not mutually exclusive.

**Table 1: Buyers and Cheating Frequency**

<table>
<thead>
<tr>
<th>Type of Cheating</th>
<th>Never</th>
<th>Less than 3 Times</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assault</td>
<td>96</td>
<td>99</td>
</tr>
<tr>
<td>Robbery</td>
<td>91</td>
<td>97</td>
</tr>
<tr>
<td>Product Fraud</td>
<td>79</td>
<td>93</td>
</tr>
<tr>
<td>Quality Fraud</td>
<td>19</td>
<td>35</td>
</tr>
</tbody>
</table>

The majority of buyers had never been assaulted (96 per cent) or robbed (91 per cent). Most buyers had never suffered from product fraud (79 per cent). In contrast, only 19 per cent of buyers had never suffered from quality fraud.

The majority of buyers had experienced product fraud (93 per cent), robbery (97 per cent), and assault (99 per cent) less than 3 times ever. Only 35 per cent of buyers experienced quality fraud less than three times ever. Thirty-seven percent of buyers suffered from quality fraud more than 10 times, and 27 per cent suffered from it more than 20 times.

**Level of cheating**

The number of transactions completed by each buyer was used to calculate the average incidence of cheating experienced per 100 transactions. Determining the total number of transactions completed by each buyer was problematic. In situations where a buyer had been purchasing cannabis for many years, and/or purchased cannabis quite frequently, they were unlikely to be able to recall the total number of transactions they had completed with any kind of accuracy. Consequently, rather than ask respondents directly to estimate the number of transactions they had completed, respondents were asked how many years they had been purchasing cannabis, and how frequently they had purchased cannabis in the previous year. These two questions were then combined to calculate the approximate number of transactions completed by each buyer.
The number of transactions completed by each buyer ranged widely. Three quarters of buyers (77 per cent) had completed over 100 transactions, just over half (53 per cent) had completed over 300 transactions, and a quarter (26 per cent) had completed over 1000 transactions.

Table 2 presents the percentage of buyers who experienced three levels of cheating per 100 transactions: less than 0.1 times per 100 transactions; less than one time per 100 transactions; and greater than five times per 100 transactions. These categories were chosen to illustrate three distinct levels of cheating. The lower category represents a situation where a buyer experiences an incident of cheating less than one time in 1000 transactions. The middle category represents a situation where a buyer experiences cheating less than one time in 100 transactions. The last category represents a situation where a buyer experiences cheating more than five times every 100 transactions. The first two categories of the table are not mutually exclusive.

Nearly all the buyers experienced assault (98 per cent) and robbery (94 per cent) less than 0.1 times per 100 transactions. No one experienced assault more than 5 times per 100 transactions. Eighty-five percent of buyers experienced product fraud less than 0.1 times per 100 transactions. Only 21 per cent of buyers experienced quality fraud less than 0.1 times per 100 transactions.

Forty-one percent of buyers experienced quality fraud more than 5 times per 100 transactions and 11 per cent experienced quality fraud more than 40 times per 100 transactions.

Table 2: Percentage of Buyers Who Experienced Three Levels of Cheating Per 100 Transactions

<table>
<thead>
<tr>
<th></th>
<th>Less than 0.1</th>
<th>Less than 1</th>
<th>More than 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assault</td>
<td>98</td>
<td>99</td>
<td>-</td>
</tr>
<tr>
<td>Robbery</td>
<td>94</td>
<td>99</td>
<td>1</td>
</tr>
<tr>
<td>Product Fraud</td>
<td>85</td>
<td>93</td>
<td>4</td>
</tr>
<tr>
<td>Quality Fraud</td>
<td>21</td>
<td>40</td>
<td>41</td>
</tr>
</tbody>
</table>

Buyers’ response to cheating

Those buyers who had suffered a type of cheating were invited to briefly state how they responded to the incident. This was an open question where buyers explained their response in their own words. Responses were summarised into broad categories based on a common theme.

Although buyers provided a range of different responses to having been cheated, two responses ‘did nothing’ and ‘changed supplier’, emerged as popular responses for nearly all the types of cheating.
In the case of quality fraud, 31 per cent of victims responded by changing supplier, 29 per cent did nothing, 20 per cent complained to the seller, and 12 per cent asked for replacement drugs or their money back. Only 3 per cent of the victims of quality fraud responded by attacking the dealer.

In the case of product fraud, 28 per cent responded by ‘doing nothing’, 22 per cent changed their supplier, 16 per cent complained to the seller, and 14 per cent asked for replacement drugs or their money back. Seven percent responded by attacking the dealer.

In the case of robbery, 39 per cent responded by ‘doing nothing’, 27 per cent changed suppliers, 15 per cent attacked the dealer, and seven per cent warned other buyers about the seller.

Finally, in the case of the 10 buyers who had been assaulted, six responded by ‘fighting back’, three did nothing, and one reported the incident to the police.

Perceptions of the safety and reliability of the cannabis market

 Buyers were asked directly how safe and reliable they considered cannabis transactions to be relative to legal transactions. They were provided with five statements about the reliability of cannabis transactions from which they were asked to choose one: ‘Very unsafe and unreliable’; ‘Pretty unsafe and unreliable’; ‘Slightly less safe and reliable than legal transactions’; ‘About the same as legal transactions’; and ‘More safe and reliable than legal transactions’.

 Fourteen percent of buyers considered cannabis transactions to be ‘More safe and reliable than legal transactions’, 30 per cent thought cannabis transactions were ‘About the same’ as legal transactions, 37 per cent thought cannabis transactions were ‘Slightly less safe and reliable than legal transactions’, 13 per cent thought cannabis transactions were ‘Pretty unsafe and unreliable’, and six per cent thought cannabis transactions were ‘Very unsafe and unreliable’.

 Most buyers (67 per cent) thought cannabis transactions were ‘about the same’, or only ‘slightly less safe and reliable’, than legal transactions. The 14 per cent of buyers who reported they considered their cannabis transactions to be ‘More safe and reliable than legal transactions’ may have had exceptionally secure exchange relationships, such as purchasing from a trusted friend or family member.

Discussion

This paper has investigated the reliability of illicit cannabis transactions in New Zealand. The simple economic model developed suggested when exchange is ongoing between the same two exchange partners, and the search costs of finding an alternative exchange partner are high, it will often be rational to honour the terms of illicit cannabis transactions even when there is no third party enforcement of transactions. Search costs are high in illicit drug markets because exchange parties are secretive and suspicious, there are no market institutions to assist
exchange parties with finding exchange partners, and market search can result in arrest or public embarrassment.

Note, the scope of the model is restricted to the incentives faced by exchange parties only, it does not investigate any incentives third parties might have to victimise exchange parties. Drug dealers and drug users are apparently attractive targets for robbery by the general criminal fraternity as they are known to carry large quantities of cash and drugs and often carry out transactions in secluded areas away from the view of the police and public (Barnett, 1987).

The ALCP survey found incidents of assault, robbery, and product fraud while purchasing cannabis from the black market were rare. In contrast, quality fraud was found to be fairly common. The selectivity of the ALCP sample means the data collected cannot be used to provide a representative picture of the cannabis black market in New Zealand. However, given the difficulties in gaining access to a representative sample of people who purchase cannabis, and the absence of any data on the reliability of the black market to date, the results of the ALCP survey provide valuable information on the reliability of cannabis transactions in New Zealand.

The ALCP sample contained a large number of experienced cannabis buyers who may well have more established, and therefore more reliable and peaceful, sources of supply than less experienced consumers. A research question that emerges from the ALCP survey, which cannot be answered with the data collected here is, are there subgroups of cannabis buyers, for example inexperienced buyers, young people, or women, who are more likely to be victimised while purchasing cannabis from the black market.

One explanation for the high levels of quality fraud experienced in the black market is that quality fraud is not sufficiently costly to cause buyers to go elsewhere for cannabis (Wilkins, 1999). Cannabis sellers are therefore aware they can ‘get away’ with this type of cheating without their customer going elsewhere. The difficulties in finding cannabis sellers may mean buyers will only quit an existing seller when the costs of cheating are large enough to justify the time and effort involved in finding a new seller.

An alternative explanation for the high levels of quality fraud relates to the lack of an objective measure of the quality of cannabis in the black market (Wilkins, 1999). The absence of product packaging and product labelling in black markets means there is no accessible objective measure of cannabis quality. Inflated black market prices may encourage a general feeling amongst buyers of not receiving value for money. Buyers may therefore feel they have been victims of quality fraud even when no fraud was intended.

**Conclusion**

Several groups in New Zealand have suggested the legalisation of cannabis is required to protect those who buy and sell the drug on the black market from economic and physical victimisation. The ALCP survey suggests cannabis transactions in New Zealand are generally peaceful and reliable.
prohibition does not appear to place those who purchase the drug from the black market in any extreme physical danger. The principal risk of victimisation appears to be economic. Cannabis buyers are occasionally sold a fraudulent product, and believe they regularly receive a lower quality product than they pay for.

The extent of the social benefits gained from a legal and regulated cannabis market, in terms of improving the reliability of cannabis transactions, may therefore be fairly limited. Those in favour of limiting the use of illicit drugs might consider the economic victimisation experienced by cannabis buyers and sellers to be a justified harm for those who persist in using illegal substances, and who support and earn profit from the criminal trade in drugs.

From a broader policy perspective a number of questions can be raised about the extent to which legalisation and regulation of the cannabis market would actually reduce victimisation and violence in society. A number of policy commentators have pointed out that even if drugs were legalised, a significant black market may continue to persist if the taxation and regulation of the market were too strict (Kleiman and Saiger, 1990; Jacobs, 1990).

This would appear to be a particular risk in the case of cannabis because of the ease with which the plant can be cultivated and the widespread nature of the existing black market. For many drug consumers the transaction costs of participating in the legal market will exceed the transaction costs of continuing to transact in the illegal market (Wilkins and Scrimgeour, 2000). If a significant cannabis black market persisted after legalisation any victimisation and violence related to the black market would presumably continue.

Alternatively, if the cannabis black market were significantly reduced by the legalisation of the drug violent criminals involved in the cannabis trade may simply switch to involvement in, and expansion of, other illicit drug markets, such as the heroin or methamphetamine trade, or for that matter any number of other criminal activities. Goldstein (1997) believes much of the systematic violence related to illicit drug markets is ‘face-saving’ violence committed by naturally aggressive individuals. The violence and victimisation associated with the cannabis black market may therefore simply shift to other criminal activities rather than be greatly reduced or eliminated.

An anonymous referee made the point that it is not entirely clear that a legal cannabis market would completely eliminate the quality cheating found in the illicit market. The work of Barzel (1989) has shown that even in legal markets property rights are never perfectly specified or perfectly enforced, and consequently valuable attributes of products are left in the common pool to be captured by opportunistic exchange parties. The level of cheating in the illicit market should therefore be compared with the level of cheating that would persist in a legal market.

Of course the future of cannabis policy in New Zealand will not be decided by the reliability of black market cannabis transactions alone. The impact any law change might have on the prevalence of cannabis use, and the cost of the enforcement regime, are still likely to be the most influential factors in the
selection of a cannabis control policy (see Field and Casswell, 2000). There is a real concern about the extent the legalisation of cannabis would contribute to an increase in the use of the drug, and the extent increased use would contribute to greater cannabis related health and social problems (see, for example, Kleiman 1989 and 1992; Wilson, 1990; Inciardi and Saum, 1996). The issue examined here is just one amongst many that emerges from the evaluation of cannabis policy options and the results and discussion in this paper should be viewed in this wider policy context.

References


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The Australian Productivity Miracle: A Sceptical View

John Quiggin

Since the beginning of systematic microeconomic reform in the early 1980s, there has been a steady flow of official and unofficial predictions that the improvement in productivity made possible by reform would yield improved living standards for all, or at least most, Australians. The first such predictions were made by Kasper et al. (1980) who estimated that the adoption of a program of microeconomic reform broadly similar to that subsequently implemented would result in annual growth in income per person of 3.8 per cent for the period 1975–2000, while continuation of past policies would yield annual growth of 1.7 per cent. The implied cumulative net impact of reform was an increase in income of more than 70 per cent.

Subsequent estimates of the benefits of reform, mostly made by government agencies, including the Bureau of Industry Economics (1990), the Economic Planning Advisory Council (1996), Filmer and Dao (1994) and the Industries Assistance Commission (1989), were more modest, but still substantial. The most widely quoted was the estimate made by the Industry Commission (1995) that the implementation of ‘Hilmer and related reforms’ would yield medium-term benefits equivalent to a permanent increase in GDP of 5.5 per cent. This estimate covered a broad range of reforms, including competitive tendering and contracting, regulatory reform in a number of industries and restructuring of government business enterprises. Although the time-scale for the realisation of benefits was not entirely consistent, the majority of the benefits were projected to be realised over a period of five years. The estimates excluded a number of major reforms that took place during the 1990s including reductions in tariffs, labour market reform and privatisation of public utilities.

The estimates listed above covered overlapping sets of reform initiatives and time periods. However, they all implied that the benefits of microeconomic reform would be equivalent to an increase of at least one percentage point in the growth rate of GDP, and most were presented as partial or conservative. It therefore seems reasonable to summarise the conclusions of these studies by saying that the program of microeconomic reform commencing in the early 1980s was expected to raise the medium-term growth rate of GDP by between one and two percentage points.

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Microeconomic Reform Outcomes

Predictions can be debated indefinitely, but after two decades of reform it seems reasonable to focus on observed outcomes. Within a few years of the onset of microeconomic reform, supporters of reform began to look for, and frequently claimed to have found, evidence of the benefits of reform both in individual sectors and for the economy as a whole.

The first important piece of microeconomic reform in the 1980s was the deregulation of the financial sector. Supporters of this reform pointed to benefits in two main areas. First, the growth of financial takeovers, promoted by ‘entrepreneurs’ such as Alan Bond, John Elliott, Robert Holmes a Court, Christopher Skase and John Spalvins, was interpreted, following the arguments of Manne (1965), as creating a market for corporate control and promoting more efficient allocation of resources. Bishop, Dodd and Officer (1987:80) concluded that the activities of ‘raiders’ such as the Bell Group (controlled by Holmes a Court), Bond Corporation (Bond), Elders (Elliott), and Adelaide Steamship (Spalvins) ‘lead to more profitable uses of company assets, and as such they play a vital role in the capital allocation process’.

Second, the successful management of the ‘banana republic’ crisis of 1986, which included large, but temporary, increases in interest rates, was interpreted as evidence that the economy had become more ‘flexible’ in its response to economic shocks.

A widely noted assessment, was that of Higgins (1989:x)

We have had a decade of remarkable and fundamental economic and social policy reform; reform which in all its major contours and, arguably, in 99 per cent of its detail, is efficiency-enhancing.

Higgins echoed the views of Henderson (1989) who judged that: Australia had gone further in reducing fiscal imbalance and distortions in the tax system than most OECD countries; was among the leaders in financial market liberalisation and trade liberalisation; and was a model in the transparency of its assistance measures. A similar assessment was offered by Sieper and Wells (1989).

Among other things, the optimistic view of the benefits of reform reflected in Higgins’ assessment was used to justify the maintenance of high interest rates during 1989, as a response to inflationary pressures and current-account problems. The resulting recession showed that the economy was not as flexible as had been hoped. It also led to the bankruptcy of most of the leading ‘entrepreneurs’, exposing a pattern of bad investment decisions and dubious financial manipulations, which cast doubt on claims about the efficiency-enhancing properties of takeovers. Critics, such as Mathews (1991:7) blamed microeconomic reform for the severity of the recession, stating that ‘the economy
has been brought to its knees by financial and economic deregulation, the elimination of tariffs, free trade in agriculture [and] privatisation’.¹

During the early 1990s — a period of high unemployment and relatively slow economic recovery — fewer claims were made regarding the macroeconomic benefits of microeconomic reform. Rather, attention was focused on the concept of multifactor productivity (MFP), which is discussed in more detail below.

Although optimistic claims about productivity outcomes had been made from the late 1980s onwards, the Industry Commission took a more cautious view. In its 1995-96 Annual Report, however, the Commission was willing to claim a measure of success (Industry Commission, 1996:3):

There are early signs that past reforms are contributing to a structural improvement in Australia’s productivity performance. In contrast to its poor relative performance previously, Australia’s productivity increased at twice the rate of the OECD between 1989 and 1994 ... To sustain this momentum, it is important to lock in the gains from past reforms and seek further improvements in efficiency.

The estimated annual rate of total factor productivity growth between 1989 and 1994 was 1.1 per cent, compared to 0.5 per cent for the OECD as a whole.

The claim that the benefits of reform were already evident has been made with increasing confidence since the mid-1990s. However, there has been a subtle shift in the nature of the claims put forward. The Industry Commission (1996) presented the period 1989–94 as one of recovery from a previous trend of weak and deteriorating productivity growth. By contrast, in more recent assessments of microeconomic reform, the period of decline has been extended into the early 1990s, and it has been argued that strong productivity growth did not commence until 1993-94. Since the benefits of higher productivity growth flow through to higher living standards with a considerable lag, there is an element of ‘always jam tomorrow, never jam today’ in these shifting timeframes.

**Multifactor Productivity**

The need to focus on multifactor productivity may be understood in the light of critical responses to official estimates of the likely benefits of microeconomic reform. As Forsyth (1992) pointed out in his discussion of the Industries Assistance Commission (1989), this study, like most predictions of the benefits from microeconomic reform, incorporated the assumption that capital stock would grow substantially, either through increased foreign investment or through increased domestic saving. Since this additional capital input would have to earn

¹ Note that neither critics nor supporters of microeconomic reform gave any credence to the revisionist view, popular in the late 1990s, that microeconomic reform did not really get under way until after 1990. This view has some validity in relation to labour markets, but is otherwise inconsistent with the historical record.
the rate of return to capital determined by world markets, estimates of increases in GDP overstate the increase in economic welfare associated with the predicted outcomes.

A related point was made by Quiggin (1997) who argued that many of the reforms analysed by the Industry Commission (1995) were associated with increases in the pace and intensity of work. Thus, the benefits of increased output were achieved at the cost of increased effort by workers. A correct assessment of the welfare benefits of the predicted outcomes would take this cost into account.

The point common to the objections made by Forsyth and Quiggin is that a benefit is not necessarily associated with increasing output if this increase is accompanied by a proportional increase in inputs. Increasing the use of inputs is beneficial only if it is achieved through bringing unemployed workers into the labour force or through the use of unemployed, and immobile, capital and resources. A crucial element of the microeconomic reform debate, however, has been the view that short-term concerns about employment should be subordinated to longer-term measures designed to increase productivity.

For most purposes, then, the most appropriate measures of the economic benefits of microeconomic reform are measures of productivity, that is, the ratio of output (as measured, say, by GDP) to some appropriately-chosen index of inputs of labour and capital. Such measures are typically referred to as measures of ‘multifactor productivity’ or ‘total factor productivity’ to distinguish them from partial measures of the productivity of individual inputs such as labour and land.

An important problem in analysing productivity is the need to distinguish underlying productivity trends from cyclical fluctuations. Productivity tends to decline or grow slowly during recessions because firms hoard labour and keep capital partially or completely idle. In the early stages of a recovery, rapid growth can be achieved simply by making full use of existing capacity. During an expansion phase, technical innovations and new enterprises that could not be financed in a recession may be implemented, yielding further productivity gains. Hence, productivity is generally pro-cyclical. The simplest, and generally most appropriate, response to this problem is to measure productivity over the course of an entire business cycle, usually from peak to peak or from trough to trough.

**Multifactor Productivity Estimates**

Although various measures of economic performance have been used to support claims of improved economic performance in the 1990s, the most important are Australian Bureau of Statistics (ABS) estimates of multifactor productivity growth (ABS, 1998; 1999; 2000). Experimental ABS statistics on multifactor productivity growth, published in 1999, suggested that the period since 1993-94 was one of historically unprecedented productivity growth. Most notably, capital productivity that until the 1990s had consistently declined in line with neoclassical models of the implications of capital deepening, was estimated to have increased significantly since 1993-94.
Although revised estimates of multifactor productivity growth were published in 1999, the revision did not receive the wide publicity given to the original estimates. Some commentators, including Kasper (2000), have continued to rely on the original estimates. Others, including Snape (2000), have presented the revised data, but have adhered to judgements formed on the basis of the original data. Hence, to understand the development of the debate, it is necessary to look at both sets of estimates.

Table 1: Original ABS Estimates of Multifactor Productivity Growth

<table>
<thead>
<tr>
<th>Year ending June</th>
<th>Market output</th>
<th>Labour input</th>
<th>Labour productivity</th>
<th>Capital input</th>
<th>Capital productivity</th>
<th>Multifactor productivity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965–69</td>
<td>5.1</td>
<td>2.5</td>
<td>2.5</td>
<td>7.0</td>
<td>-1.9</td>
<td>1.3</td>
</tr>
<tr>
<td>1969–74</td>
<td>4.5</td>
<td>1.6</td>
<td>2.9</td>
<td>6.0</td>
<td>-1.5</td>
<td>1.6</td>
</tr>
<tr>
<td>1974–82</td>
<td>2.1</td>
<td>-0.3</td>
<td>2.4</td>
<td>3.9</td>
<td>-1.8</td>
<td>1.3</td>
</tr>
<tr>
<td>1982–85</td>
<td>2.0</td>
<td>-0.4</td>
<td>2.2</td>
<td>3.8</td>
<td>-1.8</td>
<td>1.2</td>
</tr>
<tr>
<td>1985–89</td>
<td>4.3</td>
<td>3.2</td>
<td>0.9</td>
<td>4.0</td>
<td>0.3</td>
<td>0.8</td>
</tr>
<tr>
<td>1989–94</td>
<td>1.8</td>
<td>-0.2</td>
<td>2.0</td>
<td>2.6</td>
<td>-0.8</td>
<td>1.1</td>
</tr>
<tr>
<td>1994–98</td>
<td>4.6</td>
<td>1.7</td>
<td>3.1</td>
<td>3.8</td>
<td><strong>0.8</strong></td>
<td><strong>2.4</strong></td>
</tr>
<tr>
<td>1965–74</td>
<td>4.8</td>
<td>2.0</td>
<td>2.7</td>
<td>6.5</td>
<td>-1.7</td>
<td>1.5</td>
</tr>
<tr>
<td>1981–89</td>
<td>3.3</td>
<td>1.7</td>
<td>1.5</td>
<td>3.9</td>
<td>-0.6</td>
<td>1.0</td>
</tr>
<tr>
<td>1989–98</td>
<td>3.0</td>
<td>0.6</td>
<td>2.5</td>
<td>3.1</td>
<td>-0.1</td>
<td>1.7</td>
</tr>
<tr>
<td>1965–98</td>
<td>3.4</td>
<td>1.0</td>
<td>2.4</td>
<td>4.4</td>
<td>-1.0</td>
<td>1.4</td>
</tr>
</tbody>
</table>

Source: ABS (1998) and author’s calculations.

The initial ABS estimates are presented in Table 1. Column 1 gives time periods, consisting of one or more productivity cycles, as defined by the ABS (see below). The data are derived from the national accounts and therefore refer to financial years. For example, the first row, listed as 1965-69, refers to the four-year period from 1964-65 (the year ending June 1965) to 1968-1969 (the year ending June 1969). All growth rates are computed from ratios of annual values in the same fashion as annual growth rates computed on a ‘year-to-year’ basis. For example, if \( Y \) denotes market output, the growth rate for \( Y \) in Column 1 is given by:

\[
G = \left( \frac{Y_{69}}{Y_{65}} \right)^{1/4} - 1 \approx \frac{\ln Y_{69} - \ln Y_{65}}{4} \approx \frac{Y_{69}/Y_{65} - 1}{4}
\]

where \( Y_{65} \) denotes the year 1964-65, \( Y_{69} \) denotes the year 1968-69, \( \ln \) is the natural logarithm and \( \approx \) denotes approximate equality.
Column 2 shows the annual growth rate of market sector output. Column 3 shows the annual growth rate of labour input, measured in hours. Column 4 is equal to the difference between Columns 2 and 3, and is the standard measure of labour productivity. Column 5 is the rate of growth of capital services, and Column 6 the associated measure of capital productivity. Column 7, the multifactor productivity growth measure, is the difference between the rate of growth of output and the rate of growth of an input index in which capital and labour inputs are weighted according to an estimate of their share in total input costs. More detail on the derivation of multifactor productivity measures is given in ABS (2000).

Rows 1 to 6 show the results for the six productivity cycles identified by the ABS between 1964-65 and 1993-94. Row 7 (in bold) shows the 'productivity miracle' supposed to have taken place between 1993-94 and 1997-98. Rows 8 to 10 have been derived by combining ABS productivity cycles to correspond more closely to business cycles (see below). Row 11 shows the results for the entire data period.

Although the rate of growth of market sector output from 1993-4 to 1997-8 was no greater than in the period from 1964-65 to 1972-73, the estimated rate of multifactor productivity growth was substantially higher. On the basis of this evidence, Parham (1999:vii) concluded that ‘Australia’s productivity performance is now at an all-time high. Productivity growth is faster now than in the so-called “Golden Age” of growth around the 1960s.’

Quiggin (1999a, 2000) presented a number of objections to the ABS estimates. One of these objections was that the apparent improvement in capital productivity was inconsistent with the weak investment reflected in the slow rate of growth of capital inputs. A genuine increase in the productivity of capital should increase the number of projects with a positive present value and, therefore, raise the level of investment. An increase in measured productivity combined with weak investment is more consistent with a cyclical recovery in capacity utilisation.

Revised ABS data released in 1999 raised the estimated rate of growth of capital inputs for the 1980s and 1990s and largely resolved this issue (see Table 2). The estimated rate of capital productivity growth was revised down to –0.3 per cent (Table 2, Row 7), better than the historical average, but not startling for an expansion. According to the revised data, productivity growth since 1993-94 has been only modestly better than that of the ‘golden age’ ending in 1973-74 (an annual rate of 1.7 per cent since 2000 compared to an average of 1.3 per cent in the ‘golden age’), rather than clearly superior as was the case with the original estimates.

Another noteworthy feature of the revised data in Table 2 relates to the period from 1988-1989 to 1993-1994 that, at the time, was regarded as providing evidence that microeconomic reform was beginning to yield productivity benefits. According to the revised estimates, multifactor productivity growth in this period was near the all-time low reached in the immediate aftermath of financial deregulation and lower than in any period before the onset of microeconomic
reform. However, as discussed below, this result is sensitive to cyclical timing. For the period 1989-1990 to 1993-1994, the growth rate of MFP was 0.9 per cent, while for the period from 1983-1984 to 1989-1990, the rate was only 0.2 per cent. Thus, a different choice of cyclical timing would give more support to the hypothesis of an improvement in performance.

Table 2: Revised ABS Estimates of Multifactor Productivity Growth

<table>
<thead>
<tr>
<th>Year ending June</th>
<th>Market output</th>
<th>Labour input</th>
<th>Labour productivity</th>
<th>Capital input</th>
<th>Capital productivity</th>
<th>Multifactor productivity</th>
</tr>
</thead>
<tbody>
<tr>
<td>1965–69</td>
<td>5.1</td>
<td>2.5</td>
<td>2.5</td>
<td>6.3</td>
<td>-1.1</td>
<td>1.1</td>
</tr>
<tr>
<td>1969–74</td>
<td>4.6</td>
<td>1.6</td>
<td>2.9</td>
<td>5.5</td>
<td>-0.9</td>
<td>1.5</td>
</tr>
<tr>
<td>1974–82</td>
<td>2.1</td>
<td>-0.3</td>
<td>2.4</td>
<td>4.0</td>
<td>-1.8</td>
<td>1.0</td>
</tr>
<tr>
<td>1982–85</td>
<td>1.8</td>
<td>-0.4</td>
<td>2.2</td>
<td>3.7</td>
<td>-1.8</td>
<td>0.8</td>
</tr>
<tr>
<td>1985–89</td>
<td>4.2</td>
<td>3.2</td>
<td>0.9</td>
<td>4.6</td>
<td>-0.4</td>
<td>0.4</td>
</tr>
<tr>
<td>1989–94</td>
<td>1.8</td>
<td>-0.2</td>
<td>2.0</td>
<td>3.4</td>
<td>-1.5</td>
<td>0.6</td>
</tr>
<tr>
<td><strong>1994–00</strong></td>
<td><strong>4.8</strong></td>
<td><strong>1.7</strong></td>
<td><strong>3.1</strong></td>
<td><strong>5.1</strong></td>
<td><strong>-0.3</strong></td>
<td><strong>1.7</strong></td>
</tr>
<tr>
<td>1965–74</td>
<td>4.8</td>
<td>2.0</td>
<td>2.7</td>
<td>5.9</td>
<td>-0.9</td>
<td>1.3</td>
</tr>
<tr>
<td>1982–89</td>
<td>3.2</td>
<td>1.7</td>
<td>1.5</td>
<td>4.2</td>
<td>-1.0</td>
<td>0.7</td>
</tr>
<tr>
<td>1989–00</td>
<td>3.1</td>
<td>0.6</td>
<td>2.5</td>
<td>4.2</td>
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<tr>
<td>1965–00</td>
<td>3.4</td>
<td>1.0</td>
<td>2.4</td>
<td>4.3</td>
<td>-1.1</td>
<td>1.1</td>
</tr>
</tbody>
</table>

Source: ABS (2000) and author’s calculations

The second objection to claims of a productivity ‘miracle’ put forward by Quiggin (1999a) relates to cyclical timing. As noted above, the standard procedure in assessing economic performance over time is to compare cycles on a peak-to-peak or trough-to-trough basis. Since the 1990s expansion did not peak until late 2000, only recent analysis using peak-to-peak comparisons avoids the possibility of bias in favour of the null hypothesis that performance in the 1990s has been no better than in the past. However, any such bias would be small, and, in any case, conservatism is appropriate in testing hypotheses of fundamental economic change.

The literature on recent productivity growth in Australia includes a range of cyclical comparisons, most of which are biased in favour of the hypothesis of a productivity miracle. Parham (1999) focuses on a ‘productivity cycle’ from June 1994 to June 1998, identified by the ABS on the basis of internal characteristics of the time series of multifactor productivity estimates. As shown in Tables 1a and 1b, the ABS identified four productivity cycles in the period since June 1982,
corresponding fairly closely to the two business cycles (from mid-1982 to late 1989 and from late 1989 to the present) evident in data on GDP, unemployment and other macroeconomic data.

To apply a peak-to-peak approach, it is necessary to estimate the timing of cyclical peaks. One approach is based directly on the ABS productivity data. The market sector data presented in Tables 1a and 1b show that the productivity cycles since 1981-2 fall into pairs. The 1982–5 and 1989–94 cycles, both of which include severe recessions, display low growth in inputs and outputs, particularly labour. The 1985–89 and 1994–90 cycles, both of which occurred during economic expansions, show strong growth in outputs and labour inputs. The two productivity cycles of the 1980s and the 1990s each correspond fairly closely to a single business cycle.

Data limitations and the weakness of the business cycle during the ‘golden age’ create some problems for the assessment of the period before 1973-74. Contemporary assessments suggest that, following the mild recession of 1960-61, the 1960s were a period of uninterrupted expansion. For this reason, rows 8, 9 and 10 in Tables 1a and 1b show the effect of combining pairs of productivity cycles into three business cycles, namely 19 64-65 to 1973-74, 1981-2 to 1988-9 and 1989-90 to 1999-2000.

As shown in Table 1b, the combination of data corrections and the use of appropriate cyclical comparisons eliminate the apparently above-average performance of the 1990s. On measures of output, partial productivity and multifactor productivity, performance since 1988-89 has been: very close to the average for the period since 1964-65; better than the 1980s; but slightly worse than the ‘golden age’ up to 1973-74.

Conclusions about economic performance in the 1990s are, however, quite sensitive to cyclical timing. The correspondence between productivity cycles and business cycles is close, but not exact. The Melbourne Institute (2001) estimates that the relevant cyclical peak occurred in either November 1989 (growth cycle measure) or December 1999 (classical cycle measure). This is significant because 1989-90 was a year of moderate output growth but very poor capital productivity growth. If 1989-90 is shifted from the 1990s cycle to the 1980s cycle, estimated MFP growth for the 1980s is reduced to 0.4 per cent, and estimated MFP growth for the 1990s is increased to 1.4 per cent, strengthening the case for an economic ‘miracle’.

For the period 1964-65 to 1973-74, the classical cycle measure presented by the Melbourne Institute confirms this view. However, the Institute’s growth cycle series includes three cycles over this period from 8/1960 to 4/1965, 4/1965 to 1/1971 and 1/1971 to 2/1974. Although the growth cycles do not match the ABS productivity cycles exactly, combining the two growth cycles from 4/1965 to 2/1974 and the two productivity cycles from 1964-65 to 1972-73 gives a reasonably good match.

The estimates presented in Table 1b are consistent with the results of Dowrick (2000) that are also based on the revised data set. Other procedures, not based on complete business cycles, yield different results.
Gruen and Stevens (2000) address the problem of cyclical timing by comparing expansions. In principle, this procedure is unbiased, but is inefficient because the information associated with contractions is discarded. In practice, the comparison is biased in favour of the expansion that followed the deepest contraction, namely that of the 1990s. Parham (2000) relies primarily on the ABS productivity cycles in his formal analysis. However, his graphical presentation of the data is biased in favour of the hypothesis that performance has improved in the 1990s. A peak-to-peak trend for the 1970s is compared with a peak-to-trough trend for the 1980s and a trough-to-peak trend for the 1990s, as shown in Figure 3 from Parham (2000), reproduced below as Figure 1. The effect is to bias the trend growth line downwards for the 1980s and upwards for the 1990s.

**Figure 1: Multifactor Productivity (Market Sector) 1964-65 to 1998-99**

(Index 1997-98 = 100, log scale)

![Multifactor Productivity (Market Sector) 1964-65 to 1998-99](image)

Source: Parham (2000:Figure 3)

The effect of the revision may also be seen by comparing estimates of the relationship between the capital–labour ratio and the output–labour ratio. Figure 2a, from Parham (1999) shows a clear structural break in the relationship after 1990-1. Figure 2b, from Parham (2000) is also drawn to show a structural break, but casual inspection suggests the alternative hypothesis of a linear trend over the period 1974–2000, with no structural break apart from the secular decline at the end of the 'golden age'. Statistical evidence on this point is indecisive.
Figure 2a  Australia’s growth patha, 1964-65 to 1997-98
Indexes 1996-97 = 100

\[ R^2 = 0.99 \]

a The fitted curve uses data for years up to 1992-93. The curve is of the form \( \ln(\gamma_t) = 40.66 \ln(\gamma_t) - 98.39 \). Additional observations from 1993-94 are represented as shaded squares.

Source: Parham (1999: Figure 4.2)

Figure 2b  Australia’s growth patha, 1964-65 to 1998-99
Indexes 1996-97 = 100

\[ R^2 = 0.99 \]

a The fitted curve uses data for years up to 1992-93. The curve is of the form \( \ln(\gamma_t) = 41.82 \ln(\gamma_t) - 99.64 \). Additional observations from 1993-94 are represented as shaded squares.

Source: Parham (2000: Figure 1)
The final objection raised by Quiggin (1999a), and expanded by Quiggin (2000), relates to the measurement of labour input. Two issues arise here. The first relates to the construction of estimates of market sector output and employment by the ABS. The ABS confines attention to those sectors for which a reliable measure of market output is available. In particular, this excludes the property and business services (PBS) sector. However, since most of the output of the PBS sector consists of inputs to the market sector, any error in measurement of PBS output generates an equal and opposite error in measurements of value added in the market sector. By assumption, outputs are set equal to inputs in the PBS sector and productivity growth is set to zero. If these assumptions understate the level and growth of PBS productivity, there is a corresponding overstatement of productivity in the market sector. Hence, the most reliable estimate of aggregate market sector output and productivity is obtained by adding the PBS sector to the market sector. However, it should be noted that, to the extent that PBS output is consumed directly by households, this procedure may overcorrect the biases present in the standard measures.

This adjustment is important because employment in the PBS sector grew by 52 per cent during the expansion from 1993-4 to 1997-8. The fact that this growth was primarily due to the outsourcing of a range of business services underlines the unreliability of estimates of productivity for the market sector that exclude PBS. Including PBS employment and output in the market sector reduces estimated annual labour productivity growth for the period 1993-94 to 1999-2000 from 3.1 per cent to 2.4 per cent, but has little effect in other periods.

Gruen and Stevens (2000) suggest an alternative procedure using estimates for the entire nonfarm sector. This yields labour productivity growth rates of 2.0 per cent (1970s expansion), 0.8 per cent (1980s) and 2.2 per cent (1990s) compared to 2.1 per cent, 1.4 per cent and 2.9 per cent respectively for the market sector over the same periods. Whereas in the market sector data, labour productivity in the 1990s is clearly superior to that of the 1970s, for the non-farm sector as a whole there is almost no difference. The main difference with the analysis presented above is that Gruen and Stevens find that the exclusion of PBS overstates productivity growth in the 1980s as well as in the 1990s. The data set used by Gruen and Stevens (2000) may also be used to derive MFP estimates for the period since 1971, using data for the entire period, rather than expansions alone. The resulting MFP growth rates are 1.0 per cent (1971–81), 0.6 per cent (1981–89) and 1.2 per cent (1989–2000).

The second issue involves work intensity and the measurement of labour input. Quiggin (2000) argues that the intensity of work has increased throughout the period of microeconomic reform. Work intensity can be increased on a number of margins. First, the number of officially-measured hours at work can be increased. During the 1990s, the ABS measure of working hours per full-time worker increased from 39 hours per week to 41 hours per week, an increase of around 5 per cent. This increase was offset by an increase in the proportion of

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2 I thank David Gruen for providing the data set.
part-time workers. Changes in average working hours affect the measured labour input and are therefore taken into account in productivity calculations.

The second margin on which work can be intensified is that of the difference between measured and actual hours of work. An unmeasured increase in hours can arise from reductions in tea and lunch breaks, replacement of continuous shifts with split shifts, pressure to forgo leave entitlements, and so on. Such unmeasured increases in inputs are not taken into account in productivity calculations.

Changes that are likely to generate unmeasured increases in working hours have been demanded by employers in enterprise bargaining negotiations for the unionised workforce, and there is little doubt that similar changes have been imposed in workplaces not covered by enterprise bargaining (Australian Centre for Industrial Relations Research and Training, 1999). Changes of this kind, referred to as increasing ‘flexibility’, have been presented as an important element of microeconomic reform on many occasions. Thus, it is reasonable to assume that they account for at least part of any measured productivity gains associated with reform.

Roach (1998) argues that unmeasured increases in working hours have been a major source of bias in estimates of productivity growth in the United States. Australian estimates of working hours are based on individual surveys, unlike those in the United States, which are derived from surveys of establishments and thus likely to be more reliable. Nevertheless, many of the biases identified by Roach are relevant to Australia.

The third margin, and the most difficult to measure, is that of ‘pace of work’. Most employees report increases in work intensity and stress. The Australian Workplace Industrial Relations Survey undertaken in 1995 (Morehead et al., 1997) found that a majority of employees reported increases in stress, work effort and pace of work over the previous year, while less than 10 per cent reported reductions in any of these variables. This is consistent with evidence from the United Kingdom and some, though not all, other European countries (Green and McIntosh, 2001). Moreover, Green and McIntosh observe that the increases in work intensity are associated with higher productivity (as would be expected) and are positively correlated with exposure to competition and with reductions in union density. Thus, it seems reasonable to conclude that at least some of any increase in productivity associated with microeconomic reform results from increased work intensity. Increased work intensity may also be associated with unmeasured changes in output quality, particularly in the non-market sector where output is imputed rather than being measured directly. If measured labour input and measured outputs are unchanged, an increase in work intensity should be associated with higher output quality. However, where increases in work intensity are imposed through reductions in employment with no change in measured output, output quality will decline.

The evidence of increasing work intensity resolves a number of puzzles that arise from the standard interpretation of the 1990s as a decade in which both labour productivity and total factor productivity increased rapidly. The first puzzle is why employment growth has been weaker in the 1990s than in the
1980s. The second is why, despite high unemployment, real wages have increased more in the 1990s than in the 1980s. The third is why the aggregate rate of GDP growth has been no higher in the 1990s than in the 1980s. \(^3\)

The hypothesis of increased work intensity implies that effective labour input has grown more rapidly than measured hours of work, while productivity and wages per unit of effort have grown more slowly than measured productivity and hourly wages. As with the revisions to the capital stock series noted above, adjustment of the estimated labour input to take account of increases in work effort would eliminate all the apparent paradoxes.

Another issue in the measurement of labour input is that of composition effects. The proportion of the labour force employed full-time has declined over the 1990s, with the decline being particularly evident among younger workers and less-qualified older workers. Consequently, the full-time workforce now contains a higher proportion of prime-age and qualified workers. Given the process of downsizing and selective attrition that has contributed to the contraction of full-time employment, it is likely that remaining full-time workers also have unmeasured characteristics more favourable to productivity than those that have left the workforce. As with increased work intensity, productivity growth from this source it is not sustainable.

Finally, in assessing the growth performance of the 1990s, it is necessary to take account of sources of productivity growth other than microeconomic reform. These include, technological change, such as increased use of information technology and increased skills and experience in the workforce (human capital). The magnitude of technological change associated with information technology, and the extent to which a flexible economy has contributed to technological innovation, have been the subject of vigorous debate in the United States. However, technological change related to information technology is largely exogenous to Australia. Hence, the only potential impact of microeconomic reform can be to accelerate the rate of adoption of technical innovations.

As regards human capital, Australia’s performance in the 1990s is a subject of deep concern. During the 1980s, measures of educational attainment, such as the rate of school completion, improved dramatically and contributed to higher levels of skills in the workforce of the 1990s. Largely as a result of programs of microeconomic reform, rates of school completion declined in the 1990s (Quiggin, 1999b). Other things being equal, this can be expected to reduce economic growth in the future.

In the short term, changes in the composition of the workforce can affect average productivity. It is commonly argued that the depressed real wage growth associated with the Accord on Prices and Incomes during the 1980s led to increased employment growth and reduced labour productivity growth as less-skilled workers were drawn into employment. Conversely, the relatively weak

\(^3\) The average rate of GDP growth has been about 3.5 per cent in both decades. Growth in GDP per person was higher in the 1990s, but the rate of population growth should not have been an important constraint on growth in view of the sustained high unemployment that characterised the entire decade.
growth in employment (particularly full-time employment) during the 1990s might be associated with an increase in average skill levels and therefore in productivity.

Concluding comments

Claims that the Australian economy has experienced a productivity ‘miracle’ or entered a ‘new era’ have been made with increasing frequency and confidence since the late 1990s. Krugman (1998), in his discussion of the Asian financial crisis, described Australia as the ‘miracle economy of the financial crisis’. Although this accolade referred to macroeconomic management, many Australian commentators attributed the successful management of the Asian crisis to the benefits of microeconomic reform, just as the successful management of the ‘banana republic’ crisis in 1986 had been attributed to the flexibility arising from financial deregulation.

This optimistic view has been reflected in the titles of more formal assessments of Australia’s economic performance. Bean (2000) assessed the 'miraculous' performance of the Australian economy (quotation marks in original). Parham (1999) uses the term 'new economy' (no quotation marks in original) and claims that that ‘Productivity growth is faster now than in the so-called “Golden Age” of growth around the 1960s’.

Similar claims have been made on behalf of many developed countries in the past twenty years. A partial list includes Ireland, Finland, Japan, the Netherlands, New Zealand, Sweden, the United Kingdom and the United States. Such claims typically appear over-optimistic in retrospect. The performance of the OECD economies as a group remains significantly weaker than it was during the ‘golden age’ of the 1950s and 1960s, despite strong performances by particular economies in particular cycles. In these circumstances it is appropriate to subject evidence of allegedly ‘miraculous’ performance to critical scrutiny.

Claims of a fundamental improvement in Australia’s economic performance do not stand up to such scrutiny. To summarise, when cyclical comparisons are made on a peak-to-peak basis, using revised ABS data, the productivity performance of the 1990s no longer appears miraculous, though it does exhibit some recovery from the very weak performance of the 1980s to levels comparable with those of the 1970s. The recovery in the 1990s appears stronger, and the performance of the 1980s weaker, if the Melbourne Institute cycle dates are used in place of those derived from the ABS productivity data. On the other hand, much of the apparent recovery arises from measurement errors associated with an inappropriate definition of the market sector and the failure to take account of increases in the effective labour input arising from unmeasured increases in working hours and work intensity.

The claim that economic performance in the 1990s was comparable with that of the ‘golden age’ of the 1960s is inconsistent with the empirical evidence. There is some evidence of a recovery in productivity growth from the very low levels of the 1980s. However, in view of the difficulty of estimating changes in the
effective labour input, and the sensitivity of the outcomes to issues of cyclical timing, no firm conclusion can be drawn on this point.

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Australian Postgraduate Financing Options

Bruce Chapman and Tony Salvage

Since 1991 Australian universities have charged fees, paid in advance (up-front), for a proportion of students undertaking postgraduate courses. In this paper it is argued that this is poor public policy, for both economic and social reasons. The conceptual basis for this case is explained fully.

Given the strength of argument, it is difficult to understand why different Commonwealth governments have allowed and encouraged the expansion of postgraduate up-front fees in this period. The policy situation is particularly hard to justify since a much more equitable and efficient charging arrangement, the Higher Education Contribution Scheme (HECS), has been in place for undergraduates since 1989.

The important point for policy is that HECS collects student charges contingent on incomes, and thus requires no payment at the point of entry. It is argued that a collection system of this type is a more correct policy for postgraduate education, and it is shown that such a reform can be implemented without administrative difficulties.

In January 2001 the Federal Government announced intentions to change post-graduate fee arrangements consistent with the reform promoted in this paper. The proposal is known as the Postgraduate Education Loan Scheme (PELS), and its basis and implications are considered in what follows. It is argued that while PELS is a major advance over current arrangements its institution will have important and arguably undesirable consequences with respect to the level of student charges and, more importantly, concerning taxpayer subsidies of postgraduate education. If and when these effects come to pass, the government will face the need to change the scheme. An economically and administratively viable reform to PELS is explained and justified.

A Brief History of Higher Education and Post Graduate Financing

In 1974 the Federal Labor Government abolished tuition fees for higher education and soon after took over the responsibility of university funding from the States. By 1978 the Tertiary Education Commission (TEC), a statutory body, was the sole administrator of higher education funding, including all postgraduate courses (DEET, 1993). Over the next decade or so there were no significant changes in the nature of university funding — so-called ‘free’ higher education was apparently accepted by both the TEC and the government as the correct approach.

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This policy stance changed significantly in 1986 with the institution of the Higher Education Administration Charge (HEAC), a small up-front charge on all university students of $250 that did not vary with respect to course load. HEAC is important in an understanding of the policy dynamics in two respects.

First, its institution signalled a change in the nature of political influence with respect to higher education financing since it was a Cabinet, not a TEC, initiative. In this respect it represented the beginning of a transfer to the government of decision-making power with respect to higher education financing. Second, HEAC represented government endorsement of student fees, and thus set the scene for more radical reforms involving user-pays.

While HEAC was symbolically critical, the revenue raised was trivial in comparison to the total costs of higher education (unlikely to have exceeded three per cent of teaching costs). Thus in 1987 it remained the case that taxpayers provided practically all of the finances for higher education, including postgraduate courses. At this time the conjunction of several forces made it close to inevitable that the government would move the financing arrangements towards increased contributions from students, and these were as follows.

First, the rapid increase in year 12 retention rates over the 1980s was not accompanied by a commensurate expansion in higher education places. This resulted in large and growing queues of qualified prospective students. Second, while this problem could have been solved with increased Commonwealth budget outlays, the Labor Government was intent on fiscal parsimony and not prepared to spend the required additional taxpayer resources (see Chapman, 2001; and Edwards, 2001). Finally, and perhaps most importantly, at least two Cabinet Ministers, John Dawkins and Peter Walsh, were strongly in favour of student fees on the basis that a no-charge higher education system constituted a regressive distribution, from all taxpayers to university graduates, the majority of whom came from relatively privileged backgrounds.

In late 1987 the Minister, John Dawkins, set up a committee (chaired by former NSW Premier, Neville Wran), to examine options for university funding including student contributions. It was clear from the Terms of Reference that the government’s intent was to set the scene for the introduction of fees, including for postgraduates.

The Wran committee duly delivered, albeit in a radical way. It recommended that all undergraduates be required to pay a charge, with the timing and level of the obligation being dependent on students’ income. At the time the income contingent feature of the Higher Education Contribution Scheme (HECS) was unique internationally.

With the introduction of HECS it was opportune for the government to initiate financing reform in the postgraduate area, and this took the following form. In 1989 universities were permitted to charge fees for a limited range of postgraduate courses, including for employed Australian students enrolled in skill-related courses. This policy change was justified through reference to: the benefits of revenue increases for higher education institutions; and the presumed
advantages of institutions being able to develop specialist postgraduate courses to satisfy growing industry demand.

In 1994 the government removed all restrictions on universities with respect to postgraduate fees. This situation remained unchanged to 2001.

As illustrated in Table 1, this policy history resulted in an extraordinary growth in the number of postgraduate students paying up-front fees in the 1989-2000 period. Specifically, there has been more than a ten-fold increase over these eleven years, with the number of postgraduate Australian students paying up-front fees in 2001 implying an average increase since 1989 of more than 20 per cent per annum.

Table 1: Fee-Paying Postgraduate Australia Students: 1989-2000

<table>
<thead>
<tr>
<th>Year</th>
<th>Student Load (EFTSU)</th>
<th>Annual Increase (%)</th>
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<tbody>
<tr>
<td>1989</td>
<td>2,351</td>
<td></td>
</tr>
<tr>
<td>1990</td>
<td>5,374</td>
<td>128.6</td>
</tr>
<tr>
<td>1991</td>
<td>4,763</td>
<td>-11.4</td>
</tr>
<tr>
<td>1992</td>
<td>6,113</td>
<td>28.3</td>
</tr>
<tr>
<td>1993</td>
<td>7,500</td>
<td>22.7</td>
</tr>
<tr>
<td>1994</td>
<td>9,562</td>
<td>27.5</td>
</tr>
<tr>
<td>1995</td>
<td>11,761</td>
<td>23.0</td>
</tr>
<tr>
<td>1996</td>
<td>13,514</td>
<td>14.9</td>
</tr>
<tr>
<td>1997</td>
<td>16,327</td>
<td>20.8</td>
</tr>
<tr>
<td>1998</td>
<td>20,457</td>
<td>25.3</td>
</tr>
<tr>
<td>1999</td>
<td>24,097</td>
<td>17.8</td>
</tr>
<tr>
<td>2000</td>
<td>24,977</td>
<td>3.7</td>
</tr>
</tbody>
</table>

Note a: Effective Full-time Student Units


These changes in Australian postgraduate financing arrangements were investigated by a review commissioned by the Labor Government in 1995 (the Review of the Committee to Review Fee-Paying Arrangements for Postgraduate Courses chaired by Gordon Stanley). The review acknowledged up-front fees might not be the best approach, but did not recommend changes to the arrangements. Its support of the status quo relied on the argument that there was insufficient evidence of up-front fees adversely affecting access to postgraduate study by the disadvantaged. The view was not supported in an empirically
convincing way. The Committee noted that up-front fee coverage of the postgraduate sector was small in the early 1990s. Importantly, it argued that in the event of postgraduate fees becoming widespread the government should consider the adoption of a HECS-type loan policy in this area. Even so, the key proposition of the Committee was that while a HECS-type arrangement might be preferable eventually, up-front fees were not widespread enough to warrant reform.

The number of students paying postgraduate up-front fees grew considerably in the late-1990s. Notwithstanding this, both Labor and Coalition governments ignored the critical suggestion of the Stanley Review of the possible move towards a HECS-style loan for postgraduate students. This changed in early 2001 with the government recommending the adoption of an income contingent loan arrangement for postgraduates. The policy is considered in detail below.

Postgraduate Financing Options: Conceptual Issues

The framework underlying the analysis presented in this section is that of the economics of education, and is based on human capital theory. This approach considers education as a process of investment, and thus involves costs and benefits for both students and taxpayers.

There are alternative ways of analysing government approaches to university funding and, as Pincus (2000) argues, to be made operational the human capital framework implicitly makes quite restrictive assumptions. As well, he stresses correctly that there are important measurement issues in interpreting rates of return to human capital as a basis for policy direction. Nevertheless, the framework is less contentious when the key policy issues concern changes in relationships, and this is the orientation of much of the empirical analysis following.

The human capital orientation leads to the promotion of three principles underlying postgraduate student charges. They are that: students should pay for some part of the costs of their education; the government should subsidise some part of the direct costs; and, charges should be collected through the tax system, contingent on a postgraduate’s income. These principles are now explained.

Students should pay part of the costs of postgraduate courses

The argument that students should pay for some part of the costs of postgraduate education rests on a simple proposition. It is that individual students gain private benefits from the process. These benefits take many forms, with the most obvious economic dimension being lifetime incomes. Data are available on this issue.

The questions are, do individuals with postgraduate qualifications have high earnings compared to individuals with lower levels of educational qualifications and, if so, what is the size of this advantage? These issues are now addressed using the 1994/95 ABS Income and Housing Survey. The survey has information on the labour market experience of the members of around 30,000 households, with data for full-time workers on earnings (from the main job) cross-categorised
by age, sex and educational attainment. This allows an exploration of the possible earnings advantages associated with educational qualifications.

It is useful to define some hypothetical scenarios to illustrate the relationships between formal skills and earnings. This was done by exploring the earnings consequences for both males and females for three education levels, namely: leaving education at age 18, and taking a full-time job until age 55; undertaking a 4 year Bachelor’s degree, and taking a full-time job at age 22 until age 55; and, undertaking a 4 year Bachelor’s degree followed by a 2 year postgraduate course, and taking a full-time job at age 24 until age 55.

The data were adjusted to be in year 2000 prices and the (smoothed) annual earnings profiles for these hypothetical scenarios are presented in Figures 1 and 2, for men and women respectively, and by educational level. These profiles can be used to estimate (hypothetical, and average) lifetime earnings advantages of postgraduates, relative to the earnings of those with Bachelor’s degrees and those without post-school qualifications. The (before-tax) results are shown in Table 2.

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1 A conventional simple earnings function approach was used to smooth the data. The estimations have satisfactory econometric characteristics. The results are available from the authors.
The obvious conclusion from Figures 1 and 2 and Table 2 is that, on average, there are clear lifetime earnings advantages associated with postgraduate study. The size of the benefits estimated from these data is as follows.

On average over their lifetimes, men and women with postgraduate qualifications earn around 60-70 per cent more than individuals with no qualifications, and 4-11 per cent more than those with Bachelor’s degrees. More sophisticated methods used to illustrate these relativities reinforce the broad findings. The results of the above exercise imply that there are private economic

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Table 2: Lifetime Earnings (Before Tax) by Educational Qualification

<table>
<thead>
<tr>
<th>Education Level:</th>
<th>Males</th>
<th>Females</th>
</tr>
</thead>
<tbody>
<tr>
<td>No Qualifications</td>
<td>$1,122,229</td>
<td>$727,461</td>
</tr>
<tr>
<td>Bachelor Degree</td>
<td>$1,744,718</td>
<td>$1,139,876</td>
</tr>
<tr>
<td>Postgraduate</td>
<td>$1,820,745</td>
<td>$1,267,904</td>
</tr>
<tr>
<td>Postgraduate/No Qualifications</td>
<td>162.2 per cent</td>
<td>174.3 per cent</td>
</tr>
<tr>
<td>Postgraduate/ Bachelor Degree</td>
<td>104.4 per cent</td>
<td>111.2 per cent</td>
</tr>
</tbody>
</table>

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2 These methods include calculation of so-called ‘rates of return to education’ — the extent to which postgraduate investments in education benefit individuals over their lifetimes taking account of income foregone through the additional study. These
benefits from postgraduate study in Australia, at least for the 1990s. From the perspective of the economics of education, this justifies there being a student charge, for several reasons. The most obvious of these relates to equity with respect to taxation and public expenditure, and is as follows.

The equity justification for charging for postgraduate courses can be explained through consideration of the implications of having no postgraduate course charges for students. If the government does not require contributions from the individuals benefiting from postgraduate education, it follows that those who receive it are being subsidised by all taxpayers with an important part of this subsidy very likely contributing to high private postgraduate benefits.

That this is inequitable is clear. Nick Barr (2001) makes this point best with respect to the UK by asking rhetorically a question of the form: ‘why should unskilled labourers and truck drivers be asked to underwrite all the costs of services which directly benefit the privileged?’

**Taxpayers should contribute to costs of postgraduate courses**

A second financing principle is that there should be a public subsidy for postgraduate education. This implies that postgraduates should not pay the full costs of their courses. The issue is pertinent for current Australian debate, since, if true, it promotes a case against allowing universities to charge full fees. The basis for a taxpayer subsidy is now explained.

The most important generic point concerning government subsidies is as follows. If a society derives benefits in addition to those accruing directly to the individuals participating in an activity, that activity should be subsidised to ensure it is sufficiently provided from a societal perspective. These ‘externalities’ or social ‘spillovers’ from higher education are usually thought to take the forms of:

- more informed public debate and voting behaviour, and more tolerance;
- the benefits accruing to workers and others from the imitation of the skills of the highly educated;
- higher tax revenue resulting from the higher productivity and wages of the more highly educated; and
- higher economic growth resulting from higher levels of education

A case for subsidising postgraduate study should include the societal benefits from research, given the critical importance played in postgraduate training of the exploration and analysis of new ideas. That is, research spillovers for the public good are likely to be a critical part of the case for subsidising postgraduate

Calculations indicate there is about a nine per cent per annum return to postgraduate education compared to not having any post-school qualification, and about a 2-5 per cent return to postgraduate education compared to having a Bachelor’s degree.
education. The main reason is that research leads to higher productivity, which then contributes to economic growth and thus increases in per capita incomes.

The supposed link between postgraduate education levels and economic growth is probably strongest with respect to technological change, the engine of economic progress. Economists need to know much more about the determinants of technological change, but there is an emerging consensus that the speed of countries’ adoption of innovation is enhanced when there are very high education levels in the population (Bartel and Lichtenberg, 1987). This helps make the case for a public subsidy for postgraduate education: if technological progress is determined in part by the number of postgraduates in the workforce, and this results in higher levels of economic growth, taxpayer subsidies are warranted.

A final issue relates to the fact that postgraduate students often undertake academic careers and, in this capacity, might provide spillovers as a result of their contributions to community information and policy debate. This might take the forms of media commentary and debate, and by way of informing journalists, politicians and others of significant research findings.

The bottom line is that there seems to be a strong case for some taxpayer subsidy of postgraduate education, although it is a matter of conjecture and subjectivity as to what the correct level of this subsidy should be. And there is no doubt that the appropriate subsidy is highly contingent on the nature of the postgraduate study and the subsequent occupation. While these are important qualifications, they do not undermine the case for some overall taxpayer contribution. The implication is that the costs of postgraduate study should not be financed entirely by students.

**Income contingent repayment**

The financing policy points from the above discussion are that both students and government should jointly contribute to the costs of postgraduate courses. While this is arguably a useful contribution to debate, the major financing policy issue with respect to postgraduate charges is not about the right level of student charges. Rather, the critical issue concerns the financing mechanism — specifically, how the charge should be collected.

The reason this warrants serious attention is that over the decade or so in which Australian universities have had up-front charges for postgraduate education, all governments have endorsed the wrong financing approach. This mistake has arguably had deleterious consequences for both aggregate Australian economic performance and lifetime income inequality, although neither assertion is ever likely to be established in an empirically compelling way.

There are myriad ways of financing postgraduate education, and the advantages and disadvantages of the major forms are considered in Chapman (1997). In what follows two approaches are compared, chosen because the first is what has taken place in Australia (up-front fees) and the second is what should have taken place (income contingent payment).
As described above, Australian universities are allowed to charge students for postgraduate courses, and the practice is now commonplace. For courses involving fees, Commonwealth governments have provided no financing assistance. This non-involvement of the public sector is markedly at odds with basic economic theory.

The major economic problem associated with charging up-front fees for higher education is that those who can't afford to pay are unable to access loans to cover the cost. The basic concern for a bank lending for human capital investments is that, unlike many other investments, there is no saleable collateral in the event of default, such as would be the case for the housing capital market. This arises in part because slavery is against the law, and banks are thus unable to possess and sell the human capital development undertaken.

The above issues have the following important implication: up-front fees with no government financing assistance mean that many prospective students without financial resources will be excluded. There are two consequences for policy.

The first is that up-front fees erect significant barriers to the participation of the disadvantaged in undergraduate and postgraduate education. Whether or not this matters depends in part on a normative judgement of what constitutes a just society. Those valuing equality of educational opportunity will necessarily be very uncomfortable with the regressive implications of up-front fees.

Second, up-front fees mean that many educationally able and motivated people are unable to best develop and fulfil their labour market potential. This leads to a waste of talent and thus societal loss. In the economics of education framework, this social cost is the forgone delivery of maximum spillovers.

The capital market problem for educational investments is well recognised, and many different public sector policy approaches to the issue currently operate internationally. Among others are: means-tested scholarships; government subsidised bank loans; and income contingent charges. A brief consideration of the relative merits of alternative policies now follows.

A common approach involves up-front fees with fee exemptions. In this approach, fee exemption eligibility is determined by a means test applying to family income. There are important inadequacies associated with means-testing. The critical problem is that means-tested scholarships have the potential to deny access for prospective students who are not eligible and in families not prepared to pay the up-front fees. As well, these schemes are potentially regressive in that many students with scholarships will have considerable lifetime earnings benefits from postgraduate education and this benefit has been paid by all taxpayers.

Perhaps the most common higher education financing arrangement internationally involves Government subsidised bank loans. This approach has the following problems.

First, there are significant default costs, because collection mechanisms are difficult to enforce. Second, similar to scholarship arrangements, loan eligibility is usually means-tested. Thus, there is the potential of access being denied for prospective students not eligible and in families not prepared to help. Third, some prospective students will be unwilling to take bank loans as there is considerable
uncertainty associated with graduates’ capacity to meet future debt obligations — after all, returns to human capital investments have a large variance.

The final financing policy approach is income contingent repayment, such as operates with HECS. This is unquestionably the best payment method — so long as it is designed sensibly — because it avoids all the problems associated with the above alternatives. The specifics are now documented.

First, since an income contingent scheme applies to all students, means-tested eligibility on the basis of family income is unnecessary. Consequently, there is no inter-family sharing issue. Thus prospective students ineligible for the means-tested fee exemptions or means-tested access to bank finances will have no access barriers with a universal income contingent arrangement.

Second, with income contingent repayments there should be no concern for prospective students with respect to their capacity to repay the loan. That is, income contingent approaches to debt repayment offer the significant advantage of there being no repayment obligations in periods in which graduates experience adverse economic circumstances. This benefit of income contingent repayment is likely to be of particular importance for higher education investment decisions since there is considerable uncertainty with respect to graduates’ future incomes.

Third, so long as the collection mechanism is efficient, the administrative costs are low. With respect to HECS, for example, the use of the Australian Taxation Office to collect the debt costs less than $12 million per annum, which is currently less than 1 per cent of the revenue collected. In comparison, some bank loan schemes operating internationally are able to deliver less than half of the total outstanding revenues.

It should be recognised, however, that there are several implications of HECS which some commentators find disturbing (Harrison, 1997). Three points are worth noting, and are as follows:

- An implication of the scheme is that not all of the debt will be recovered. The contributing reasons are that: for students choosing to repay later, once the debt is incurred there is no real rate of interest, and this suggest the potential for a high level of subsidy in net present value terms (Harrison, 1997); and there will be a small amount of default due to some graduates emigrating or dying before the debt is repaid.
- HECS does not provide price signals because institutions are required to charge set amounts varying only by course. This suggests that there are no market mechanisms inherent in the system, and thus no obvious potential for the scheme to influence resource allocation.
- Because the debt owed in any given time period is collected only after a former student’s income exceeds an initial threshold, at this threshold (currently around $23,000 per annum) the effective marginal tax rate is extremely high. This might result in perverse labour supply behaviour, although it is unlikely that this will be very important (Chapman, 1997).
Observation

The bottom line is that the up-front fees arrangement for Australian postgraduate students has been poor policy, in both economic and social terms. It is remarkable that successive Commonwealth governments over the last decade or so have supported and promoted such an undesirable situation when income contingent collection — the more correct approach — sits comfortably and highly visibly in the form of HECS. While HECS has some limitations (particularly its lack of resource allocation implications) it still provides the appropriate charge mechanism for university funding generally. A belief in the value of research for policy should mean that argument and evidence would lead to reform, and in 2001, this happened with the government’s PELS policy.

PELS: A Reform in Need of Change

In January 2001 the government announced, as part of its Innovation Statement, that an income contingent loan would soon be available to all fee-paying non-research postgraduate students to cover current up-front charges. The Minister, David Kemp, subsequently provided details of the scheme (The Australian, 2001).

The scheme will operate in a similar manner to HECS, with one main exception. This is that HECS charges are set by the Commonwealth and are invariant between universities, but with PELS individual institutions set the tuition fee for all postgraduate courses. Eligible students will be able to borrow enough to pay any tuition fee set, and will repay the loan according to HECS parameters.

As stressed earlier in the conceptual discussion, there are powerful reasons for replacing postgraduate up-front fees with an income contingent charge mechanism. Allowing the payment of up-front fees with the use of HECS-style loans will increase the access of the relatively disadvantaged to postgraduate studies. This will have the two important effects of increasing the pool of talent available for postgraduate studies and expanding the access of the system to the less privileged.

Because income contingent payment is far preferable to up-front fees, this policy change should be applauded. Moves away from up-front fees and towards income contingent repayment reflect correct principles of reform for the Australian higher education system. There are some complicated issues with respect to the form of this particular proposal, however, and they might well mean that PELS will need to be changed soon after its institution.

Some implications of PELS for postgraduate charge levels

The Minister has argued that competition would restrict the extent to which universities would commensurately increase postgraduate fees, saying: ‘We’re not expecting that there will be any significant change in fees as a result…’. However, this is more complicated than is apparent. In analysing the implications of this change it is critical to recognise that a postgraduate charge paid with an
interest-free loan is necessarily different to the fee received by the university. This is because the university receives the money at the time of enrolment, but the student repays the debt later. Critically, the absence of a real rate of interest on the debt means the student will necessarily be facing a lower financial impost than the actual charge. In other words, there will be a government-financed subsidy.

The extent of the subsidy depends on the length of time before the student begins to repay the postgraduate loan, and the time taken to repay it once repayments begin. That is, among other things, the subsidy depends on students’ expected future incomes and the level of unpaid HECS undergraduate debt at the time the postgraduate loan is taken. The latter point is critical because the postgraduate obligation will only start to be repaid once other HECS obligations have been met. This means that those students starting a postgraduate qualification when they have a large undergraduate HECS debt will have a long period of subsidised benefit, and thus will implicitly face a relatively small charge in true financial terms. On the other hand, postgraduate students with no HECS debts already earning income above the first repayment threshold will receive relatively small subsidies.

Unambiguously, however, if the nominal size of the charge remains unchanged, the new scheme financially benefits all students taking the loan. This has a very important implication for a university’s postgraduate pricing policy in the context of the government allowing complete postgraduate fee flexibility. This is that, because these new arrangements mean that the effective charges faced by students are now lower than before, universities will be able to increase the fee. Importantly, these fee increases, while real for the university, are not necessarily true financial increases for students since they can now defer the payment and consequently benefit financially from the interest rate subsidy implicit in HECS, and PELS.

The existence of competition between the universities will have limited impact on the above. After all, all universities will have the benefit of students now facing lower true charges. The obvious prediction then is that postgraduate charges, in nominal terms, will increase. These higher entry charges mean that universities will be unambiguously better off, since they will be receiving the additional revenue at the time of student enrolment. The financial implications for prospective postgraduate students are ambiguous, since the benefits of having an interest rate subsidy will be offset by the nominal charge increase.

A critical policy issue is that the costs of the subsidy will be financed by the public sector. This is because the government will be providing loans when students enrol, but recovering only the same nominal repayment later. That is, the interest rate subsidy from the new scheme comes from taxpayers, implying that PELS has a regressive potential.\(^3\)

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\(^3\) This is a complicated issue. PELS will only be regressive unambiguously, compared to current arrangements, if postgraduates pay less than before in true financial terms, and if they earn more than average taxpayers.
Estimates of taxpayer subsidies

An obvious way to work out the size of the subsidies to students (and universities) implicit in PELS is to compare the up-front charge with calculations of the ‘net present value’ of the debt repayment. The net present value calculation takes into account the financial benefit to the student of not having to pay a real rate of interest on the debt. It is thus lower the longer it takes to repay the debt, since the student has the gift of the rate of interest subsidy for every year that the debt is outstanding.

There are an infinite number of possible illustrations of the size of the subsidy from PELS, and for simplicity in what follows we report just a few. The calculations use the 1994/95 ABS Income Distribution Survey, employed previously, to illustrate the relative income advantages of postgraduate education.

The first scenario is as follows. Imagine a person has completed a four-year undergraduate degree begun at age 18 and completed at age 22 and has already incurred a middle-range HECS debt of $19,720. It is assumed that the PELS debt is $19,750 per year for a two-year postgraduate course (that is, the current charge for an MBA at the University of Melbourne). In this case students will have the benefit of not paying any real interest on the additional debt until their existing HECS debt is repaid. In this scenario the up-front fee is $39,500 and the net present value of the charge is $19,507 for men and $16,022 for women. That is, the subsidy is around 50 and 60 per cent for men and women respectively.

The second hypothetical scenario involves 32-year old student undertaking a two-year postgraduate course with an annual up-front fee of $8,000 who have already paid their HECS debt. In net present value terms the up-front fee is $15,849 and the net present value of the PELS debt is around $13,000 for both men and women. That is, the subsidy is of the order of 9 per cent.

Policy responses as a result of the subsidy

In response to this budgetary issue the government has several options. One possibility, already raised publicly, is that increases in nominal postgraduate charges could result in the government capping the total amount of a student’s HECS plus PELS debt. This would be an undesirable policy response, for the following reason.

Putting a limit on student debt in a context in which universities are able to set postgraduate charges is very likely to mean that many postgraduates will then face charge obligations exceeding the level of income contingent loans available to cover charges. This would result in students having to pay top-up fees to be paid with no access to income contingent loans. The social and economic arguments against any forms of up-front fees, as explained previously, then apply. This would be a very poor policy outcome.

Second, the government could cap postgraduate charge levels while allowing unrestricted access to HECS-style loans. Such a policy response would essentially be an extension of the differential form of HECS introduced in 1997. This has the
significant advantage of ensuring an income contingent method of payment for all postgraduate student charges, and is thus far preferable to the first option.

However, neither of the above policy responses address the subsidies implicit in PELS. A third option achieves this, and could work as follows.

This policy would allow universities to set the postgraduate fee, perhaps with a maximum level for courses determined by the government, with students having access to a HECS-style loan covering all charges. However, those students choosing the loan option would commit to repaying an extra 25 per cent of the charge in nominal terms. There are several advantages of this approach, now explained.

The first is that the additional impost on students significantly decreases the subsidy implicit in PELS. That is, with this option the government would eventually recover loan repayments higher in nominal terms than the finance provided to students at the time of the charge.

The major benefit of the approach is that in net present value terms students taking the pay later option would be paying approximately the same as students paying up-front. With this innovation the new PELS scheme would not be introducing an additional subsidy for postgraduate studies.

The second benefit of this option concerns administrative simplicity. That is, it would mean the institutionalisation of a financing reform for postgraduate financing which is entirely consistent with the current HECS arrangements for undergraduate education. That is, undergraduate HECS offers a 25 per cent discount for an up-front payment, and this is equivalent to there being a 25 per cent higher nominal payment for students taking the pay-later option. Policy consistency between undergraduate and postgraduate financing arrangements would be the desirable result.

**Observation**

The Government’s suggestion to make available income-contingent loans to assist postgraduates to pay fees is a productive development in Australian higher education financing policy. As a result there should be decreases in the incidence of up-front fees for postgraduate study, and this means a lower wastage of educational talent, a better workforce, and improvements in opportunities for less well off prospective students.

However, because the new scheme entails the use of an interest-free loan, a sizeable proportion of students will receive a government subsidy and will increase effective demand for the service. This is likely to facilitate nominal charge increases, meaning that universities will receive higher charge revenues. The government will thus be subsidising both students and universities more than currently with no apparent justification. Moreover, a possible response to the above would be for the government to cap a student’s total HECS debt. This would have the very undesirable result of moving the system to top-up fees.

A preferable response to this issue would be to offer a 25 per cent discount for those paying up-front — the way undergraduate HECS works. This limits the
subsidy going to those who choose to pay later and would promote administrative efficiencies. Application would be straightforward: the government pays the fee to the university for the student and the student agrees to repay through the tax system a nominal sum which is 25 per cent higher.

**Conclusion**

In the 1989—2000 period the incidence of up-front fees for Australian postgraduate courses increased considerably. In principle the existence of a charge for the service should not be controversial if Australians with postgraduate qualifications receive important private benefits from the process. The existence, and even the growth, of these charges is not a major higher education policy problem. However, the critical issue for policy relates to the financing arrangements associated with postgraduate charges. The paper explains that the lack of government financing assistance for Australian postgraduate students over the last decade or so has probably meant that prospective talented students have not been able to access the system. There are associated social and economic costs.

It is argued that government financing assistance with respect to postgraduate charges is necessary, with the best approach being an income contingent charge system, such as HECS. This has recently been recognised by the government with the suggestion of PELS, which allows students access to HECS-style loans to pay postgraduate fees. This is an important and productive reform.

However, the paper argues that the PELS arrangements will result in higher nominal charges for students and, more importantly, significant potential increases in taxpayer subsidies to universities. It is likely that when this is understood the government will seek to change the scheme. There are several options, and it is explained that a preferred solution would be to have a 25 per cent discount for the up-front payment of postgraduate charges.

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*The authors acknowledge constructive critical comments from two anonymous referees. Errors are the responsibility of the authors.*
Governance


Reviewed by John Freebairn

Governance of modern economies, including Australia, has become more difficult, and there is more doubt that our political institutions are capable of resolving the conflicts and ensuring further rises in economic and social well-being. These two books represent the first two of a series of three arising from a project Future of Australian Governance explaining ‘the implications for policy, institutions and citizenship of global and domestic pressures’. The two volumes reviewed provide a description and critical evaluation of Australia, with particular emphasis on the last 30 years, and they provide some commentary and a limited projection of future challenges and options. A general theme is one of optimism with a reasoned set of arguments that Australia in general and its governance institutions in particular have adapted well to a changing world.

The Future of Governance: Policy Choices explores the forces for change on Australia in general, and on its governments in particular. Forces for change are grouped under the headings of globalisation, technology, society and community, political divides and ideas, and attitudes to government. After a general introduction there are individual chapters on economic policy, industry and regional policy, labour markets, equity and social policy, environmental policy, cultural policy, and international policy.

Forces for change creating both opportunities and threats to well-being are partly exogenous and endogenous and the forces are partly domestic and worldwide. The global interdependence of economies, people, images, values and ideas has been important in Australia since white settlement, but the focus has changed over time. Keating in his chapter argues that the Australian governments will continue to have considerable autonomy and independence. The impact of technology has been one of simultaneous job destruction and job creation placing a premium on a flexible and adaptable workforce. Recent developments in the power of information technology are placing different pressures on political systems and players. Society and community expectations are changing with higher education, greater material wealth, demographic and social changes, and increased individual aspirations and empowerment. Much of the current popular
Concerns with government are attributed to aspirations and wants running ahead of government capacity to provide, especially with a reluctance by the electorate to increase the share of resources diverted away from private use to governments. Australians continue to be staunch defenders of democracy and of systems of checks and balances on politicians and bureaucracies. The electorate is now much more volatile, with less attraction to the main political parties and more weight to a growing number of special interest groups. However, as the main parties search for the median voter, changes in government result in a high degree of policy continuity.

Economic performance of the Australian economy over the 1980s and 1990s is shown to have been surprisingly good, with the exception of unemployment. Globalisation, technological changes, and neo-liberalism policies have combined to significantly increase GDP per capita. While the distribution of market incomes tended to become less equal, developments in taxation and especially social security systems improved effective disposable income equality. It is argued that the responsibilities and objectives of economic policy have changed very little, but that different policy strategies have had to be developed, and that the Australian governments retain considerable independent capacity to assist or hinder economic outcomes. Future policy debates on the relative roles of cooperative solutions versus market solutions to economic policy decisions are highlighted.

Keating and Mitchell provide an excellent review of the evolution of social policy over the twentieth century and of future challenges. Over the century government support was extended to more and more categories of people, but with the almost unique Australian system of means testing. While the latter has the virtue of reducing social security outlays, the adverse incentive effects of high effective marginal tax rates and complexity will have to be considered. The authors write optimistically about the compulsory superannuation scheme. Given the relatively low contribution rate of 9%, when others suggest 14% or more is required, the increasing share of the workforce with part-time jobs and broken careers, and evidence that a proportion of the increases in compulsory superannuation substituted for less voluntary saving in other forms, together with complexity of the system, it seems likely superannuation reform will have to return to the policy debate agenda.

Environmental policy provides an illustrative example of the evolution of forces on government and of government adaptation to these economic, social and political changes. Papadakis and Young describe changing policy responses in the 1970s, 1980s and 1990s. The environment is a good example of market failure, yet one where market type solutions based on property rights, taxes and tradeable permits are promising. The international dimension of some externalities and policy pressures, the likely quite large redistributive effects of policies affecting the environment, and the importance of environment interest groups in the policy process are noted as challenges to good government affecting the use of the environment in the coming decades.

Because of market failures governments have, and will continue to have, important policies affecting the arts, cultural productions, the media,
communications, multiculturalism and other dimensions of cultural policy and national identity. A wealthier and more diverse population has increased the complexity and challenges of governance. Craik, Davis and Sunderland track major changes in government policy towards culture. These include the greater use of arms length organisations to dispense funds, more emphasis on competition and international benchmarking, and greater integration of national culture in a global world.

Building on the first book, the second book, *Institutions on the Edge? Capacity for Governance*, examines the way parliament, the public service, cabinet, political parties, quasi-government agencies, federal-state relations, interest groups and the High Court have evolved in the process of collective governance of Australia over the twentieth century. Most of these institutions were originally established around the time of Federation, some quite formal and others more a result of convention. In the face of very significant economic, political, social and technological changes already described, the institutions as well as the personalities have evolved and adapted. The editors and authors of chapters in this volume conclude there are no crises, in fact the system has and is performing remarkably well, and they are optimistic that further incremental evolution of Australian governance institutions will continue to generate and administer effective policies.

Cabinets, and especially the leaders, are seen as the power focus in the modern political system. This is where political and administrative interests intersect and where the bulk of policy coordination takes place. With the growth in the number of issues and the complexity of issues, cabinet focuses on broader policy coordination, with details left to individual ministers and the bureaucracy. Secrecy is seen as a major area of concern, with growing pressures for more open and transparent government.

Davis and Rhodes describe a process of continual and substantial changes in the public service over the twentieth century. With domestic pressures for value for taxes paid and with benchmarking to achieve international competitiveness there have been changes to raise efficiency. Changes include adoption of business management practices, flatter operating structures, international benchmarking, contracting out supply, and in some cases privatisation. It is argued that the reform process still has some way to go, and that problems associated with fragmentation in service delivery, accountability of agencies and the development of effective monitoring mechanisms remain.

An important component of governance in Australia is undertaken by quasi-independent government agencies such as the Reserve Bank of Australia, the Australian Industrial Relations Commission, the National Competition Council and the Australian National Training Authority. While operating under government guidelines and ultimately responsible to government, these agencies are at arms length to the government, they are highly specialised and in general are considered more transparent than the public service. Argy documents a shift in focus of these agencies from consensus building to greater emphasis on promoting the development of competitive markets over the last decade. His questioning of
the trend is one example of concerns expressed in these two books about the relative merits of competitive market versus consensus decision making for future governance of Australia.

Keating and Wanna discuss the evolution of federal-state governance relationships and reach the unfashionable conclusion that cooperative federalism has served Australia well. While agreeing that relations are often strained and that Australia's federal system is perceived by many as a hindrance to good policy development and to efficient supply of public services, they argue that 'Federalism has provided the escape valve of democratic expression that has helped to sustain unity through its capacity to respond to and thus contain differences. This has been achieved while still maintaining a sense of national purpose’. Virtually no consideration is given to options of dispensing with the states or of clarifying relative responsibilities over health, education and other areas.

Continued dominance of the two main political party groupings is predicted by Weller and Young. Despite the fall in share of first preference votes, the small and declining party memberships, and the breakdown of the old labour versus capital split, the political system favours incumbent parties and the associated adversarial system. Party leaders are seen as policy brokers. The ever increasing number of special interest groups and think tanks described by Marsh are more likely to initiate and develop new policy options than the main political parties.

Future Australia will have to confront many difficult issues. Those now known include aged care, aboriginal rights, the environment, consumer protection, unemployment and biotechnology. No doubt issues not now of concern will arise. *Institutions on the Edge?* is more concerned about the ability of Australian governance institutions to provide forums for informed and logical debate about the relative merits of different options, than it is about day-to-day administration. Parliament itself is not seen as effective, and the authors are not convinced the system of parliamentary committees as now operating is effective.

Both books provide highly readable, informative and challenging discourses on the changes bearing on the Australian economy and society, and on the ways in which governance institutions have evolved over the twentieth century, and of some options for the future. Clearly not all readers will agree with the arguments presented, however all should be informed and stimulated to develop their own positions.

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This is an interesting, well-crafted book aimed at understanding the link between economic duress and crime. The authors, who work at the New South Wales Bureau of Crime Statistics and Research, clearly have an impressive knowledge of the theoretical and empirical criminology literature.

The main thesis of the book is that the channel by which economic stress is translated into criminal behaviour is through the disruption to parenting. Under economic or social duress parents devote less time to their children, for example, by allowing juveniles to return home late at night or by allowing them to miss school. Of those juveniles susceptible to be involved in crimes, some will get involved in criminal activities but others will not. Therefore, an additional step is necessary to link economic stress to crime. This is accomplished by appealing to peer-group pressure. Those juveniles who, in addition to lacking parental supervision, are associated with criminals will engage in crime. Those who lack parental supervision but are not direct associated with criminals will not engage in crime.

The theory put forward by Weatherburn and Lind is at the same time complex and intuitive. It provides a viable framework to analyse the interplay between economic and social conditions, individual and collective incentives and participation in crime. I will come back to this point in more detail later in this review.

The book is organised in eight chapters. In the first chapter the authors review some of the theories and evidence related to the argument that economic stress motivates individuals to offend – the economic stress-induced offender motivation (ESIOM) paradigm. They point out five anomalies between the ESIOM paradigm and the existing empirical evidence: (1) the lack of consistent evidence both at the individual and aggregate level that economic adversity is positively correlated to crime; (2) the strong correlation between violent (non-utilitarian) crime and economic adversity; (3) the fact that many processes that might influence one’s involvement in crime precede one’s entry into the labour market; (4) the evidence that economic stress in the neighbourhood appears to influence individual’s offending rates; and (5) the possibility that income inequality might be a better
predictor of area offending rates than levels of income. These five anomalies provide the motivation for an alternative theory to link economic duress to crime.

Chapters 2 to 6 review existing studies with the aim to provide support for the main thesis of the book. Chapter 2 reviews the existing literature on the effects of economics and social stress on parenting. Chapter 3 presents evidence that is consistent with the hypothesis that the missing link between economics duress and crime is related to both parental supervision and peer group processes. In Chapters 4 and 5 the authors report the results of individual and aggregate-level research they conducted that again lends support to the main thesis of the book. They based their individual-level study on a large 1993 Western Australia epidemiological survey of child health and well-being. The lessons from the analysis based on this representative household survey are clear – around 20 per cent of 12-16-year-olds from single parent low-income families are allowed out most evenings, whereas less than 4 per cent from any other combination of family type and income are allowed out frequently. Over 40 per cent of those allowed out most evenings have been related to criminal activities, while less than 20 per cent of the better supervised 12-16-year-olds were involved in crime. Moreover, those living in crime-prone areas are twice more likely to be involved in criminal activities than those who live in other areas.

Chapter 5 combines aggregated data on neglect, abuse and juvenile participation in crime for New South Wales with census data on poverty, unemployment, single-parent families, stability (measured by changes in address) and crowded dwellings (those with more than 1.5 persons per bedroom). The results are again consistent with the main thesis of the book. It is important to point out that, as in Chapter 4, the results can only be used to justify the particular assumptions of their theoretical model and they do not constitute a test of the theory. Indeed, the results in Chapter 5 also indicate that the effect of economic and social stress on juvenile crime might be transmitted directly rather than through parenting factors, lending support for the ESIOM paradigm. The authors conjecture that this might be a result of their inability to obtain adequate measures of the relevant parenting factors at the aggregate level but certainly this deserves further investigation.

Chapter 6 contains a simple epidemic model of the offender population growth based on assumptions that are consistent with the observations from the previous chapters. This is the chapter that will attract most of my criticism. From reading all previous chapters one develops an understanding that the relationship between economic and social duress and crime is very complex, and getting a grip on the mechanism by which these two phenomena are related ought to be an important part of any model building exercise. The model however is simply a mechanical description of the interaction between the number of individuals who are susceptible to be involved in crime at a particular time, the number of delinquents at a particular time, and the various probabilities from moving from one state of the world to another.

I am afraid however that the complexity that governs the link between individual behaviour, social interactions and crime requires models that might
allow some of these relationships mentioned above to emerge endogenously as a
function of the primitives such as social norms, level of economic and social
duress, types of neighborhoods. Indeed, there exists a body of literature in
economics that aims at modeling the relationship between individual behaviour
and social interactions, such as Durlauf (2001), Brock and Durlauf (2000a,
2000b), Glaeser and Scheinkman (2000; 2001), and another body that intends to
understand the relationship between social interactions and crime such as, Glaeser,
Sacerdote, and Scheinkman (1996). A natural next step that suggests itself is to
combine these different types of models to study the link between individual
behavior, social interaction and crime. Such a model would provide a much richer
framework to analyse the link between economic and social stress and crime.

It is important to note that in Chapter 7, where a number of alternative
theories about the spatial distribution of crime are reviewed, the authors seem to
agree with the general lines of the research agenda specified in the previous
paragraph: ‘…the best way forward is to develop an adequate account of how
aggregate crime rates are influenced by the supply of motivated offenders and then
seek to integrate this account with a theory about how these offenders are affected
by their supply of opportunities and incentives for crime. Our preoccupation has
been with the former task.’

Finally, Chapter 8 explores the obvious corollary that better parenting would
imply in a reduction in crime in the long-term. More specifically, the authors
argue that macroeconomic policy is an important instrument given the relationship
between child neglect and abuse and poverty. They argue further that
macroeconomic policy should aim at more than sustained economic growth. It
should combine policies that increase the rates of employment among families
under social and economic distress with an effective child maintenance scheme
and high-quality (subsidized) childcare services. They also put forward the
necessity to develop measures to reduce the spatial concentration of poverty and
social disadvantage, perhaps even ‘…measures which seek to create improved
employment opportunities within impoverished neighborhoods.’

There are two caveats on these policy recommendations. Firstly, the insights
from the economics of information, developed over the last thirty years by
economists such as 2001 Nobel laureates George Akerlof, Michael Spence and
Joseph Stiglitz, suggest that less intrusive forms of regulation might be more
efficient than direct interventions. Programs such as those designed to provide
parental support and advice in the first few years of a child’s life or to provide
access to training for the unemployed or low-paid workers might be preferable to
direct payments. The second caveat is related to the role played by schools and
universities. The existing evidence indicates that providing good education at all
levels might be a very effective way to promote social mobility and to reduce
crime.

In summary, it is an interesting thought-provoking book that deserves the
attention of academics and policy makers alike. Its main contribution is to point
out that the link between economic stress and crime is likely to be indirect and to
pose a positive theory suggesting that such a link is provided by a combination of
bad parenting and peer-group pressures. There are some real challenges in terms of further research. First, such theory will have to be reconciled with the recent experience in the US where there has been a decline in crime. Although such decline is in the context of a booming economy, there is a perception that the income inequality if anything became wider over the last decade or so. The second challenge is to build a testable model that integrates individual incentives, social interactions and crime.

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NON-AGENDA

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

—Jeremy Bentham (c.1801)

The Seven Pointed Star

William Coleman

The grandest colonial building in Hobart is its Custom House. It is a magnificent vestige of the time colonies imposed tariffs on the import of commodities from each other. It was completed in 1903: two years after the Federation that abolished Tasmanian tariffs. That farcical Custom House might symbolise the befuddled state of Australian Federation.

Another reminder of the tragi-comedy of Federation is found in the impressive bearded face of George Adams, whose steely stare meets the eye in every Tattersalls’ stall in Tasmania. In the 1890s Adams’ lottery business had been driven out of Victoria, New South Wales, and Queensland by laws that had been contrived by the same sort of high-minded parsons who today preach against poker machines. In Tasmania Adams found a welcoming jurisdiction that saw lotteries as a pleasing source of revenue for a financially derelict polity. In 1897 — the same year as the University of Tasmania opened its door — the great oaken barrel of Tattersall was cranked for the first time. Assisted by one Mr Iken, Mr Adams himself, with a pair of tongs, removed the first number to be graced by the goddess Fortuna.

The Tattersall business thrived. It did so, not on the basis of Tasmanian sales, but largely on the sale of tickets through the post to persons residing in the five larger colonies. But Tattersalls’ happy course was not long to remain unmenaced. The advent of federation allowed the frustrated adversaries of lotteries in Victoria, and elsewhere, to counter-attack using the new Constitution. The Constitution did not, of course, assign to the Commonwealth the power to make laws over gambling. But Section 51 did vest the Post Office in the Commonwealth. The means to cripple Adams in his Tasmanian lair lay there.

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The newly established Commonwealth Post Office needed only refuse to deliver letters to Tattersalls’ address to interrupt the flow of ticket orders from the mainland. And it did so. This action, however, proved insufficient. For some sly individuals had hit upon the underhand scheme of sending their lottery order to a third party in Hobart, who would then pass them on to Tattersalls. But the Post Office was not to be bandied with. It drew up a register of persons believed to be engaged in this nefarious traffic and simply banned them from receiving any letter, or other article whatsoever, through the Post. Mr Iken found himself struck-off completely incommunicado with the rest of the universe by such a Post Office edict. This Post Office policy was not repealed until a Tasmanian, Joseph Lyons, became Commonwealth Post-Master General in 1929.

In 2001 the Tattersalls-Post Office confrontation is repeated. But instead of lottery tickets it is now internet gambling. The Tasmanian Government, as always at the cutting edge of the exploitation of gambling revenue, had cleared a space for internet gambling, only to find the Federal Government using Section 51 powers to close it down. Will we have to wait until Jim Bacon becomes Minister for Communications, Information Technology and the Arts so that we may use a computer to do what we can already do by phone?

The Battle of Powers

The above episode illustrates how the original vision of the Federation as a division of powers quickly deteriorated into a battle of powers. In this battle, the Commonwealth has made almost every advance.

- A large part of the States’ revenue base has been dismantled and removed to the Commonwealth. Tasmania, for example, obtains 67 percent of its revenue from Commonwealth Grants. For New South Wales the figure is 51 percent. This ‘imbalance’ has more than a financial significance — the revenue of the state is the state, as Edmund Burke once observed. And a decline in regard will follow such a decline in the power of the States. Respect always circuits power — there is a courtier inside us all.
- Significant areas of law and policy, which remain with the States in other federations, have been removed to the centre (the welfare state from 1946, higher education from 1973).
- The High Court is an active organ of centralisation, such that the construction of a dam may now be seen to be part of the province of Commonwealth law making.
- A city of 310,000 has been constructed on the banks of the Molonglo so that the organs of Federal Government could be located at safe distance from where most Australians actually live.
- The States treat local government with exactly the attitude of the Federal Government for the States — derision.
- Public attitudes to Federation range from apathy to antipathy. And this, significantly, is a wholly bi-partisan apathy/antipathy. It is most floridly
expressed by Rodney Hall, an indefatigable author, prolific poet, and sometime novelist (The Day We Had Hitler Home), in his 1998 work, Abolish the States! Australia’s Future and a $30 Billion Dollar Answer to our Tax Problem.

Abolish the States

One interpretation of this steady advance of centralisation is that it is the rational consequence of vastly increased communication and mobility. And here a relic of old Hobarton may again be illustrative. Provoked by visiting French whalers, and the occasional presence of the Russian fleet in the South China Sea, various cannons were installed on the Derwent before 1870 to defend the capital of Van Diemen’s Land. The Russian navy having failed to materialise, the cannons were never used apart from ‘making a great noise on the King’s Birthday’ and firing a single shot at midday to allow the inhabitants of Hobart to set their clocks. But this shot at midday was at a different time from that at Fort Denison in Sydney, as ‘12.00’ came at a different time in Hobart and Sydney. Indeed, 12.00 came at a different time in Melbourne and Brisbane too. For in Colonial Australia each colony defined 12.00 by the solar noon of its capital, and so each colony had a different time than the other. But with the establishment of cheap and reliable telegraphy this difference became, at least, inconvenient. As a consequence all the old colonial times were rolled into a neat, tidy and uniform Eastern Standard Time. ‘Abolish the States!’

It may be further argued that this increased communication and mobility has spelt another doom on federalism through the decline in State consciousness. Thus it has been argued, in a similar vein, that local football declined because suburbs and towns do not mean what they did before, say, 1950. In those car-less days mobility was less, and what mobility there was (in terms of public transport) was highly structured; your locality limited you, and delimited you. Today that old structure of life has gone, and all is fluid. Victorian regional football, I read, is defunct. The VFL becomes the AFL. And Tasmanian football is in disarray, as players and fans turn their eyes to the AFL. ‘Abolish the States!’

But the theory on which this account of the decline of federalism is based is a false one. This theory may be called the community theory in that it claims that a state government is for ‘almost-nations’. This theory finds some popularity in polities composed of ethnic groups in unhappy political union (Belgium, Nigeria, and to some degree Canada). But the true impulse of federalism disregards any vision of the state (national or sub-national) as an expression of some cultural or ethnic identity.

In any case, the premise to which the false theory of federalism is applied is faulty; State consciousness remains real. One small proof of that is the decline in ratings of the ABC’s 7.30 Report after it ditched a State-by-State format in 1997, in favour of a ‘national’ format. A greater proof is the fact that the political preferences (over both party and personality) of the States are far from correlated — can one imagine a Beattie winning in Victoria?
And, more generally, no advance in communication has eliminated the significance of Australian geography. Australia is a big place. It is 3660 km from Cape York to South East Cape, almost exactly the same distance as from Madrid to Baghdad. Scattered around this mass are five, and only five, distinctly large cities (each over a million) and one island. This natural and human geography gives a shape to lives that the Internet has not abolished. The six points of the star are based on this natural and human geography.

The Struggle Between Liberalism and Centralism

I would argue that the extent of decline in Australian federalism is not found in material factors (for example, communications) but in ‘ideal’ factors. I would argue that the decline reflects the progress of the conflict between liberalism and various forms of anti-liberalism. For the debate over federalism is, in essence, just one bout in the contest between those charmed by a vision of a “great state”, and those who place their faith in a “referee state” that enforces the rules but doesn’t play itself, and is working best if not noticed.

It is true that the defence of locality is often taken to be a conservative instinct, rather than a liberal one. Certainly, classic liberal theorists have neglected federalism. Thus J.S. Mill favoured a unitary state, although on utilitarian, rather than liberal, grounds. But in the Anglo-Saxon world ‘conservatism’ is so irrigated with liberalism that a ‘conservative’ defender of locality such as Edmund Burke would be better classified as a liberal-conservative.

The struggle over federalism is one front in the war between liberalism and its adversaries, since the great state favours centralism. Any government is more powerful the less competition it faces from other governments. The opponents of federalism welcome centralisation as a means of monopolisation of government power, and therefore as a means to increase government power.

Federalism, by contrast, goes with a diminished state, a dispersion of power, pluralism, or, if you like, ‘democracy’. Not ‘democracy’ in the sense of a Rousseauian General Will of 50 percent plus 1 ruling all: that sort of democracy is an enemy of federalism. But democracy in the sense of a sharing of power. I would be willing to venture a ‘Law’ such that federalism correlates with democratic pluralism. Here are a few conforming instances of the law:

- **Brazil.** Brazil’s political history consists of an alternation between centralization and decentralization - centralizing tendencies peaked under the “New State” of the strong man Getúlio Vargas (1937-45), and peaked again under a series of military governments from 1964 to 1985. It was the return to civilian government in 1985 that occasioned a resurgence of local and regional autonomy.

- **South Africa.** In the second half of the 19th century various attempts at contriving a federal South Africa were made. The new Union of South Africa of 1910 destroyed her old provinces, and created a unitary South Africa that established Afrikaner hegemony (in a racist variant of the 50 percent plus 1
rule), and all that flowed from that. It was the creation of democracy in 1993 that saw the recreation of provincial legislatures.

- **France.** This country epitomises the Rousseauian vision of democracy that equates any opposition, or counterweight, to the power state as a form of rebellion. It was quite logical therefore that in 1790, amidst the political foundation of modern France, the provinces were dismembered into powerless ‘Departements’. It was also quite logical that in 1793 the Jacobins stigmatised as the ‘Federalist Rebellion’ the revolt of moderates in Lyons, Toulon and Marseille against Jacobin oppression, on the grounds that the insurgency menaced the unity and power of the new French state.

- **Russia.** The great democratic figure in Russian history, Boris Yeltsin, gave Russia what it had never had: a federal structure. This consisted of the division of Russia into about 80 oblast with locally elected governors and legislatures, and the creation of a Russian upper house (based on the German Bundesrat) in which governors approved or rejected legislation. The first act of the pseudo-Tsarist restorationist Vladimir Putin in his campaign to suffocate Russian democracy was not to close down opposition media (as he did), or to ban minor political parties (as he did), or to restore Stalin’s National Anthem (as he did): it was to crush Russian federalism. Soon after his electoral victory in 2000 the upper house was neutered, some honest but trouble-making governors were deposed on fraudulent corruption charges, and, displacing governors, seven ‘gauleiters’ were appointed by Putin to enforce his will in their allocated satrapy.

Britain may seem an exception to the correlation between pluralism and federalism, in that it is a pluralistic polity, but (until recently) a unitary state. The Scottish parliament was abolished in 1707, and the Irish Parliament in 1800. However, the Act of Union of 1707 at least preserved Scottish law and courts (which meant a good deal when the Statute Book grew only very slowly). And the end of the Irish Parliament was hardly evidence of pluralism or democracy — it was strongly contested in Ireland and largely achieved by bribing the required number of Irish MPs.

This link between federalism and liberalism suggests federalism has atrophied in Australia in the 20th century because liberalism has atrophied in the 20th century. The story of Australian governance in the 19th century consisted of the dispersion and localisation of power — from its original concentration in Whitehall, it spread to the Governor, from the Governor to Legislative Council, and from New South Wales to various other colonial parliaments. The 20th century, in keeping with its anti-liberal spirit, saw a dense concentration of power.

One mournful explanation of the contrast of liberalism of 19th century Australia with the illiberalism of 20th century Australia is that 19th century Australia was a British colony, while 20th century Australia was not. While Australia began as an inherently illiberal penal colony, the fact that it was a *British* penal colony is significant … Britain established many of the institutions we now think of as liberal …As a British colony … Australia was fortunate to inherit these
liberal institutions… but the fact that liberal institutions were adopted through imitation rather than historical struggle or deep understanding is perhaps one reason [why,] … on the quite liberal foundations of the Constitution the early federal governments built the so-called ‘Australian Settlement’ containing several illiberal elements’ (Norton, 2001:230-231).

**Federalism: More than a Matter of Utility**

The upshot is that the case for federalism is not simply a utilitarian consequence of federalism — it has a basic element that is more ‘moral’ or ‘ideal’. Once we appreciate the case for federalism is not simply utilitarian we need not seek to justify its formations in terms of utility. We need not find a utility in the curious variegation of State laws. We need not find a utility, for example, in the fact that in some States priests may be cross-examined in court about statements made in the Confessional, while in other States they may not.

Nevertheless, mundane utilitarian arguments can be advanced in favour of federalism. The remarkable centralisation of decision-making at a point remote from where the majority of Australians live simply cuts governance off from a considerable fund of human capital. A good number of Australians who would usefully staff the organs of central government do not wish to move 1000 kilometres to reside in Canberra.

On a more theoretical level, a federal structure helps ensure that potential Pareto improvements of Commonwealth become actual Pareto improvements. Let us suppose, for example, that blocking the damming of the Franklin River was a potential Pareto improvement — the gains of the winners were sufficiently large, making possible the compensation of the losers with winners still remaining better off. It was federalism that ensured that losers were actually compensated.

**The Disutility of Federalism?**

But utilitarian arguments against federalism can also be advanced.

The most naive utilitarian argument against federalism turns on the benefits of uniformity. The naivety of this argument does not lie in the presumption that uniformity has benefits. Uniformity does have benefits — a State line between Albury and Wodonga, or between Coolangatta and Tweed Heads, can be an encumbrance. The naivety lies in the presumption that the benefits from uniformity require some central authority to impose them. The truth is that these benefits can be, and have been, secured by agreement between independent authorities. Thus, the joys of Eastern Standard Time were not brought by a wise edict from a nation building state, but by the agreement of colonial legislatures in 1894-5. Nor was the agreement unique. American Eastern Standard Time, that replaced a multiplicity of local and company times, was purely a creation of US railway industry. Government was not involved, although within days of its introduction on 18 November 1883 seventy percent of schools, courts and local governments had adopted it as their official time. Congress did not ratify the Standard Time until 1918 (Blaise, 2000:104).
A more plausible utilitarian objection to federalism turns on the notion of ‘unproductive competition’. Thus it is objected that the States compete to see which can contrive the most satisfying donation of their citizenry’s income to multinational car makers. Or, they compete to see which can reduce death duties to zero fastest. But this case against the unproductive competition of federalism is overstated. The States have never been nearly as generous with public income to the car industry as the Federal Government has. And I suspect the best way to give some political incentive to reducing Australia’s unjust and penal income tax rates is to restore income tax powers to the States — let a little income tax competition bloom. Joe DeMaggio left the high income taxes of California for the lower income taxes of Florida. That sort of interstate emigration might give an incentive to State governments to lower tax rates. We see some sort of tax competition in the matter of payroll tax.

The truth seems to be that utility does not suggest any strong superiority of one level of government over the other. The States do their best to wreck economic reform, but it is Federal legislation that begot the Foreign Investment Review Board, and promptly introduced the White Australia Act after Federation. The States baulked at restricting guns, but it is the Federal Government that wrecked aboriginal employment in the pastoral industry with Commonwealth Arbitration legislation.

State legislation does not have more or less utility than Federal legislation — it just has a different source. State legislation is more sensitive to material interests, while Federal legislation is more sensitive to ideal (or ideological) interests. Thus, State legislation in land use accommodates developers, while Federal legislation accommodates environmentalists. This difference turns on the fact that material interests are local, while the ideal interest is national or global. Thus, the material interest in favour of developing/destroying rainforest is restricted to a few farmers or hoteliers. The ideal interest encompasses millions, or hundreds of millions, of persons across the country and the world who are disturbed at the threat to the habitat. Within a State the material interest will often outweigh the ideal interest. But as the unit of governance extends, more ideal interests are included in the electoral franchise, and the electoral balance tips towards the ideal interest.

Thus, whether State legislation is better than Federal legislation, or vice versa, would seem to turn on whether material motives are better than ideal motive. And that is hard to judge. ‘Ideals’ can be noble. They can also be extremely evil. I suspect that State legislation is more likely to glow in mediocrity, and Federal legislation to achieve both grander heights and more dismal depths.

**Federalism: A Hopeless Case**

The foundation of federation on liberal ideals, rather than directly upon utilitarian advantage, suggests that the restoration of federalism is, in one sense, hopeless. Federalism is sickly in Australia because the breath of the true spirit of liberal democracy is so sickly in Australia. As long that spirit is enfeebled no operation
on the federal polity can restore life to federalism. But one may still imagine what changes a reinvigorated federal spirit may make to Australian federalism.

- **The Senate.** The current method of electing the Senate is a means of representing sectional opinion, not ‘State opinion’. Thus, Tasmania returns Bob Brown (8.7 percent of Tasmanian vote in 1996) and Brian Harradine (7.9 per cent of the Tasmanian vote in 1998). To ensure that the Senate reflects the balance of opinion in a State, election to the Senate should be on a ‘winner takes all’ basis, so that (after the distribution of preferences) the ticket with a majority of votes would get all senators. This gives a useful incentive for all senators to actually chase votes as part of chasing pre-selection from their own sect. Winning the balance of opinion in a State would now become a priority.

- **State borders.** Section 129 of the Constitution makes provision for the revision of borders by legislation of Parliament, subject to the approval by referendum of the States in question. If a State line between Albury-Wodonga makes for a genuine problem then let the border be redrawn.

- **Canberra.** The identification of Canberra with Federation would be dissolved. There would no longer be the presumption that a ‘National’ Library, ‘National’ Gallery, and ‘National’ Museum should be located Canberra, as if the whole purpose of their location was to maximise the difficulty of the median Australian to use these institutions.¹

- **The Australian Capital Territory.** The ACT should be ‘Vaticanised’. All of it should be incorporated into New South Wales, save for a few square kilometres encompassing the Parliament, and Old Parliament, the High Court, and (perhaps) the Lodge. ‘Abolish the ACT!’ This would prevent the ACT becoming a serious constitutional anomaly.

- **Local Government.** The third tier of Federation should be given some constitutional significance. Local government is at present the creature of State Governments. A true federal spirit would make it less so. Ultimately, there might be a constitutional provision that the units of local government be altered only with the approval of a majority of the electors in the unit.

All these proposals have problems, some contingent and some more theoretical.

For example, the proposal to elect the Senate on a winner takes all basis is costly to the representation of marginal shades of opinion (for example Brown and Harradine), and tends towards a Rousseauian democracy of the General Will.

¹ Milton Friedman: ‘In general, Canberra gives the impression that it is overgrown and much too big for Australia. Australia has a population of about fourteen million, roughly comparable to the population of the state of Illinois. Canberra and the Parliament House ought to be comparable with Springfield, whereas they put on all the pretensions of equality with Washington, D.C’ (Friedman and Friedman, 1998, p.442). (Friedman visited Australia in 1981).
This tendency is objectionable. Having only every second half-senate election done on the basis of winner takes all might moderate this tendency.

In any revision of State borders by referendum the area affected by the proposal may approve of it, but the areas outside may not. What then is the proper outcome? The democratic sentiment would appear to recommend the proposal be implemented. But is there not a prisoner’s dilemma issue here? Is it not possible that each given area might find it advantageous to secede, but that if all do all will be worse off? Are not the ‘indissolubility’ provisions of a federal constitution (such as Australia has) an attempt to secure against ‘free riding secession’ by making the contract binding?

The Vaticanisation of the ACT would need to surmount the Constitutional provision that requires the ‘seat of government’ to be in a Territory at least 100 square miles in area. It would also need to surmount potential opposition from inhabitants of Canberra affronted by a loss of control of their city. A partial answer may lie in special legislation that would assign to ‘Canberra in New South Wales’ more powers than the standard ‘City Council’ of New South Wales receives.

Conclusion

Federation in Australia is an unloved inheritance, probably doomed, and saved from present extinction only by expediency. In this respect a parallel can be drawn between federation and the monarchy, another unloved, ill-fated but expedient inheritance. But there is a significant difference. If we put aside important questions of practicality, the division over monarchy and republic is, I would venture, largely a matter of sentiment. The divisions between monarchists and republicans are, therefore, unaccountable and, to a large degree, unarguable. But behind the struggles over federalism there lies a far more universal, telling and deeper division; a division between liberalism and various forms of anti-liberalism — between those who invest their confidence in a great central organising power, and those who mistrust it.

References


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2 In truth, the inhabitants ACT may not regret this loss of control. A majority of ACT electors voted against self-government in 1978. Self-government was imposed in 1988 by Commonwealth legislation.

3 Centralism and Republicanism coincide in the rhetorical stress on nationalism. Thus the Centenary of Federation saw certain Republican commentators disparage the Federation movement of 1901 as monarchist and not truly Australian.


*The author gratefully acknowledges the benefit of the comments of two anonymous referees*